Relations between Head Offices and Permanent Establishments: VAT/GST v. Direct Taxation: The Two Faces of Janus

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I. Introduction

Tax is like life. There are few black and white answers. There are grey areas depending on the angle from which you look at it. A typical example of this situation is the direct tax[1] and value added tax (VAT)[2] treatment of relations between head offices and secondary establishments where different approaches may apply to the same "transaction".[3]

Firstly, VAT[4] and direct taxes have different purposes. Under direct taxes, profits need to be allocated appropriately between permanent establishments whereas VAT is a tax on consumption that uses proxies. As such VAT can occur at only one jurisdiction, the jurisdiction where the consumption of the supply is deemed to take place according to the proxy.[5]

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1. For the purpose of this paper, "direct tax" will normally refer to corporate income tax.
2. Some countries cite their form of value added tax as a "Goods and Services Tax" (GST). For ease of reading we refer to all value added taxes as "VAT".
3. For the purpose of this paper, "transaction" will normally refer to "dealings" and/or "supplies" between the head office and the secondary establishments, depending on whether the "transaction" is looked at from a direct tax ("dealings") or VAT ("supplies") point of view.
4. See Stéphane Buydens, C*onsumption tax trends 2008 – VAT/GST and excise rates, trends and administration issues* (2008) OECD publishing, pp. 9 et seq.: "The value added tax system is based on tax collection in a staged process, with successive taxpayers entitled to deduct input tax on purchases and account for output tax on sales in such a way that the tax finally collected by tax authorities equals the VAT paid by the final consumer to the last vendor. These characteristics ensure the neutrality of the tax, whatever the nature of the product, the structure of the distribution chain and the technical means used for its delivery. When the destination principle, which is the international norm, is applied, it allows the tax to retain its neutrality in cross-border trade. According to this principle, exports are exempt with refund of input taxes ("zero-rated") and imports are taxed on the same basis and with the same rates as local production.".
5. See Stéphane Buydens, *Consumption tax trends 2008 – VAT/GST and excise rates, trends and administration issues* (2008) OECD publishing, pp. 9 et seq.: "The

Secondly, VAT and direct taxes do not rely on the same definitions of a secondary establishment. Parts of a single legal entity that qualify as "taxable persons"[6] are usually referred to as permanent establishments (PEs) by direct tax people or fixed establishments (FEs)[7] by indirect tax people. For the purpose of this paper, we will use the word "branch" when referring to parts of a single legal entity.

Thirdly, there are two schools of thought for taxing or not taxing "transactions" within a single legal entity (often referred to as inter-branch transactions). One considers that it *is* possible to enter into an agreement with yourself and that that there may be several taxable persons inside a single legal entity. The OECD Model Tax Convention on Income and on Capital (OECD Model) and its Commentaries say so. For the purpose of this paper, this first school will be referred as the "economic approach". The indirect tax people are still debating this. Most, but not all, take the view that it *is not* possible to have several taxable persons within a single legal entity. This second school of thought will be referred in this paper as the "legal approach".

Fourthly, to the extent that inter-branch transactions are taxable under both VAT and direct taxes, the question of their valuation needs to be considered. Contrary to direct tax, where the OECD's Transfer Pricing Guidelines can be persuasive, discussions on how to apply – for instance – an open market value to transactions subject to VAT are ongoing.

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application of the destination principle is relatively easy for the cross-border trade in goods but not always so for services due to their normally intangible nature. Since it is not easy to assess their place of effective consumption, and hence of taxation, most countries have developed a range of proxies. Within the European Union, those proxies are based on the place where the supplier or the customer are established. However, different criteria may be applied e.g. in Australia and New Zealand. Although those different systems attempt to reach a similar goal (taxing consumption where it occurs) their application can give rise to differences of treatment for cross-border supplies and create areas for potential double taxation, involuntary non-taxation and uncertainties for business and tax administrations.".

6. For the purpose of this paper, a "taxable person" will normally refer to an entity or part of an entity to which "tax personality" is recognized irrespective of its legal status. For VAT purposes, a "taxable person" is normally referred as a person who independently carries out an economic activity.
For direct tax purposes, a "taxable person" may be allocated profits. For VAT purposes, a supply would normally enter into the scope of VAT only if it is provided by a taxable person although that person may not necessarily be required to account for the VAT on the supply when such supply is subject to VAT. There are some mechanisms that allow the obligation to account for VAT to pass from the supplier to the customer; this is often referred to as the reverse-charge mechanism.

7. This is particularly so in the European Union and in countries that have followed the EU model of VAT.

These are key issues. In a globalized world, international transactions between related parties are playing an increasing role in world trade and the global economy. This might be a bigger concern for companies carrying out VAT-exempt activities such as financial services, banking and insurance. Under most VAT regimes, suppliers of exempt goods or services are unable to recover the VAT on their costs incurred in making such supplies. Conversely, suppliers of taxable goods and services are able to recover this tax, commonly referred to as "input tax". In the context of the current financial crisis, VAT might be the only tax that companies in these sectors might end up paying as it is likely that the banking and financial institutions in particular will be paying little, if any, corporate income tax for the next few years.

This paper identifies the current differences between the direct tax and VAT approaches.

It looks first at the conceptual approaches when defining PE or fixed establishments to show that in both cases an economic analysis generally prevails over a legal analysis when determining the relationship and transactions of these establishments with third parties. Secondly, when looking at the relationships between parts (or, in VAT terminology, "branches") of a single legal entity, it shows that a legal analysis is in many countries still dominant from a VAT point of view although there would seem to be a need to take into account an economic analysis in the tax treatment of the inter-branch transactions. It shows that both approaches may, paradoxically, be based on the need to limit the risk of tax avoidance. Thirdly, the paper shows that when transactions within a single legal entity are recognized for tax purposes, it is desirable to ensure consistency between the valuation of those transactions from a transfer pricing and a VAT point of view. The paper notes that a lack of uniformity may create tax avoidance opportunities and uncertainty both for businesses and tax administrations and reflects on the desirability of some measure of harmonization.

II. Permanent establishment v. Fixed establishment

Both for direct and indirect tax purposes permanent establishments are crucial in the international allocation of the tax base and the international division of taxing power. In many jurisdictions the term "permanent establishment" (PE) is used both for direct tax and VAT purposes while, in certain jurisdictions, the relevant term adopted for indirect tax purposes is "fixed establishment" (FE). The two concepts do not cover exactly the same kind of situation. Moreover, it would seem that, although a branch would normally not have a distinct legal personality from its head office, the concept of PE or FE for both direct tax and VAT purposes can include branches as well as subsidiaries in the context of relationship with third parties as an economic analysis is normally applied.

1. Comparing conceptual approaches[8]

One of the major issues in direct taxation is the establishment of a means of achieving a workable compromise between residence-linked and source-linked taxation. The conceptual definition of the "permanent establishment" is usually seen as the cornerstone of this tax construction.[9]

Of equal fundamental importance is the conceptual definition of the permanent establishment i.e. "fixed establishment" (FE) in the VAT field. It is adopted in many cases as a proxy for identifying the place of consumption of services[10] and therefore the place of taxation of these supplies of services.

The concept of FE is, however, not relevant with respect to cross-border supplies of goods as those supplies are normally taxable under VAT at import or when an intra-Community acquisition of goods is made (trade in goods across borders of the Member States of the European Union is no longer referred as "imports") as this is generally deemed to be an appropriate proxy for consumption.

As regards direct taxation, a general consensus has been reached in the OECD Model Tax Convention on the basic conceptual elements that are necessary for the existence of a PE. Art. 5 of the OECD Model defines a PE. According to paragraph 1, a "permanent establishment" means "a fixed place of business through which the business of an enterprise is

8. For the purposes of this paper the comparative conceptual approach of these two terms (i.e. permanent establishment and fixed establishment) will focus on two issues which seem to determine significantly the approach of tax administrations to the tax treatment of relations between PEs and head offices: the legal form, i.e. the absence of autonomous legal personality, and the economic analysis.

9. The existence of a permanent establishment may be decisive for the application of Art. 7 (Business Profits), of Arts. 10 (Dividends), 11 (Interest), 12 (Royalties), 13 (Capital Gains), 15 (Income from Employment), 21 (Other Income) and 22 (Capital) of the OECD Model Tax Convention 2008.

10. For example, in Art. 43 and 56 of the EC VAT Directive (ex art. 9(1) and (2) of the Sixth EC VAT Directive).

wholly or partly carried on"[11]. There is no reservation on paragraph 1 either by OECD member countries or by non-member countries.[12] Paragraph 3 provides expressly that a building site or construction or installation project constitutes a PE when it lasts more than 12 months. Finally, paragraph 5 provides that an enterprise should also be treated as having a PE, even though it may not have a fixed place of business, if there is a person acting for it under certain conditions, i.e. a dependent agent. An enterprise would qualify as a dependent agent if it is acting on behalf of this enterprise and if it has and habitually exercises the authority to conclude contracts in the name of the enterprise.

However, for VAT purposes this issue is more problematic. In the European Union, fixed establishment has to be assumed to be a "Community concept" and the definition must be derived from the European Court of Justice's (ECJ) case law. In a number of cases[13] the Court has followed the same jurisprudential line that a precondition for the existence of a fixed establishment for indirect tax purposes is the permanent presence of both the human and technical resources necessary for the receipt and provision of services. The elements of the ECJ's definition have, however, been affected by the circumstances of the individual cases in which the ECJ developed its view on FEs.[14]

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11. The Commentary on Art. 5(1) of the OECD Model defines in paragraphs 2 et seq. the meanings of "place of business", "fixed" and the "the carrying on of the business of the enterprise through this fixed place of business". According to paragraph 4, the term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. According to paragraph 5, "fixed" means that there has to be a link between the place of business and a specific geographical point. It follows that the PE can be deemed to exist only if the place of business has a certain degree of permanency. According to paragraph 6 of the Commentary on Art. 5(1), practice shows that there were many cases where a PE has been considered to exist where the place of business was maintained for a period longer than six months. Finally, paragraph 7 defines the "carrying on of a business through this PE" by the need to have operations carried out on a regular basis.
12. Note, however, the Czech Republic's and Slovak Republic's position in the OECD Commentary 2008, Art. 5 para. 60.
13. We refer to the following Court cases: (i) ECJ 4 July 1985, Case C- 168/84, *Gunther Berkholz v. Finanazamt Hamburg – Mitte Altstadt*, [1985] ECR 2251; (ii) ECJ 2 May 1996, Case C-231/94, *Faaborg-Gelting Linien A/S v. Finanzamt Flensburg*, [1996], ECR I-2395; (iii) ECJ 17 July 1997, Case C-190/95, *Aro Lease BV v. Inspecteur der Belastingdienst Grote Ondernemingen, Amsterdam*, [1997] ECR I-4383; (iv) ECJ 7 May 1998, Case C-390/96, *Lease Plan Luxembourg v. Belgian State* [1998] ECR I-2553; and (v) ECJ 23 March 2006, Case C-210/04, *FCE Bank plc v. Ministero dell' Economica e delle Finanze*, [2006], ECR I-2803.
14. Joep Swinkels, "Fixed establishments and VAT – Saving Schemes", *International VAT Monitor* 2006, p. 416.

