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# The link between Value Added Tax, Transfer Pricing and Customs

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## Background

The tax landscape in the Kingdom of Saudi Arabia (KSA) is witnessing a rapid transformation. The consolidation of the Corporate Income Tax (CIT) authorities with the Customs authorities have led to the transition of the former General Authority of Zakat and Tax (GAZT) to the Zakat, Tax and Customs Authority (ZATCA).

The objective of the transition was to ensure a greater level of coordination between the two authorities. This also meant a fresh set of challenges for taxpayers in addressing joint queries from ZATCA, covering Value Added Tax (VAT), Corporate Income Tax (CIT) and Customs. A frequent question that comes to mind is how do Customs, VAT and Transfer Pricing (TP) interplay and relate to the import of goods from related parties. The objective of the TP and Customs authorities is to ensure that goods are purchased at a value which is consistent and at a fair market value. However, the end result could be conflicting due to the nature of the transaction flow.

To elaborate the issue at hand further, for Customs valuation purposes, import transactions between two distinct and legally separate entities of the same Multinational Enterprise (MNE) group are treated as related party transactions. Such transactions may be examined by Customs authorities to determine whether the price declared for the imported goods is influenced by the relationship. In other words, is the price at which the goods have been sold at a lower level than it would have been had the parties not been related and the price had been freely negotiated?

On the other hand, the price at which MNEs exchange goods, services and assets within the group is known as Transfer Pricing. The Organization for Economic Co-operation and Development (OECD) has developed guidelines based on the arm's length principle for the setting and testing of transfer prices for direct tax purposes. The arm's length principle is generally accepted as the international standard used by businesses and tax authorities.

The aim of both Customs valuation and TP methodologies is very similar; whereas Customs are establishing whether or not a price has been influenced by the relationship

between the parties, the tax objective is to seek an arm's length price. Each is ensuring that the price is set as if the parties were not related and had been negotiated under normal business conditions between unrelated parties.

Thus, tax authorities are generally concerned about a pricing arrangement which is higher than the arm's length transfer prices and are predisposed to reduce incoming transfer prices to increase taxable income; whereas Customs authorities are generally concerned about a pricing arrangement which indicates a lower arm's length prices and is predisposed to increase incoming transfer prices.

Therefore, an important question concerns the various types of adjustments which take place for TP purposes. To what extent, and in what circumstances, do TP adjustments have an impact on the Customs value? Additionally, to what extent does a TP adjustment impact the VAT position of a Company?

## TP adjustments and impact on Customs

Based on internationally accepted principles and the guidance available in the World Customs Organization (WCO) guide to Customs Valuation and TP, we outline the various types of adjustments that may be made for TP purposes, depending on the particular case, applicable domestic law and the applicability of a tax treaty:

- **Primary Adjustment:** Adjustment made by the tax administration in order to increase (or decrease) the taxable income of a taxpayer in accordance with the arm's length principle.
- **Compensating Adjustment (Actual price adjustment):** Self-adjustment made by the taxpayer, whereby the actual transfer price is adjusted in order to be compliant with the arm's length principle. This would involve the price adjustment being recorded in the accounts of the taxpayer and a debit/credit note being issued.
- **Compensating adjustment (for tax purposes only):** Self-adjustment made by the taxpayer, whereby the taxpayer reports an (arm's length) transfer price for tax purposes that differs from the amount actually charged by the associated enterprises.

- **Corresponding adjustment:** Adjustment to the tax liability of an associated enterprise corresponding to a primary adjustment made with respect to another associated enterprise in relation to a transaction with the first associated enterprise so that the allocation of profits between the enterprises is consistent and no double taxation of the same income occurs.
- **Secondary adjustment:** Adjustment that arises from imposing a tax on a secondary transaction (that is, a constructive transaction asserted in order to make the actual allocation of profits consistent with the primary adjustment).

Customs' treatment of TP adjustments however is currently inconsistent around the world. Some Customs administrations consider both upwards and downwards price adjustments and make corresponding duty adjustments where appropriate, others do not, or only consider upwards adjustments (with additional duty payment) but do not consider downwards adjustments (duty refund). Some consider tax only adjustments, whilst others only consider actual price adjustments. This inconsistency has been one of the main concerns expressed by the business community.

Where the adjustment is initiated by the taxpayer and an adjustment is recorded in the accounts of the taxpayer and a debit or credit note issued, it could be, depending on the nature of the adjustment, considered to have an impact on the price actually paid or payable for the imported goods, for Customs valuation purposes. In other cases, particularly where the adjustment has been initiated by the tax administration, the impact may be only on the tax liability and not on the price actually paid or payable for the goods. Where such an adjustment takes place before the goods are imported then the price declared to Customs should take into account the adjustment.

