

# Transfer Pricing

## Legal Alert

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### International: Transfer Pricing - Who Will Remember?\*

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#### Key Points:

- All those within a multi-national enterprise (MNE) group need to work very hard now to build their defences against revenue authority attacks. It is essential for the Tax Risk Manager to remember this time and to record in a forensic way all directly and indirectly relevant events.
- It is predicted that audits of MNE transfer pricing policies, procedures, documentation and particularly outcomes would be stepped up considerably. The Australian Taxation Office's (ATO) focus is almost entirely fixated on the perceived "transfer pricing gap" between reported economic performance and tax payable.
- Even if a parent entity survives these times, it may not be prepared to fund a transfer pricing dispute outside its borders, which might not get before a Court for another 5 to 10 years from the date of issue of an amended assessment. Meanwhile, the disputed tax is accruing interest and penalties.
- There will be major efforts by revenue authorities to ignore (even deny) events and/or challenge the recall of businesses of these circumstances and "read down" their impact on a particular entity.

#### Introduction

The current global economic circumstances have likely generated substantial revenue and capital losses for most businesses, ordinary people and governments. At best, there has been material diminution in current and predicted revenue collections. By way of illustration, in its November 2008 Mid-Year Economic and Fiscal Outlook, Australia's Federal Treasury reported a forecast Budget Deficit because its tax revenues would be AUD40 billion less than when it tabled the 2008-09 Federal Budget in May 2008. In February 2009, the Treasurer issued an Updated Economic and Fiscal Outlook in which he revised, upward that shortfall to AUD115 billion, mainly due to China's reduced demand for Australia's mineral resources. However, in the Australian Federal Budget for 2009 - 2010, the Treasurer announced a forecast deficit of AUD188 billion and total "temporary" debt of AUD315 billion. The order of magnitude of this budget deficit and debt need to be considered in the context of Australia's relative population and GDP. The capacity of the economy to generate wealth and surpluses to service the interest burden will be seriously tested.

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Given this is an unprecedented operating environment creating extraordinary dynamics for most industries, and assuming there will be a recovery and “normalcy” returns, who will remember these events and the years before them? Who will have taken the time to document and record their effect on an individual business or collective industry?

The Budget papers were vague on precise measures which the Australian Taxation Office might be expected to pursue but I expect its response on a transfer pricing front will be "robust".

Why is this relevant? I think history shows that transfer pricing “controversies” take many years to formulate and then play out to a conclusion. In that time, there is a significant reliance upon ascertaining facts and understanding relevant circumstances. In the absence of these, any outcome is likely to be flawed and probably unfair. Both sides must be objective, truthful and accurate, especially if comparability is to be considered.

Regardless of whether you call it a recession, depression, financial crisis, meltdown, collapse of capital markets, or the end of capitalism, I would expect that these events and their pain would be burnt into the corporate and personal consciousness of every free enterprise organization or individual and should be squarely on the agenda of every Audit Committee and Tax Risk Manager. However, unfortunately I am not confident that this will be the case.

While the Board of Directors and senior management of many companies are focused on corporate and personal survival strategies and actions, it would be easy (but unacceptable) for Audit Committees to allow tax risk management to slip off the immediate corporate radar and into the “do it later category”.

Now is the time to make clear, accurate and detailed records of the state of affairs of the company, the operating environment in which it is carrying on business and the dynamics of its immediate and related industry. In my view, all taxpayers, but in particular those within a multi-national enterprise (MNE) group need to work very hard now to build their defences against revenue authority attacks. It is essential for the Tax Risk Manager to remember this time and to record in a forensic way all directly and indirectly relevant events. Given that the burden of proof almost always lies with the taxpayer, the records need to be able to be:

- of impeccable quality;
- stored for several years; and
- readily retrievable.

In circumstances (e.g. in Australia) where there is an alleged tax shortfall arising out of an audit adjustment, the administrative penalties likely to be imposed are very high (up to 75%) and (whilst potentially subject to remission) are capable of materially altering the equation, i.e. fight or settle.

Who else other than the Audit Committee and Directors will have the interest or responsibility to remember?

## **Current Position**

In the non-communist world, governments have not been required to play such an interventionist role in the affairs of their key institutions or in the lives of their citizens since the Great Depression (1929 to 1935, which too had its genesis in the United States), or the rebuilding programs undertaken at the end of World War I (1914 to 1918) and World War II (1939 to 1945). As then, we have witnessed the total collapse of some institutions, real or virtual involuntary nationalizations of others and the future global financial power changing to Asia, the current holders of large scale investments in, among others, United States (US) Treasury Bonds and securities. All this is taking place in one form or another to save capitalism as we currently understand it, because the wisdom is that the alternative is unthinkable.

Taxpayers globally, justifiably, have a right to expect that the collective trillions of their funds that have already been applied and/or pledged in various bailouts, rescue programs and stimulus packages will be recovered and repaid to their National purse in the near term. Whether this is realistic within a modest number of years is arguable. Most likely this will never occur in full. In some countries, the demography of their taxpayer base may result in this never happening, such that they will remain creditor states forever, probably altering the structure of their economies permanently. It is clear that the next two generations of citizens will be left a nasty legacy in any event.