The concept of fixed establishment may therefore not cover exactly the same kind of situation compared with that of a PE for direct tax purposes, e.g. building sites that may qualify as fixed establishments may not qualify as a PE if they do not meet the specific duration criteria[15] provided by the OECD Model. Conversely, a PE may not qualify as an FE if it lacks the permanent presence of human resources.[16]

2. Economic reality v. legal form

By definition, from a *legal* aspect, a permanent establishment (a branch) is simply a place of business with no distinct legal personality from the head office, i.e. the principal place of business used for the substantive administrative or management activities of any trade or business.

For direct tax purposes PEs are usually differentiated from head offices mainly on the basis that a permanent establishment is not a separate legal person but part of the legal entity (head office).[17] The same applies to fixed establishments which normally have no legal personality of their own. According to the opinion of Advocate General Leger in the *FCE Bank*

15. Art. 5(3) of the OECD Model provides that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

16. There might be, however, some exceptions as it would seem that some countries have a definition of a PE for VAT purposes that is very close to the definition of a PE for direct tax purposes. For instance, in Canada, sec. 123(1) of the Canadian Excise Tax Act (ETA) provides that:

> "Permanent establishment", in respect of a particular person, means:
> (a) a fixed place of business of the particular person, including
>   (i) a place of management, a branch, an office, a factory or a workshop, and
>   (ii) a mine, an oil or gas well, a quarry, timberland or any other place of extraction of natural resources, through which the particular person makes supplies, or
> (b) a fixed place of business of another person (other than a broker, general commission agent or other independent agent acting in the ordinary course of business) who is acting in Canada on behalf of the particular person and through whom the particular person makes supplies in the ordinary course of business;".

It looks therefore as though sec. 123(1) (a) (i) and (ii) has been build over a strong analogy with Art. 5(1) of the OECD Model as it is copying almost the same wording, except that it refers to the concept of "supplies" that is a VAT concept. Similarly, there is some analogy between sec. 123(1)(b) and the concept of dependent agent described under Art. 5(5) of the OECD Model.

17. Art. 5(7) of OECD Model where it is explicitly stated that a subsidiary does not by default constitute a PE.

case[18]: "By definition the branch is simply a place of business with no legal personality".

Therefore, it would seem that as far as VAT and direct taxes are concerned, the PE's or FE's lack of legal personality is a fundamental element to be taken into consideration.

However, this is not applied consistently.

In the field of direct taxation – as is made clear by para. 41 et seq. of the Commentary on Art. 5(7) of the OECD Model – a subsidiary may be the PE of its parent company when it is fulfilling the conditions under Art. 5. This may be the case when the premises of this subsidiary are used as a fixed place of business of the parent or when it is acting as the dependent agent of its parent (because it undertakes activities for its parent company and has and habitually exercises an authority to conclude contracts in the name of the parent).

In the field of VAT, the Court expressly affirmed, in the *DFDS*[19] case, that consideration of the actual economic situation is a fundamental criterion for the application of the common VAT system and may result in a subsidiary constituting a fixed establishment of its parent company. It was of particular importance in the *DFDS* case that the subsidiary was wholly-owned by its parent company and was subject to various contractual obligations imposed by its parent.

It would seem, therefore, that the economic analysis prevails when characterizing a permanent or fixed establishment in its relationship with third parties. This is because one legal form over the other – branch or subsidiary – should not be preferred for tax purposes. The question that remains is whether that economic analysis should also prevail when the PE is providing supplies of goods or services to another part of the same legal entity (i.e. within itself). This question relates directly to the issue of the tax treatment of relations between head offices and PEs both from direct and indirect tax aspects.

18. Opinion of Advocate General Leger, 29 September 2005, Case C-210/04, *FCE Bank plc – Ministero dell'Economia e delle Finanze*, point 46.

19. ECJ, 20 February 1997, *DFDS A/S – Commissioners of Customs and Excise*, C-260/95, [1997] ECR I-1005. In this case a UK subsidiary of a Danish company operated in the United Kingdom as a commercial agent for its parent company, selling package tours organized by the latter.

III. Tax treatment of cross-border transactions within a single legal entity

Direct and indirect taxes have different aims. Direct taxes attribute revenues to the country of residence (or in some occasions the country of source) whereas VAT normally taxes supplies in the country where consumption occurs. In theory, this can lead to opposing outcomes when attributing revenues to one country or another.

There would appear to be two schools of thought – for both direct or indirect taxes – when considering the taxation of transactions within a single legal entity and that a trend would see the economic reality prevailing over the legal status of the entity.

Because VAT does not look to attribute revenues to the country where they are generated but where the supplies are consumed, it might be interesting to reflect on the need to combine one approach with the other – as the ECJ did in the *FCE Bank* case.[20]

It might be that both approaches when allocating profits for direct taxes or taxing or not taxing supplies in the country of consumption for VAT also seek to limit tax avoidance.

1. Two schools of thought

Most countries take the view that there cannot be a *domestic* transaction within a single legal entity as far as direct taxes and VAT are concerned.[21] This reflects a legal perspective that a minimum of two parties are needed to enter into an agreement and that one entity cannot therefore contract with itself.

There may, however, be a different approach to the taxation of *cross-border* transactions between branches or permanent establishments and their head office. This follows from an analysis of the economic reality over and above the legal status.

20. ECJ, 23 March 2006, Case C-210/04, *Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc.*

21. There are some exceptions. For instance, South Africa allows taxpayers to register their branches separately for VAT purposes, so that they constitute another taxable person. See Sec. 50 of the South African Value-Added Tax Act, 1991 (Act 89 of 1991).

1.1. The direct tax approach: The prevalence of economic reality

As far as direct taxes are concerned, Art. 7 of the OECD Model, which governs the attribution of profits to a PE, prefers the economic approach.

Transactions between a branch that would qualify as a PE in one country and its head office in another country are not in the scope of Art. 9 of the OECD Model, which governs transfer pricing issues. Art. 9 has its scope expressly limited to adjustments between associated enterprises, i.e. enterprises independent of each other, such as subsidiary companies and companies under common control (see paragraph 1 of the OECD Commentary on Art. 9).

Art. 7 of the OECD Model does, however, also allow the attribution of profits to a PE in the context of the relationship between this PE and the rest of the enterprises to which it belongs. This is conducted on the basis of an economic analysis.

On 17 July 2008 the OECD Council approved the release of the final version of the Report on the Attribution of Profits to Permanent Establishments.[22] This Report provides guidance on the principles for attributing profits to a permanent establishment under Art. 7 of the OECD Model. It reflects the results of work undertaken to examine how the principles developed in the OECD's Transfer Pricing Guidelines for application to separate but associated enterprises should apply in the context of the relationship between a permanent establishment and the rest of the enterprise to which it belongs.

The Commentary on Art. 7 of the OECD Model has been amended on 17 July 2008 to incorporate a number of the Report's conclusions that do not conflict with the previous version of the Commentary.

It has not changed the fundamentals of the OECD Model and the underlying logic but has clarified the Commentary by substituting an attribution of profits based on a functional and factual analysis to the previous approach. This is what the OECD calls the "Authorised OECD Approach" (AOA). This confirms that an economic analysis of the PE in its relationship with parts of the undertaking of which it is part prevails.

22. This followed the earlier approval of the Report by the Committee on Fiscal Affairs at its June 2008 meeting.

The new Commentary describes a two-step approach. Paragraph 14 et seq. of the Commentary on Art. 7 of the OECD Model acknowledges that the profits to be attributed to a permanent establishment are those that it would have made if it were a distinct and separate enterprise engaged in the same or similar activities under the same and similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment (the arm's length principle). The PE is therefore first hypothesized as a "functionally separate entity" from the rest of the enterprise of which it is a part. This is done by attributing "functions", "risks", "assets" and "capital" to the PE[23] and then by recognizing "dealings" between the PE and the rest of the enterprise (a threshold needs to be passed to ensure that the transaction at stake is of significant importance).

Thus, profits may be attributed to a PE when this PE is dealing with the rest of the enterprise of which it is part. This means that the branch may be attributed profits even if the entity as a whole is making a loss. The profits attributed to this PE will include all transactions with other independent enterprises and associated enterprises but also "dealings" with other parts of the enterprise – i.e. all internal transactions within the same legal entity (see para. 17 of the Commentary on Art. 7 of the OECD Model).

In the second step of the approach, the profits of the permanent establishment are determined by applying by analogy the Transfer Pricing Guidelines' arm's length principle, including its comparability analysis, to dealings between the permanent establishment and the rest of the enterprise. Pricing is in accordance with the Guidelines applied to any transactions with associated enterprises attributed to the permanent establishment.[24] The arm's length principle normally requires parties involved in a controlled

23. According to AOA approach*, functions* will be identified in the PE. Those functions are the ones that people working in the PE carry out. Those functions range from ancillary or support functions to "significant" people functions. Further to the identification of these "significant" people functions, the PE will be attributed the *risks* inherent or created by these functions. Similarly, the PE will be attributed the *assets* – tangible and intangible – relevant to the significant people functions; that is, the PE will be attributed the tangible assets that are used for performing the relevant people functions or the intangible functions for which its people functions are taking active decision-making. Eventually, the PE will be attributed a certain amount of *capital/funding* required to support the significant people functions it undertakes. This approach consists therefore of fictitiously creating a deemed company within a single legal entity by attributing to it all the economic characteristics generally granted to an economically independent undertaking.