If, on the other hand, the adjustment takes place after importation of the goods, (i.e., it is recorded in the accounts of the taxpayer and the debit/credit note issued after Customs clearance of the goods), then Customs may consider that the Customs value is to be determined on the basis of the adjusted price.

Regarding TP adjustments which affect only the tax liability (i.e., no actual change to the amount paid for the goods), Customs may consider whether this is an indication of price influence. In other words, there is an acknowledgement that the original price was not arm's length for TP purposes, but the price actually paid has not been adjusted.

In KSA we have recently witnessed a few instances, mainly related to the pharmaceutical industry, where assessments initiated by ZATCA were related to Customs and later moved on to the applicability of the arm's length principle as demonstrated in the taxpayer's TP documentation. Therefore, it is imperative that the taxpayer ensures consistency between Customs and TP.

## TP adjustments and impact on VAT

Similarly, a TP adjustment may imply that the taxpayer has the value of supply or value import for VAT purposes. Therefore, a TP adjustment may also warrant certain VAT adjustments.

Further, it has been our experience that TP adjustment at times is not only affected through adjustment in the price of the underlying supply, but also in the form of a fee or charge or subsidy etc., requiring an invoice to be raised; In other words, as a revenue earned through the fee/charge/subsidy etc., as opposed to an adjustment in the cost of goods sold.

From a VAT perspective, invoicing for such charges by the KSA entity raises a question around whether such charges can be subject to a 0% VAT rate or not. Additionally, there could also be corresponding implications from a Customs and CIT perspective due to such fee/charge/subsidy etc.

In addition, we have quite often seen that legacy inter-company agreements from pre-VAT/pre-TP regimes are continued without factoring in the implications from a VAT and TP perspective.

Therefore, it is imperative that an appropriate strategy is formulated to carry out TP adjustments and analyze the same from the lens of Customs and VAT, depending on the specific situation of the issue being dealt with.

## Expectations from the tax authorities resulting from the consolidation of GAZT and the Customs Authority

Following the merger between the former GAZT and the General Authority of Customs to form the ZATCA, it is intended to improve:

- the authority's tax and Customs procedures,
- mutual awareness,
- exchange of information, etc.

Customs administrations are encouraged to consider information from tax filings (including TP filings), where available, when examining related party transactions. Thus, any discrepancy in the data with the Tax authorities vis-à-vis the Customs authorities may result in detailed scrutiny and increased risks of adjustments.





## Our industry focused approach

Our experience with certain industries such as the pharmaceutical, defense etc. that are regulated by the Government authorities worldwide, is that there is greater complexity to balance out the Customs Valuation aspects and maintaining the arm's length nature of the related party (inter group) transactions. ZATCA lays special focus in reconciling the Customs compliances information/documents with the TP compliance information/documents available with them. Further, during the course of audit proceedings, special attention is given by the ZATCA for the valuation adopted at the time of declaration of assessable value for payment of duties and the selling prices from a related party to the end user customers.

Further, TP adjustments in price regulated sectors such as the pharmaceutical sector is a commonly seen phenomenon – which along with it brings additional complexities under VAT as well as Customs. The mechanism through which the TP adjustments are carried out also play an important role in determining the consequent VAT and Customs implications, which if not properly managed can lead to assessments and demands from the tax authorities.

## Deloitte can help

### TP and Customs audit defense strategy and readiness

For MNEs looking to minimize their audit and controversy risk, Deloitte has extensive experience in proactively managing these risks and ensuring they are kept to a minimum. Our team of controversy specialists is able to provide practical and informed insights on local tax, VAT, TP and Customs requirements.

Our services include preparing for and managing TP, VAT and Customs audits, reviewing existing related party disclosures and Customs declarations, intragroup agreements, recommend TP, Customs, and VAT alignment strategies, submission of Advance Valuation Rulings and Customs value adjustment application(s) if required, supporting internal controls and providing customized solutions for businesses – so that the risks can be mitigated before any audits/assessment from the authorities.

### ZATCA audit assistance

Our combined team of local TP, VAT and Customs specialists are able to assist with all ZATCA enquiries, including documentation requests, ZATCA meetings and field audits, double tax agreement information requests and drafting responses and appropriate defense documentation review and audit correspondence management.



### TP, VAT and Customs objections and disputes

When TP, VAT and Customs controversies or disputes arise, Deloitte's professionals are able to provide assistance with:

- Providing technical and advisory opinions relating to the controversy
- Assisting with drafting and filing objections against the assessments
- Representing businesses at settlement and appeal committees

With our team of controversy specialists, including former Tax and Customs authority inspectors, lawyers, economists and industry specialists, Deloitte can bring the right resources to the issue.

## Contacts

For further information, please get in touch with one of our experts listed below.



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