24. Mary Bennett, "The Attribution of Profits to Permanent Establishments: the 2008 Commentary on Art. 7 of the OECD Model Convention", *European Taxation* 2008, p. 467 et seq.

transaction to charge the same prices that would be charged in comparable circumstances by independent parties. The Transfer Pricing Guidelines' arm's length principle is applied here by analogy as the reality is that there is a single legal entity.[25]

1.2. The indirect tax approach: Somewhere between legal and economic reality

The economic analysis of inter-branch transactions – transactions between different parts of the same legal entity – is also used for VAT purposes by some countries although the tax consequences are not the same (reallocation of profits as far as direct taxes are concerned/taxation or non-taxation of a supply for VAT). The basic reasoning for treating these very similar situations has evolved in a parallel manner from what was a legal analysis to a more pragmatic economically-based analysis as far as supplies of services are concerned. Conversely, the VAT treatment of cross-border inter-branch supplies of goods has not evolved as it is based on an analysis of the location of goods.

1.2.1. *Supplies of goods*

Supplies of goods, whether supplied between two parts of the same legal entity, or between two separate legal entities, follow the normal VAT rules. Cross-border supplies of goods are normally taxed at import or when an intra-Community acquisition (trade in goods between Member States of the European Union are no longer referred to as "imports") is made. The legal analysis of the relationship between supplier and customer is completely ignored. Hence cross-border supplies, or movements, of goods between branches will be liable to VAT.

This is because VAT is based on the flow of the goods irrespective of their ownership: such supplies are usually taxable where they are located when transported or dispatched to the recipient. In most jurisdictions, as in the European Union, what is relevant is to behave like the real owner of the goods, which does not mean that the recipient needs to be the legal owner.[26]

25. See Part IV of this paper "Valuing the taxable transactions".
26. See, for instance, Art. 14 of the EC VAT Directive (Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax), which states in its point 1. that: "Supply of goods" shall mean the transfer of the right to dispose of tangible property as owner".

This has, however, very little impact: transfers of goods in inter-branch transactions within a single legal entity are usually made by businesses carrying out taxable rather than exempt activities so that they can recover the VAT incurred at importation or on an intra-Community acquisition of the goods.[27] This is different for the banking, financial or insurance sectors where in most jurisdictions these activities are exempt from VAT. The consequence for those undertakings is that they cannot (or can only partly) recover the VAT on their purchases or supplies to them.[28]

1.2.2. *Supplies of services*

Many countries in the European Union – as an example – consider that inter-branch supplies of services should not be within the scope of VAT because the legal analysis does not permit a business to enter into a contract with itself.

French jurisprudence back in 1981 ruled that wire transfers from a US head office to its French branch cannot be subject to VAT because they were not made in consideration for a supply rendered by the branch.[29] Between the lines, it seemed to suggest that the supply could not be made for

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See also ECJ, 8 February 1990, Case C-320/88, *Staatssecretaris van Financiën v. Shipping and Forwarding Enterprise Safe BV*, ECR I-285, para. 6 et seq., commenting that provision: "6. It should be noted that Article 5(1) of the Sixth Directive [now Art. 14 EC VAT Directive] provides as follows "'supply of goods' shall mean the transfer of the right to dispose of tangible property as owner". 7. It is clear from the wording of this provision that "supply of goods" does not refer to the transfer of ownership in accordance with the procedures prescribed by the applicable national law but covers any transfer of tangible property by one party which empowers the other party actually to dispose of it as if he were the owner of the property."

27. This may, however, have an impact as far as customs duties are concerned (see Liu Ping, World Customs Organisation, Caroline Silberztein, OECD Centre for Tax Policy and Administration, "Transfer pricing, customs duties and VAT rules: can we bridge the gap?", *World Commerce Review, Volume 1, Issue 1, 2007*, p. 36 et seq.) although most countries have generally implemented specific regimes that allow the transfer of goods to be made under suspension of customs duties when they are not directly released into free circulation (i.e. when these goods are not marketed on a customs territory). Of course, if, on the other hand, the goods are "consumed" by the branch so that they are released into free circulation in the country where the branch is located, customs duties would be payable.

28. A VAT system is like a chain: taxpayers carrying out a taxable activity on a regular basis have to account for the VAT on their supplies and are allowed as a consequence to recover the VAT on their purchases. When the chain is broken because the taxpayers are supplying exempt supplies (without credit, e.g. financial services), they are not allowed to recover the VAT on their purchases relating to these exempt supplies.

29. Conseil d'Etat, 9 January 1981 No. 10145, *Société Timex Corporation.*

consideration because the branch and the head office were the same legal entity. This position was strengthened significantly by the French Supreme Court in 2001 when it ruled that interest paid by South American branches of a French company in consideration of loans granted by the French head office do not qualify as payments made by third parties as consideration for services.[30] It was irrelevant for the Court that the South American branches qualify as permanent establishments and act autonomously.

These French cases illustrate how far an approach based on the legal analysis can lead: notwithstanding whether the entity is able to act in fact as a separate and autonomous entity from an economic point of view, it will still be treated as being part of the same legal entity from an indirect tax point of view.

Other countries do not necessarily share this analysis. Australia[31], Canada[32], New Zealand[33], South Africa[34] and Switzerland[35] – amongst other countries – normally treat cross-border inter-branch transactions as supplies for VAT purposes. This approach seems to rely on an economic approach as those countries see no reason for treating a branch differently from a subsidiary. As with the legal approach, this approach may be too extreme as it is based on the assumption that from an economic point of view there is no difference between a branch and a subsidiary. But the reality is somewhat different: branches may be totally economically dependent on their head office. This may happen when they do not own any of the functions or resources that would allow them to work as an independent entity. For example, an office in charge of promoting products on behalf of its head office would

30. Conseil d'Etat, 29 June 2001, No. 176105, *SA Banque Sudameris.*

31. See subsection 11–15(3) of the Australian "A New Tax System (Goods and Services Tax) Act 1999" (hereafter "the GST Act") and Division 84 of the GST Act.

32. See secs. 123(1), 132, 217,220 of the Canadian Excise Tax Act (ETA). Canada is a country that has seen an evolution towards an "economic reality" approach. Previously, the Canadian tax courts decided in 2003 that payments made by a Canadian branch of a US company to the US head office should not be subject to GST because there was no evidence that services were supplied to the Canadian branch (Tax Court of Canada, 30 January 2003, *State Farm Mutual Auto Insurance Co v. The Queen*, 2003 CanLII 691 (T.C.C.)) – although it did not seem to take the view that services could not be supplied between branches belonging to the same legal entity. It would seem that the Canadian tax authorities have since then extensively reformed their tax provisions so that inter-branch transactions are normally subject to GST rules.

33. Sec. 56 of the New Zealand Goods and Services Tax Act 1985.

34. Sec. 1, sec. 8(9), sec. 11(1)(i) and 11(2)(o) of the South African Value-Added Tax Act, 1991 (Act 89 of 1991)

35. See the Swiss notice n°06 published under the reference 610.545.06 by the Administration Fédérale des Contributions, para. 1.5b.

be dependent on this head office if all related management decisions were taken by the head office. Conversely, it is likely that a subsidiary can be economically dependent on its parent company. This might be because it is heavily subsidized on the basis of an on-demand project. In this grey area, a case-by-case approach might be preferable. Such a pragmatic approach is recognized in the OECD Model.[36]

It is hard to say if the direct tax approach has contaminated the indirect tax approach – or the other way around – but it would seem – although the wording may leave some room for interpretation – that the ECJ prefers an approach somewhere between the "legal analysis" and the "economic analysis" approach when dealing with inter-branch transactions from a VAT point of view. It is interesting to see that this approach relies on the same underlying principles as the update to the commentary on Art. 7 of the OECD Model.

In the *FCE* Bank case, the ECJ ruled that a "fixed establishment, which is not a legal entity distinct from the company of which it forms part, established in another Member State and to which the company supplies services, should not be treated as a taxable person by reasons of the costs imputed to it in respect of those supplies".[37]

The reasoning of the Court was, however, a lot more complex than it at first appears. In paragraphs 35 et seq. of the judgment the ECJ held that it is necessary to determine whether the branch may be regarded as an independent entity.

It would be regarded as such, according to the Court, if it bore the economic risk arising from its business. A bank (as in the case of FCE) would normally bear that risk as a legal person. This is because a bank is normally subject to the supervision of its financial strength and solvency in the country where it is legally registered, which is the state of the head office. The immediate consequence is that a branch of this bank will be subject to the

36. See the comments under part I.: para. 40 et seq. of the Commentary on Art. 5 of the OECD Model – although acknowledging that in principle a subsidiary does not constitute a permanent establishment of a parent company because it is not the same legal entity – stressed that it may under certain circumstances be regarded as a permanent establishment when it is acting like a dependent agent of the parent company. That economic approach has also been retained under Art. 7 of the OECD Model when attributing profits to a permanent establishment: as said before, "dealings" within a same legal entity may be adjusted.

37. ECJ, 23 March 2006, Case C-210/04, *FCE*.

supervision of its financial strength and solvency in the country of the head office, so that this branch must be seen as dependent on the company (i.e. on its head office). This branch must, therefore, constitute with this company a single taxable person.

This may suggest that a branch bearing the economic risk arising from its business would be regarded as an independent entity.[38] It would then be a separate taxable person in its relation with its head office – despite belonging to the same legal entity.

It would seem that the Court – although quoting Advocate General Léger's Opinion[39] – went further than he did by adding this "single taxable person" test. The Advocate General was very supportive of the legal analysis approach according to which inter-branch transactions cannot be subject to VAT simply because they occur within a single legal entity.

It is therefore uncertain whether in practice all the Member States of the European Union have captured the subtleties embodied in the *FCE* case as many of them seem to limit their reasoning to the "legal analysis" described above and, as a result, do not consider inter-branch transactions as a supply for VAT purposes.

Moreover, the combination of the judgment in the *FCE* case with that provided by the ECJ in the *DFDS* case[40] may – in theory – end up with the unexpected result that a subsidiary, not sufficiently economically independent, would be seen as a fixed establishment of its parent company. This would result in none of its transactions with its parent company being subject to VAT, whereas, by application of the economic analysis in the *FCE* case, supplies between branches could be liable. Such outcome is rather theoretical as it would seem unlikely that any tax administration would support the non-taxation of cross-border supplies between a subsidiary and its parent company or that any national court would rule in that direction.[41]

38. This is not the first time the ECJ relied on an economic analysis. The Court already stressed in the *DFDS* case that "consideration of the actual economic situation is a fundamental criterion for the application of the common VAT system". ECJ, 20 February 1997; Case C-260, *DFDS*, [1997] ECR I-1005, para. 23.
39. Opinion of Advocate General Léger, 29 September 2005; C-210/04; *Ministero dell'Economia e delle Finanze, Agenzia delle Entrate v. FCE Bank plc*, point 46.
40. ECJ, 20 February 1997; Case C-260, *DFDS*, [1997] ECR I-1005.
41. It would, in effect, jeopardize all EU rules governing the place of taxation of cross-border supplies of services and intangibles and strike a heavy blow to the whole VAT system.

To summarize, it would seem that the ECJ is leaning towards an economic approach over a legal approach, as does the new Commentary on Art. 7 of the OECD Model. At the very least it recognizes that an economic analysis needs to be taken into account. This economic approach is not so surprising as it would seem that the ECJ is mainly concerned about the protection or promotion of the single market. Of course, the decisions of the ECJ apply only to EU Member States[42] and the OECD Model is not by definition hard law (although it has acquired a status that is more than simply guidance as the OECD Model is the basis for some 3000 bilateral treaties. Moreover, the OECD Model and its Commentaries are often used in the resolution of legal disputes). ECJ decisions may also be considered with interest by some non-European Union countries.[43]

1.3. Conclusion

Both examples of the ECJ's decisions and the OECD Model would suggest there is a need to take into account an economic analysis in the tax treatment of inter-branch transactions.

It would not, however, lead to the same tax result: considering the permanent establishment as a separate economic entity would lead to the attribution of some of the amount of the dealings to the direct tax base of that establishment whereas considering a fixed establishment as a separate taxable person from its head office would lead to VAT being applied to all of the taxable supplies delivered by that establishment to its head office.

The diversity of the solutions adopted regarding the VAT treatment of branch transactions inside[44] and outside the European Union would suggest that some degree of harmonization is needed at a global level in order

42. It is worth noting that it is not clear whether the decision of the ECJ in the *FCE* case was limited (or not) to intra-European Union transactions only. In para. 38 of its decision, the Court said that "*the present case which concerns transactions between a company resident in a Member State* [of the EU] *and one of its branches established in another Member State*". ECJ, 23 March 2006, Case C-210/04, *FCE*, para. 38.

43. As an additional remark, it is worth noting that some tax specialists suggest that the European Commission may skirt around the increasing difficulties faced in implementing new tax legislation (due to EU enlargement and the requirement for unanimity of all Member States) by proposing "soft law" instead of "hard law" regulations. That would be an approach similar to the OECD approach. See Michel Aujean, Guy Gest, Jean-Pierre le Gall, Philippe Martin, Patrice Poulignen, Pascal Saint-Amans, "L'ordre fiscal international", *Droit Fiscal n 37*, 13 September 2007.

44. It would seem that, despite the decision in the *FCE* case, many EU Member States still rely on a strict legal analysis of inter-branch transactions.

to avoid double taxation or unintended non-taxation. Such harmonization could be based on Art. 7 of the OECD Model – i.e. an economic rationale – or could adopt the legal analysis.

Whatever the approach taken, this leads to the question of why these legal or economic approaches in international direct and indirect taxation are applied. It would seem likely that tax avoidance is a very strong concern of many countries.

2. Anti-avoidance rationales

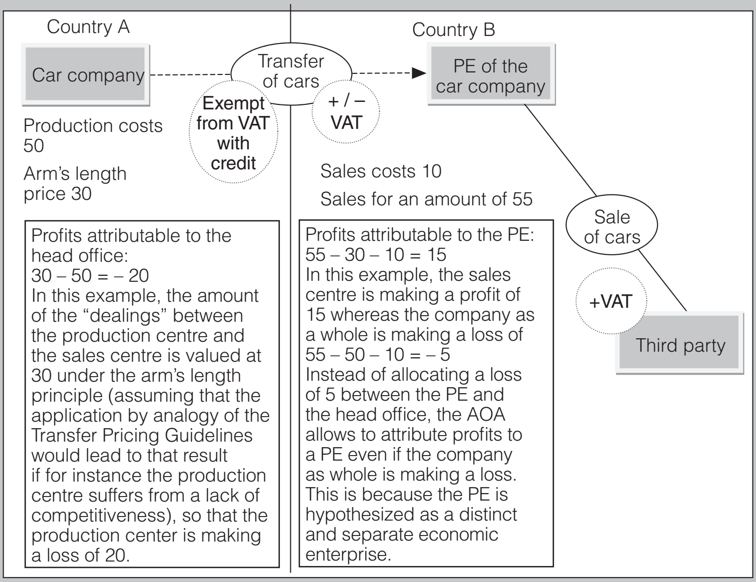
Some believe that the reason for taxing inter-branch transactions or treating them as a supply is based on tax neutrality. Branches should not be treated differently than subsidiaries. Equally, it may be the other way around, given the opposite view – also based on tax neutrality – that cross-border inter-branch transactions should not be treated differently from domestic inter-branch transactions and should be ignored for tax purposes.

The rationale behind direct and indirect tax provisions as regards the treatment of inter-branch/PE transactions within a single legal entity seems to be, at least in fact, to minimize the risk of tax avoidance.

From a direct tax point of view, relying on a pure legal analysis would lead to non-taxation as presumably an entity cannot contract with itself. The non-taxation of those transactions would then allow avoidance schemes because it would create an incentive to locate the profits where the income tax rate is the lowest or to locate the costs where they can be easily deducted from the taxable base.

The set of rules under the Commentary to Art. 7 has been designed to protect against that and also to lead to a fair determination of the profits that should be attributed to each part of the enterprise as if they were independent companies. A PE has to be hypothesized (by attributing functions, capital, risk and assets to that PE – see 3.1.1.) so that profits can be logically determined to the dealings between the PE and other parts of the entity of which it is part. For instance, if a PE is performing the sales function, it will be attributed the margin on the sales it has realized. Similarly, the part of the entity with the production activity should be attributed the profits in relation to the production of the goods it will provide to the other parts of the entity responsible for selling those products. The issue then is to determine the price of the "dealings" between the production centre and the PE. The values of those dealings should be determined according to the arm's length principle. This should be resolved by applying, by analogy, the transfer pricing adjustment rules. Thus, the PE may be attributed profits even if the entity as a whole is making a loss.

Example No. 1:



As far as VAT is concerned, the issue is a lot more complex as anti-avoidance arguments can support both the "legal analysis" and the "economic analysis" approach as far as cross-border inter-branch supplies of services are concerned.

Supplies of goods are, as we noted before, normally subject to VAT in the country of the delivery of the goods. This is not an anti-avoidance provision but simply the application of the fact that VAT is normally based on the flow and location of the goods and normally taxes them where they are delivered. This is an appropriate proxy for consumption. Generally, a supply of those goods is exempt (with credit) from VAT in the country of origin when leaving that country because it is exported or subject to an intra-Community supply. Conversely, the recipient of the goods in the country of destination will normally account for the tax either at the border in the case of import or when receiving the goods in the case of intra-EU acquisition of goods. Technically speaking, such transfers in inter-branch transactions should be neutral as the branch that is the recipient of the goods and may be liable for VAT would also be entitled to recover this tax immediately, provided that no exempt activity is carried out. Banks, financial institutions and insurance companies are, however, likely to suffer from such provision only if they transfer goods of a substantial value from one country to another. The principle remains that VAT is due on importation of goods even when the supplier and importer are parts of the same legal entity.

VAT is therefore neutral as far as cross-border supplies of goods are concerned. The diagram above (example No. 1) illustrates the situation both from a direct and indirect tax point of view. A direct tax analysis may fear that Country A may lose some of its revenues when selling goods in Country B by using its branch in Country B. It would consider that the VAT on the supply would go to Country B instead of Country A and might see the branch as part of an avoidance scheme. This will, however, not be the case under most VAT systems. From a VAT point of view, there is no difference in the VAT treatment when selling goods directly or through a branch in Country B. In both cases, the supply of goods would normally be subject to VAT in Country B (although there might be no PE for direct tax purposes in country B in relation to those "direct" sales) simply because the location of the goods is an appropriate proxy for consumption.

The situation is different with respect to supplies of services. There is a school of thought that believes that the taxation of inter-branch transactions may create VAT avoidance opportunities and another that believes non-taxation may create such opportunities. This is due to the fact that VAT has to be considered from the perspective of both output tax and input tax. A business that carries out an exempt activity and is not able to recover the VAT on its expenses will bear indirectly the cost of the tax in proportion of the amount it cannot recover. In some countries, being exempt from VAT may entail the application of some other taxes that would otherwise not have been applicable.[45]

The school of thought that believes that inter-branch transactions should not be taxable under VAT relies on the fact that, if they were, it would create an incentive for exempt business to artificially create taxable supplies between the branches and the head office. The purpose of this would be to increase the VAT recovery ratio of the head office. In

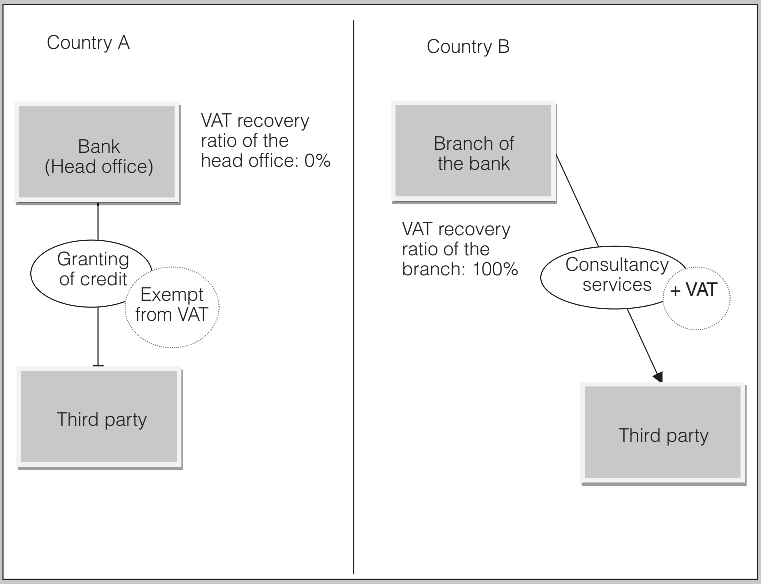
45. This is, for instance, the case in France with respect to the payroll tax (Art. 231 of the French tax code/"Code Général des Impôts").

many countries, exempt business can only recover the VAT they incur on their expenses in due proportion of the amount of their turnover that is subject to VAT or zero-rated (exempt with credit). The calculation of this ratio is generally made by dividing the amount of taxable turnover by the total amount of the turnover of the company (taxable and exempt).

In the second example, if the head office is carrying out an exempt activity only (banking, for instance) and has a VAT recovery ratio of 0% while one of its branches has a VAT recovery ratio of 100% because this branch is supplying services subject to VAT (for example, consultancy services), the artificial supply of services subject to VAT from the head office to the branch will mechanically increase the VAT ratio of the head office by increasing its non-exempt turnover (see the consequences in example No. 3). This will not create an additional tax burden for the business as the branch will be able to fully recover the VAT charged.

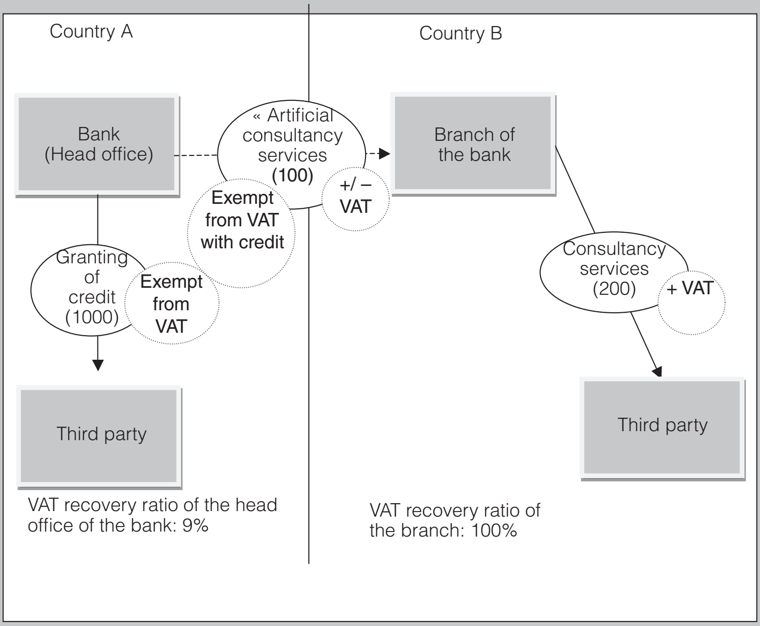
Example No. 2:

In this example no inter-branch services are supplied between the head office and the branch



Example No. 3:

In this example, "artificial" inter-branch services are supplied between the branch and the head-office with the effect that it increases the VAT recovery ratio of the head office.



In this example, the "artificial" consultancy services provided by the head office will be subject to VAT in Country B with the branch of the bank reverse-charging the tax (as we assume that all the branch activities are subject to VAT). There will, therefore, be no VAT costs for the branch. Those "artificial" services will create some taxable turnover for the head office. The computation of the VAT recovery ratio of the head office will be as follows: 100/(1000+100) = 9%. If the head office had incurred 100 of VAT on its purchases, this will allow recovery of 9 of this 100 (instead of 0 under example No. 2).

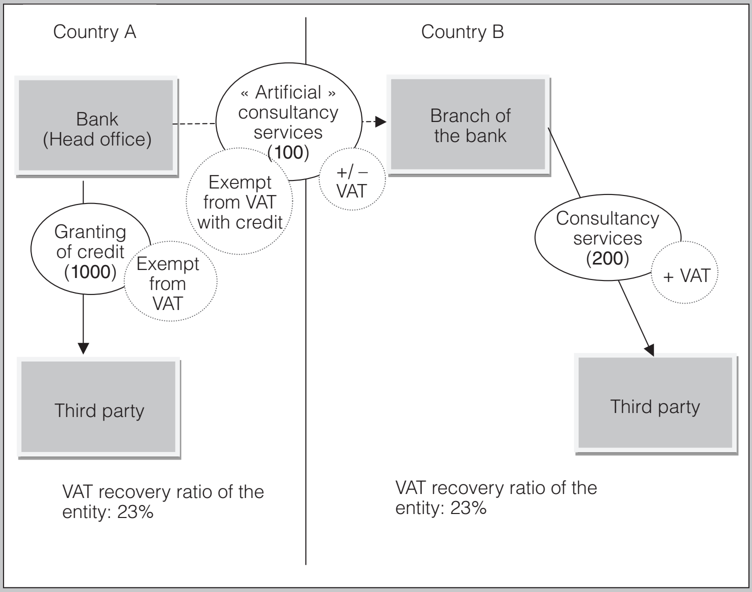
Of course, this avoidance scheme would work only if the country of the branch has not implemented specific rules to compute the VAT recovery ratio on a worldwide basis.[46] If so, the scheme would not allow

46. A global VAT recovery ratio would include the exempt or taxable turnover of the whole entity. Some jurisdictions have embodied this principle in their VAT regulations. This theory may find a solid basis in the legal provision of Art. 174 of the EC VAT Directive (Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax), which says that the deductible proportion is a result of the

tax avoidance as – supposedly – the computation of the VAT recovery ratio of the branch will take into account the exempt activity of the head office. This means in our example that most of the VAT charged (under the “reverse-charge” mechanism) on the “artificial” supply to the branch will not be recoverable by the branch (see example No. 4).

Example No. 4

In this example, “artificial” inter-branch services are supplied between the branch and the head office but the VAT recovery ratio of the head office is computed on a worldwide basis.



relationship between the amount of turnover attributable to transactions in respect of which VAT is deductible and in respect of which VAT is not deductible. Art. 271-V-d of the French Tax Code (“*Code Général des Impôts*”) includes amongst the transactions in respect to which VAT is deductible the transactions that are not taxable in France to the extent that they would qualify as transactions in respect of which VAT is deductible if their place of taxation were located in France. See Philippe Tournès and Anne Grousset, “The French VAT experience – VAT recovery and branches”, *The Tax Journal*, 31 January 2005, p.21 et seq.; Anne Grousset and Armelle Abadie, “Etablissement stable et TVA” published in two separate parts in *Option Finance,* 10 July 2006 and 4 September 2006 and see also Christian Amand, “VAT grouping, FCE bank and force of attraction – the internal market is leaking”, *International VAT Monitor*, July/August 2007, p. 237 et seq. It would seem also that some ECJ cases might support this principle (see ECJ, 13 July 2000, Case C-136/99, *Ministre du Budget, Ministre de l’Économie et des Finances and Société Monte Dei Paschi Di Siena*).

This example has been built on the assumption that the inter-branch transactions will be taxable and that the VAT recovery ratio of the entity will be computed on a worldwide basis.

The computation of the VAT recovery ratio of the entity will be as follows: 100 + 200 /(1000 + 100 + 200) = 23% compared to 200/(1000 + 200) = 17% if the inter-branch transactions were not taxable.[47]

At first sight it would seem that there is an incentive to create "artificial" inter-branch transactions because this would increase the ratio by 6 points. Assuming that the head office had incurred 100 of VAT on its purchases (same assumption as under example No. 3 – which means an amount of purchases of 500, net of taxes, if the VAT rate in Country A is 20%), it will be allowed to recover 23 of that 100 instead of 17. It would seem therefore that the "artificial" inter-branch transactions have increased the recovery by 6.

This may give an incorrect impression as the branch will now not be able to recover all the VAT accounted for on the inter-branch transactions. Assuming that the VAT rate in Country B is 20%, the branch will be able to recover only 20 x 23% = 4.6 instead of 20. It will therefore incur a "loss" of 15.4 compared to examples No. 2 and No. 3 where it could recover the whole amount of 20.

The entity as a whole may therefore incur a net global loss of 15.4 – 6 = 9.4. This calculation does not, however, take into account that the global increase of the VAT recovery ratio resulting from the "artificial" transactions may also increase the recovery of the VAT incurred by the branch on its own expenses.

In conclusion, it would seem therefore that the implementation of a worldwide VAT recovery ratio might prevent the implementation of any avoidance schemes based on taxation of inter-branch transactions, although there would be some other considerations to be borne in mind.[48]

Conversely, the school of thought in favour of taxing inter-branch transactions believes that not taxing them would create an incentive for the exempt industry (banks, financial institutions and insurance

47. When computing a global VAT recovery ratio, it is uncertain whether the inter-branch transactions should be included in the computation of the turnover as they do not constitute per se a turnover generated by the entity of which the branch is part. See Philippe Tournès and Anne Grousset, *The Tax Journal* 2005, p. 21 (p. 22). For the purpose of this example, and for simplification purposes as well, it has been decided to include such amounts in calculating the VAT recovery ratio.

48. Such as the proportion of VAT-exempt services supplied by the head office and the amount of taxable inter-branch services and services supplied by the branch. VAT rates may also affect the issue.

companies) to route purchases of goods via branches located in high recovery rate jurisdictions. This may allow the head office to purchase services VAT-free because the branch may recover all the VAT on the purchases. It then reallocates those services to the head office without being taxed because the inter-branch transactions would be ignored. A head office carrying out an exempt activity and purchasing those services directly may not be allowed to recover the VAT charged on those services. This may create a disincentive to create a subsidiary for financial groups to concentrate IT, administrative or management services in a separate legal entity. There would, therefore, be a reason not to treat branches differently from subsidiaries when they are in the same economic situation. This might be one of the reasons why the *FCE* case included an economic analysis on top of the legal analysis. It creates an exception to tax inter-branch transactions when the branch bears the economic risk arising from its business.

This incentive to exploit avoidance might be even stronger in a globalized world where groups enter into global contracts leading, at times, to difficulties, in identifying precisely who the recipient of the services is. [49]

This avoidance scheme might also be effectively stopped by implementing a worldwide VAT recovery ratio. The implementation of such a ratio would mechanically decrease the recovery ratio of the branches through which the purchases are routed because it would take into account the turnover in relation to the exempt activity of the whole entity. This would remove the incentive to set up a branch instead of a subsidiary.

It is ironic to see that both avoidance schemes – one based on taxation of inter-branch transactions and the other one based on non-taxation of inter-branch transactions – might be effectively countered by the same measure. In practice, however, it is likely that the implementation of a worldwide recovery ratio would be difficult, if not impossible,[50] probably for technical reasons.

Nevertheless, some eminent indirect tax specialists do support the idea of implementing a global recovery ratio as the only appropriate solution in the

49. According to Philippe Tournès and Anne Grousset ; "because the effects of globalization are such in the banking and financial community […] it would be an illusion to consider that expenditures incurred by a branch are only related to its own operations". Philippe Tournès and Anne Grousset, *The Tax Journal* 2005, p. 21 (p. 23).

50. Patrick Donsimoni, "Est-il possible de calculer un prorata mondial de déduction?", *La Semaine Juridique Entreprise et Affaires n 50*; 12 December 1996.

current context to compute recovery rights of a company having branches in a number of different countries.[51]

This presupposes better exchange of information and tax cooperation between countries and the implementation of a dispute resolution mechanism for VAT purposes (perhaps using the dispute resolution mechanism under Art. 25 of the OECD Model). This would require removing the restriction of the scope of this article to direct taxes only (Art. 2 provides that the OECD Model applies to taxes on income and on capital) but widen the scope to VAT, as has been done for Art. 26 (exchange of information) and Art. 27 (assistance in the collection of taxes). But this would certainly require a technical instrument powerful enough to compute the global VAT recovery ratio of a company.

Canada is following a different and original path and is changing its legislation regarding financial institutions[52] and avoidance schemes. It is implementing an original approach disconnected from the usual VAT approach.[53] The "classic" VAT approach relies on categorizing the transaction as a supply or as a non-supply. Canada prefers an approach based on corporate income tax. According to this new legislation, costs incurred by a foreign branch in support of a business carried out by the Canadian entity in Canada will be subject to GST when they relate to the Canadian activity and are subsequently deducted by the latter for Canadian income tax purposes. This builds a significant bridge between direct and indirect taxes as regards the taxation of inter-branch transactions.

51. Philippe Tournès and Anne Grousset, *The Tax Journal*, 31 January 2005, p. 21 (p. 23).

52. Canada treats inter-branch transactions as a supply. Such supplies are normally a taxable supply for GST purposes when the Canadian entity does not have a full right to deduct input GST. Canada faced avoidance from foreign branches supplying services to Canadian head offices of financial institutions that bundled those services into a single supply of exempt services – hence not subject to tax. This created an incentive to purchase services from outside Canada that would otherwise have been subject to tax in Canada.

53. Canadian proposed improvements to the application of the GST/HST to the Financial Services Sector: see http://www.fin.gc.ca/news05/data/05-079_3e.html; http://www.fin.gc.ca/news07/07-006e.html

On 17 November 2005 the Canadian Department of Finance issued a press release announcing changes to the GST treatment of cross-border branch to branch transactions. On a going-forward basis effective 17 November 2005, specific rules will be implemented for financial institutions. These proposed changes to secs. 123(1), 132, 217,220 of the Canadian Excise Tax Act (ETA) are not law yet although it is likely that most businesses will comply with them as the law when it is adopted should come into effect as from 17 November 2005.

To summarize, direct and indirect taxes may both recognize the need for an economic approach when taxing, or not, inter-branch transactions. Part of the rationale for this might be to counter tax avoidance and to a certain extent there are similarities between direct and indirect taxes. This seems even more obvious in the countries that treat inter-branch supplies of services as within the scope of VAT. There is, however, a significant gulf between direct and indirect taxes when it comes to the question of valuation. Direct taxes usually rely on a core of well-defined transfer pricing rules whereas international valuation rules in indirect taxes are, at best, still under construction or are totally absent. There would also need to be significant co-operation between direct and indirect tax policy-makers and administrators.

IV. Valuing the taxable transactions

After supplies between related parties (branches) have been characterized as taxable, the next requirement is to apply valuation rules to those supplies. As already mentioned, VAT is a general indirect tax on consumption and contrary to the corporate income tax is not imposed at the profit level. It applies to transactions without taking into consideration the profits or losses of a taxable person. As a consequence of the different purposes, structures and principles of corporate tax and VAT, as already described, there are distinct valuation approaches for direct and indirect tax purposes.

1. Two sets of rules

1.1. Valuation principles for direct taxation purposes

The attribution of profits to PEs has long been a subject of discussion. On 17 July 2008 the OECD Council approved the release of the final version of the Report on the Attribution of Profits to Permanent Establishments. This followed the earlier approval of the Report by the Committee on Fiscal Affairs at its meeting of 24–25 June 2008.[54] That report's conclusions are applicable to the extent that they do not conflict with existing Commentary. These conclusions were included in a revised 2008 version of the Commentary on Art. 7 of the OECD Model (a redraft of Art. 7 itself, along with

54. The Report on the "Attribution of Profits to Permanent Establishments" consists of Parts I (General Considerations), II (Banks), III (Global Trading) and IV (Insurance Enterprises).

new Commentaries, is being targeted for inclusion in the next update of the OECD Model, currently scheduled for 2010).[55]

This broad consensus of OECD members concludes that, for the purpose of attributing profits to a PE, the PE has to be hypothesized as a distinct and separate enterprise from the rest of the entity. Accordingly, based on a functional and factual analysis (as already analysed under *III* above), "dealings" that are recognized for tax purposes should be priced at arm's length by applying the Transfer Pricing Guidelines on an analogous basis. In other words, the remuneration of such "dealings" has to be determined on an arm's length[56] basis by applying the traditional transaction methods (comparable uncontrolled price[57], resale price[58] and cost plus[59]) or where such methods cannot be applied reliably, the transactional profit methods (profit

55. Mary Bennett, *European Taxation* 2008, p. 467 (p. 469).
56. The arm's length principle is set out in Art. 9 of the OECD Model Tax Convention as follows: where "conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly".
The arm's length principle as an internationally agreed principle goes back to 1933 where it saw the light in the field of intracompany dealings and it was only subsequently extended to transactions between separate legal entities. For historical view, see H. Hamaekers, "Arm's length – How long?", *International Transfer Pricing Journal* 2001, p. 30. See also Raffaele Russo, "Application of Arm's Length Principle to Intra-Company Dealings: Back to the Origins", *International Transfer Pricing Journal* 2005, pp. 7 et seq.
57. The glossary of the OECD Transfer Pricing Guidelines (February 1998) defines the "Comparable uncontrolled price (CUP) method" as: "A transfer pricing method that compares the price for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances".
58. The glossary of the OECD Transfer Pricing Guidelines (February 1998) defines the "Resale price method" as: "A transfer pricing method based on the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. The resale price is reduced by the resale price margin. What is left after subtracting the resale price margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. custom duties), as an arm's length price of the original transfer of property between the associated enterprises".
59. The glossary of the OECD Transfer Pricing Guidelines (February 1998) defines the "Cost plus method" as: "A transfer pricing method using the costs incurred by the supplier of property (or services) in a controlled transaction. An appropriate cost plus mark up is added to this cost, to make an appropriate profit in light of the functions performed (taking into account assets used and risks assumed) and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction".

split[60] and transactional net margin method[61]). The traditional transaction methods normally lead to the determination of a price for a transaction, whereas the transactional profit methods generally lead to the determination of the profits of the related parties participating in a transaction.

In view of the above, for direct tax purposes there is a consensus at international level[62] for the application of an objective value for direct tax purposes.

1.2. Valuation principle for indirect taxation purposes

Contrary to direct taxation, there are no similar guidelines for the valuation of transactions between affiliated parties for VAT purposes.[63] In principle, VAT is calculated on a subjective and not objective value. One could argue that since VAT is a tax on private expenditure it is the private person who pays and therefore what he sacrifices can be judged only by him. The ECJ, in a number of cases[64], clearly referred to the subjective value when it held that: "… the basis of assessment is the consideration actually received and not the value estimated according to objective criteria … [and further] [65] … the subjective value still applies when the consideration is less than the cost price".

60. The glossary of the OECD Transfer Pricing Guidelines (February 1998) defines the "Profit split method" as: "A transactional profit method that identifies the combined profits to be split for the associated enterprises from a controlled transaction […] and then splits those profits between the associated enterprises based upon an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length".

61. The glossary of the OECD Transfer Pricing Guidelines (February 1998) defines the "Transactional net margin method" as: "A transactional profit method that examines the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that a taxpayer realizes from a controlled transaction […]".

62. However, see comment of Raffaele Russo, *International Transfer Pricing Journal* 2005, p. 15, with respect to the interaction between the OECD Authorised Approach and European Union law, on the one hand, and treaties that follow the United Nations Model, on the other, whereby the recognition of certain intra-company payments is expressly denied.

63. However, this may change in the future since valuation issues are scheduled to be examined in the terms of the International VAT/GST Guidelines project already initiated by the OECD's Committee on Fiscal Affairs.

64. ECJ, 23 November 1988, Case C-230/87, *Naturally Yours Cosmetics Limited v. Commissioners of Customs and Excise* [1988] ECR 6365 and also see ECJ, 2 June 1994, Case C – 33/93, *Empire Stores v. Commissioners of Customs and Excise* [1994] ECR I – 2329.

65. ECJ, 20 January 2005, Case C-412/03, *Hotel Scandic Gasaback AB v. Riksskatteverket* [2005] ECR I – 743.

Nevertheless, there is, exceptionally, VAT legislation that introduces the determination of value on objective criteria.[66]

2. Arm's length principle and open market value: Exploring convergence

The subjective value as a general valuation rule for VAT purposes can encourage artificial constructions to be set up for the sole purpose of obtaining a VAT advantage either by lowering the final VAT charge or by increasing the VAT recovery ratio. In order to guard against such schemes, the European Union introduced an optional rule (Art. 80 of the EC VAT Directive[67]) which enables Member States to revalue certain supplies to an open market value (OMV) as defined in Art. 72 of the EC VAT Directive: "For the purposes of this Directive, 'open market value' shall mean the

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66. At the European level there are provisions that deal with self-supplies of goods, i.e. private/non-business use (Art. 74), and transfers of goods, i.e. cross-border internal supplies (Art. 76). In general, the taxable amount is the purchase price or, in the absence thereof, the cost price. Further, Art. 75 deals with the case of a self-supply of services: the taxable amount is the full cost to the taxable person of providing the services.

67. See Art. 80 of the EC VAT Directive:

"1. In order to prevent tax evasion or avoidance, Member States may in any of the following cases take measures to ensure that, in respect of the supply of goods or services involving family or other close personal ties, management, ownership, membership, financial or legal ties as defined by the Member State, the taxable amount is to be the open market value:

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

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

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

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

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

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

full amount that, in order to obtain the goods or services in question at that time, a customer at the same marketing stage at which the supply of goods or services takes place, would have to pay, under conditions of fair competition, to a supplier at arm's length within the territory of the Member State in which the supply is subject to tax".

A literal comparison of the definitions of OMV and arm's length results in them looking very similar since they both require a comparison to be made between comparable transactions even if the comparison required under the arm's length principle seem to be broader. Because the OMV refers to the "same marketing stage" for the purpose of computing a price value, it could be argued that it is determined in a way that could be comparable to the CUP method[68] as both look directly at the price charged in comparable uncontrolled transactions. Thus, there seems to be convergence between the OMV and CUP with regard to determining the objective value.[69] However, such a literal comparison based on appearances can be misleading if the functions, both of OMV and the arm's length principle, are not considered.

The scope of the application of OMV as a revaluation measure seems to be limited. It is applicable only in a small number of tax evasion and avoidance transactions. In practice, it has prompted concerns about the additional uncertainties that might be created since there is no guidance provided as to the methods to be used to determine the open market value. Contrary to this approach, the arm's length principle is applicable in direct taxes irrespective of any abusive practice.

It seems that the concept and practical application of OMV and the arm's length principle have been developed and adapted to the nature, purpose and specifics of each tax. For income taxation the application of the arm's length principle determines the profits attributable to PEs. For VAT purposes value will not normally affect the final tax liability to the extent that two taxable related parties will be entitled to a full deduction of input tax. However, value will be considered as crucial in cases where one or more parties involved are not entitled to full deduction and in such cases objective value could act as a deterrent to artificial constructions. The ECJ held in the *FCE* Bank case that the OECD Model applies for direct tax purposes

68. The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction.
69. Emmanuela Santoro, "Transfer Pricing and Value Added Tax in the European Community: Is there room for Interaction and, if so, where?", *International Transfer Pricing Journal* 2007, p. 155.

only and is of no relevance for VAT.[70] It would seem therefore that the VAT valuation principles are different from those of income tax. In the light of the above it could be argued that the concept of corporate tax transfer pricing is of limited relevance for open market value.

3. Transfer Pricing adjustment and VAT: Is there room for interaction?

To the extent that relations between Head Offices and branches are outside the scope of VAT (with the exception of supplies of goods – see Part III.), any transfer pricing adjustment will be of no relevance for VAT purposes. However, should the relations between Head Offices and branches (fixed establishments) be treated as being within the scope of VAT, then the question needs to be answered as to whether transfer pricing adjustments made for direct tax purposes trigger any VAT consequences.[71] In practice, transfer pricing matters for VAT purposes mainly in cases where the VAT incurred by the taxpayer is not fully deductible, although may be relevant in the case of any penalties for the late payment of any tax due.

This interaction, (a tango, as referred to by some authors[72]) should not be underestimated. There are again two schools of thought in respect to the passion between the dancers of this tango. There are those that view this interaction as feasible and desirable and those who are cautious.

3.1. The voluntary approach

For those who believe this interaction between transfer pricing adjustments and VAT is possible, then the implication is that where a transfer pricing adjustment[73] has been made, the input or the output VAT must be adjusted in line. However, there are no specific VAT guidelines on how to deal with transfer pricing adjustments. As a consequence, further examination of the adjustments made is needed to determine whether they qualify as falling

70. ECJ, 23 March 2006, Case C-210/04, *FCE Bank*, para. 39.
71. The question has also been discussed at the 61st Congress of the International Fiscal Association which was held in Kyoto in the terms of a seminar with the title "Transfer pricing and indirect taxation".
72. Folkert Idsinga, Bart – Jan Kalshoven and Monique van Herksen, "Let's Tango! The Dance between VAT, Customs and Transfer Pricing", *International Transfer Pricing Journal* 2005, p. 199.
73. By "adjustments" we refer to adjustments made to correct the profitability of a related party in order to comply with the arm's length principle.

within the scope of VAT and, therefore, the normal VAT rules (with respect to the concept of supply or of what may be characterized as the consideration for a taxable supply) have to be applied and interpreted.

From a VAT point of view, for the provision of services to be taxable, there must normally be a direct link between the service provided and the consideration received.[74] This normally presupposes that the service is rendered to a beneficiary that is identifiable[75] and that there is a relationship between the level of benefits provided and the amount charged.[76]

It is also normally a VAT practice to consider that any price adjustment to a supply that would result in an additional consideration or credit should copy the same VAT treatment previously applied to this supply.[77]

This means that adjustments made according to the arm's length principle would entail VAT consequences only if these adjustments have a direct link with a distinct supply of services or when there is further consideration or credit for any previous taxable supply.

In practice, the traditional transaction methods (comparable uncontrolled price, resale price and cost plus) usually rely on the determination of a price transaction by transaction (on the basis of products purchased, services supplied, interests or royalties paid for instance) – although it is possible also that transactions be combined together for valuation so that it makes the identification of each supply difficult.

This means that it should be possible, in a case where a transfer pricing adjustment is made on a transaction-by-transaction basis and entails a

74. ECJ, 8 March 1988, Case C-102/86, *Apple and Pear Development Council v. Commissioners of Customs and Excise* [1988] ECR I-1443 , para. 12 et seq.
The Court ruled that there was no direct link as 1) the consideration provided was a mandatory charge imposed on growers by the development council and as 2) there was no relationship between the level of the benefits that growers obtained from the services provided by the development council (consisting in advertising, promoting and improving the quality of apples and pears) and the amount of the charges paid.
75. ECJ, 8 March 1988, Case C-102/86, *Apple and Pear* [1988] ECR I-1443, para. 14.
76. ECJ, 8 March 1988, Case C-102/86, *Apple and Pear* [1988] ECR I-1443, para. 15.
77. See, for instance Art. 73, of the EC VAT Directive that provides that: "In respect of the supply of goods or services, other than as referred to in Articles 74 to 77, the taxable amount shall include everything which constitutes consideration obtained or to be obtained by the supplier, in return for the supply, from the customer or a third party, including subsidies directly linked to the price of the supply".

change in the cash position of the related parties, to have a corresponding VAT "adjustment". If the change in the cash position resulted from a price adjustment to an existing supply or a consideration for an additional supply (provided that the "direct link" condition between the supply and the consideration is fulfilled), then normal VAT rules will apply.[78]

Conversely, it is less likely that there would be any VAT consequences when the transactional profit methods (profit split and transactional net margin method) are used. This is because they normally lead to the determination of the profits of the related parties participating in a transaction and not to the determination of a price for a transaction.

3.2. The cautious approach

Those answering the question as to whether there is an interaction between transfer pricing adjustments and VAT in a more cautious way, refer to the existing purposes, structures and principles of direct taxation and VAT law. VAT taxes the flow of goods and the provision of services and for purposes of determining the value, each transaction should be analysed on its own merits. However, transfer pricing rules seek to properly allocate profit and income between related parties and to achieve a fair share for tax authorities and the avoidance of double taxation. Therefore, the whole commercial and financial relationship between parties is examined. Transactions may be combined for valuation together under certain conditions (e.g. product line). Further, information as regards transfer pricing is available to revenue authorities at year-end upon filing of a tax return or later upon retrospective audits. This is in contrast with VAT where the tax becomes chargeable when goods are delivered or the services are paid for or performed, i.e. at the time the supply is actually made.[79] Some countries have, however, harmonized the computation of VAT with transfer pricing rules by requiring that both be computed at the end of the year[80] (this is not unknown in VAT where, for example, the VAT recovery ratio as declared on returns rendered during the

78. For instance, should this payment be related to the equity of the two related parties, i.e. it is treated as capital contribution, then at least at the European level no VAT implications arise since there is solid ECJ jurisprudence according to which capital contributions are out of the scope of VAT. See ECJ 26 June 2003, Case C-442/01, *KapHag Renditefonds 35 Spreecenter Berlin – Hellersdorf 3. Tranche GbR – Finanzamt Charlottenburg* [2003] ECR I-6851 where the Court held that "…a partnership which admits a partner in consideration of payment of a contribution in cash does not effect towards that person a supply of services for consideration…".

79. For instance, Art. 63 et seq. of the EC VAT Directive.

80. Canada is one of those countries. For further information: http://www.fin.gc.ca

year is provisional and is subject to an annual adjustment in the financial sector and also for certain margin schemes).

From a company's perspective, the underlying objective of transfer pricing is often to allocate higher profits to a country with a low tax rate. But in many instances it will be just the opposite for VAT purposes, because a higher transfer price with a higher VAT charge to a taxable person without a full right to deduct would not allow the recipient to recover the corresponding input tax. Conversely, tax administrators may presume that an inter-branch supply provided to a branch with a low VAT recovery ratio has been undervalued and will, as a result, seek to reassess some of the VAT that the branch cannot recover; or they may, in the context of a transfer pricing adjustment, reassess the branch on the basis that the supplies to it were over-valued and have artificially reduced its corporate income tax basis.

3.3. Conclusion

To the extent that we accept that transfer pricing adjustments may affect valuation for VAT purposes then it may be necessary to deal with VAT recovery issues with adjustment of documents and reports issued for VAT purposes. This is already true as far as supplies of goods are concerned, e.g. sales listings, and there are some recent developments in the European Union with respect to the obligations in relation to supplies of services, although they will not be implemented before 2010.[81] Some of these problems may be eliminated to the extent that those taxable supplies are subject to VAT in the country where the recipient is established and therefore only the tax authorities of that jurisdiction will require adjustments of VAT.

However, the situation becomes even more complicated with countries that do not have transfer pricing rules, or have only very basic rules. It is this

81. It is true that at least at the EU level there are recent developments. The "VAT package" aimed, amongst other things, at changing the rules on place of taxation of supply of services for business-to-business and business-to-consumer supplies. It also included some new reporting requirements with respect to supplies of services. It will be interesting to see in the future if those additional reporting requirements may have an impact as far as transfer pricing is concerned. See Council Directive 2008/8/EC of 12 February 2008 amending Directive 2006/112/EC as regards the place of supply of services; and Council Directive 2008/9/EC of 12 February 2008 laying down detailed rules for the refund of value added tax, provided for in Directive 2006/112/EC, to taxable persons not established in the Member State of refund but established in another Member State.

lack of uniformity on the direct tax side that also affects the level of interaction between direct and indirect taxation.

Building a bridge between the two different procedures could be very complicated, with unpleasant consequences both for tax administrators (with the difficulty of training specialists in two very different and technical tax matters) and taxable persons. Nevertheless, it could be argued that adjustments for direct purposes can be an indication that the transactions have been incorrectly valued for VAT purposes.

4. Areas to be further explored

With increased globalization, international transactions between related parties have played an increasingly significant role in world trade. Some examples of important developments that reflect the increasing importance of considering the interaction between transfer prices and indirect taxes are, for instance, the use of shared service centres and the outsourcing of business processes as well as the supply chain optimization structures such as commissionaire, contract manufacturing or cost sharing arrangements. The existence of two sets of rules can make cross-border trade overly complicated and costly.

Clear guidance is needed for businesses that cannot be legitimately exposed to such tax uncertainties. One author has also suggested a technical solution to that problem by the implementation of technology advanced pricing agreements (IT-APA[82]).[83] They may help to harmonize transfer pricing rules by using a fixed formula that could be embedded in the taxpayer's VAT and customs software and could be linked to the financial statements and the income tax return. This may also solve the difference in timing between income tax and VAT insofar as income tax valuations are completed much later than for VAT. In a nutshell, these IT-APAs would be a voluntary,

82. The glossary of the OECD Transfer Pricing Guidelines (February 1998) defines an "Advance pricing arrangement ("APA")" as: "An arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time. An advance pricing arrangement may be unilateral involving one tax administration and a taxpayer or multilateral involving the agreement of two or more tax administrations."
83. Richard Thompson Ainsworth, "IT-APAs: harmonizing inconsistent transfer pricing rules in income tax – customs – VAT", Boston University School of Law, Working paper series, Law and Economics, Working paper No.. 07-23.

taxpayer-initiated agreement implemented through an integrated software program, the formula of which would be certified by the tax administration or a dedicated authority.

The OECD does not recommend unilateral Advance Pricing Agreements.[84] This is because the arrangement may over-allocate income to the country making the APA if a taxpayer accepts that arrangement in order to avoid lengthy or expensive transfer pricing enquiries or excessive penalties. Furthermore, such agreements would be at the disadvantage of other jurisdictions. Although the IT-APA might not be the most appropriate solution, it does imply that a powerful technical tool may be the way of the future. Having an integrated system combining VAT and direct tax information might be an excellent tool to solve the issues of valuation of inter-branch transactions.[85]

In view of the above, it becomes more essential to produce clear guidelines in the field of indirect taxation as has already been done for direct taxes, in order to improve the level of certainty for both governments and business. It may be desirable to identify areas for possible convergence of rules and coordinated approach between VAT and revenue auditors. The scope of joint advance VAT and transfer pricing arrangements, the exchange of information and cooperation between revenue authorities, the performance of joint audits at both the domestic and international level should be explored. In this respect an analysis of national, regional and global practices, with input from both business and governments, would be desirable.

Given the challenging questions posed by valuing transactions between related enterprises for both businesses and governments – particularly revenue and customs authorities – the World Customs Organisation (WCO) and the OECD have already made some progress. Among other things, they have organized conferences on Transfer Pricing and Customs Valuation

84. See points 4.148 and 4.149 of the OECD Transfer Pricing Guidelines (July 1995).

85. The Forum on Tax Administration at the OECD is currently working on the Tax E-Audit project that consists of the implementation of a Standard Audit File for Tax purposes ("SAF-T"). The SAF-T is a definition of a specific predefined file that would gather all the information needed for tax purposes in a simple format. That means that the information is provided in a standardized format regardless of the country where a company is set up. This file should make it easier for taxpayers to provide their electronic records to tax auditors in support of their tax return and for auditors to review accounting records.

aimed at addressing these challenges. VAT and customs are sufficiently aligned, because the customs value of imported goods determines the import value so any convergence between transfer pricing and customs would impact VAT. For transactions involving services the issues are, as noted above, more complex.

V. Conclusion

VAT and direct taxes are like the two faces of Janus: they look in different directions.

Direct taxes and VAT generally have different definitions for characterizing a branch located in a foreign country as a taxable person. There is the direct tax permanent establishment and what we refer to in this paper as the VAT fixed establishment. The definitions given to these notions and how they are applied are not necessarily the same.

Furthermore, although direct taxes and VAT generally agree that a branch may be treated as a taxable person in its relationship with third parties, it would seem that they do not necessarily agree as far as cross-border inter-branch transactions involving services and intangibles are concerned. Direct taxes would say that transactions between the head office and its branch lead to the attribution of profits to the PE provided that the PE is hypothesized as a "functionally separate entity" and that "dealings" are recognized. VAT would not necessarily follow that economic analysis. Some countries prefer a legal analysis and assert that those transactions should not be taxed because they occur within the same legal entity. The ECJ may prefer a combination of both analyses. It recognizes the specificity of the legal status of a branch but seems to imply that the economic analysis may prevail when the branch is bearing the economic risk in relation with the business it undertakes.

These differences are also visible when it comes to valuing transactions between a branch and its head office. Relatively clear guidance exists as far as direct taxes are concerned: the OECD Transfer Pricing Guidelines' arm's length principle. VAT does not generally require that the transaction be at an objective value. However, there have been some recent developments and there is now a requirement in the European Union that certain transactions be valued at the open market value. There is, however, no clear guidance on how to compute that value. Furthermore, VAT and direct tax administrators may have conflicting interests when reassessing valuation of relevant supplies.

VAT and direct taxes may look in different directions but, like the two faces of Janus, they belong to the same "body" (of rules): there is a need for collaboration in order that they sit together reasonably well. It would seem that there are ways to harmonize their relationship. Janus is also the god of gates and bridges.

Firstly, VAT and direct taxes do not always conflict with each other. Supplies of goods are normally taxable under VAT at "import". Moreover, some countries take the view that it is possible to have inter-branch supplies of services subject to their VAT rules effectively under an economic analysis approach.

Secondly, both VAT and direct taxes recognize that inter-branch transactions have potential for tax avoidance. In terms of tax neutrality, it is important that a business does not choose one legal structure over another for tax purposes only, although there might be some other good business or regulatory reasons for choosing a branch over a subsidiary.[86]

Thirdly, timing might be good. VAT revenue has increased whereas the revenue collected from direct taxes has been relatively stable in the past few years.[87] With the financial crisis, VAT may be the only tax that many financial institutions end up paying whereas the revenue from direct taxes is likely to be comparatively low, or even non-existent. Eventually, the increasing concern of countries about VAT abuses may lead to the implementation of

86. A branch would, supposedly, be set up relatively easily. It might help develop trust and confidence with third parties who will know that they are in a closer relationship with the head office directly through the branch. On the other hand, a subsidiary may serve as a screen between the main entity and third parties. It might also be an instrument to limit the liability only to the amount of the capital invested in the subsidiary. See Philippe Tournès and Anne Grousset, *The Tax Journal* 2005, p. 21.
Some countries may also require that companies set up a subsidiary rather than a branch for non-tax regulatory purposes. This may be the case with respect to financial institutions when jurisdictions wish to have better control and oversight over the capital invested and its liquidity.

87. OECD, *Revenue Statistics 1965–2007,* (2008), OECD publishing, see p. 107, table 29 "Taxes on general consumption (5110) as percentage of total taxation" to compare with p. 101, table 13 "Taxes on corporate income (1200) as percentage of total taxation.
See also Stéphane Buydens, *Consumption tax trends 2008 – VAT/GST and excise rates, trends and administration issues* (2008) OECD publishing, pp. 22 et seq. and pp. 40 et seq.

harmonized rules or at least clear guidance on how to deal with the reassessment of branches.

Although it is unlikely that most countries would agree on applying similar VAT treatment to inter-branch transactions, there does seem to be a need for countries to discuss the computation of the VAT recovery ratio. VAT avoidance issues might result from the creation of artificial taxable inter-branch transactions when those transactions are taxed, or from the routing of purchases through a branch with a high VAT recovery ratio when those transactions are not taxed. A possible solution to deal with these two avoidance situations would be to have a general agreement on the computation of a global VAT recovery ratio. This would require better exchanges of information and tax co-operation between countries and the implementation of a dispute resolution mechanism for VAT purposes.

When inter-branch transactions are taxed, businesses need to understand why they might be reassessed from a direct tax point of view and not from a VAT point of view (and, indeed, vice versa). For instance, the current tax situation may result in a win/win for tax administrations: either they will presume that an inter-branch supply provided to a branch with a low VAT recovery ratio has been under-valued and will reassess some of the VAT that the branch cannot recover; or they will, in the context of a transfer pricing adjustment, reassess the branch on the basis that the supplies were over-valued and have artificially reduced its corporate income tax basis.

Thus, clear guidance is needed for businesses in order that such uncertainties can be eliminated or, at the very least, minimized.

Technology might be one way to solve the double personality syndrome from which inter-branch transactions suffer (see footnote 85). Discussions in a global forum – such as the OECD's Working Party No. 9 on Consumption Taxes (through its regular interaction with business) would certainly help to achieve a better balance between the interests of all parties. The OECD work on VAT is well under way and principles on treating cross-border transactions have been established. Guidelines are under development and, hopefully, will complement the OECD direct tax rules that have been in place for many years.