In the current environment, including that of the rapidly escalating number of unemployed and underemployed workers, drastically eroding pension and superannuation entitlements, and diminution of personal wealth through crumbling asset values, Governments appear to have limited short-term tools at their disposal so as to stop the bleeding, other than to provide support and “invent” jobs. Governments know their economies and subjects are too vulnerable to withstand near term increases in the marginal tax rates or to expand the tax base (including by direct and indirect measures) or introduce new asset-based taxes designed to capture, cynically, the upside when asset values rise again. Consumption taxes require spending. Income taxes require people to be gainfully employed and occupied and businesses to be profitable.

## Expected Fiscal Response

So, in the short to medium term (I estimate for at least the next 10 years) and beyond, I anticipate that all governments will be directing their revenue agencies to assiduously monitor the causation and growth in personal and corporate tax losses (e.g. arising from unprofitable businesses and/or losses on disposals of capital assets) and to use whatever means are at their disposal to increase their challenge of claims for deduction of those losses against later year revenues. In my view, a substantial part of that effort will include challenges by revenue authorities to the “outcomes” of international related party transactions reported by multi-national enterprises (MNE’s). This will take the form of either or both, reliance upon the “Associated Enterprise” and/or the “Business Profits” provisions of various tax treaties or where there is no relevant tax treaty in force, the provisions of domestic legislation to attack the “consideration” paid or received in respect international related party transactions. I predict that revenue authorities might be motivated to initially rely on then current, rather than economic data contemporaneous with the audit period.

In short, audits of MNE transfer pricing policies, procedures, documentation and particularly outcomes would be stepped up considerably. The fact is that regardless of the level (read “quality”) of transfer pricing documentation, the Australian Taxation Office’s (ATO) focus is almost entirely fixated on the perceived “transfer pricing gap” between reported economic performance and tax payable.

In particular, heavy challenges should be expected from revenue authorities with respect to payments or receipts by MNE’s of:

- interest, directly or via thin capitalization rules;
- service fees;
- management fees;
- royalties;
- consideration for access to other intellectual property;
- consideration for marketing intangibles; and
- consideration for transfers (acquisition or supply) of tangible goods, including the price paid as sale or procurement commissions, discounts and rebates, including freight rates.

Although there is little tested authority for it, the ATO has recently made it clear that it believes it has the ability to re-characterize as equity certain loan arrangements. This is also an area of potential threat for MNE's as are many of their restructuring and financing arrangements.

It has always been populist for governments to publicly "beat up" MNE's over their transfer pricing strategies and apparent low levels of profitability and/or to claim that any transfer of functions, assets and risks out of (say Australia) to benefit from "location savings" equates to deliberate profit shifting with little economic substance. In my experience sophisticated MNE's, observing good corporate governance and tax risk management principles have, in the main, also paid careful attention to these "noises", and traditionally taken thoughtful advice, developed and documented their strategies well, including so as to have a reasonably arguable position for their stance. Believing their position to be correct, they have vigorously defended challenges by revenue authorities, if only to protect the position in the counter-party country. The usual result has been many years of audit, disputed position papers, and issue of amended assessments followed by long periods of uncertainty and litigation some of which may be funded by a foreign parent in the MNE group. It may be different now as many parent companies are themselves under siege and may be unable to fund any tax dispute, let alone one that is in a very remote part of their global reach and which represents, usually a very small portion of the MNE's global turnover and profitability. Simply put, even if a parent entity survives these times it may not be prepared to fund a transfer pricing dispute outside its borders which might not get before a Court for another 5 to 10 years from the date of issue of an amended assessment. Meanwhile, the disputed tax is accruing interest and penalties.

The ATO has not signaled any let up in its pursuit of those entities in its 'Large Business and International' (LBI) market segment (entities with turnovers above AUD 250 million). Accordingly, the LBI segment must continue to be very vigilant, especially as the ATO perceives that they have the necessary resources to perform this analysis.

The ATO made its intention clear recently with respect to small and medium enterprise (SME) taxpayers (namely those with turnovers up to AUD 250 million) when it announced a major project over the 4 years (2009-2012). By capitalising on a new improved 'risk/search engine' and using increased and more sophisticated audit tools and analysis techniques the ATO expects to collect a further AUD 5.7 billion from increased auditing of the SME segment.

To some extent, reliance may be placed upon an in situ Advanced Pricing Arrangement (APA). I seriously doubt that the settled critical assumptions would have anticipated the present conditions. Accordingly, there may be a case for the APA to be suspended, renegotiated or cancelled. Clearly, it would be prudent for the "early warning" provisions to have been activated so the ATO is aware in advance of potential "bad news".

In addition, the ATO is endeavoring to encourage companies to enter into a Private Binding Ruling (PBR) or a Forward Compliance Arrangements (FCA) and/or Annual Compliance Arrangements (ACA), in part as a means to avoid this heavy audit focus and minimize its own resource allocation, but also because the aim is to give the ATO a "real time" snapshot of large corporate tax activities. The alleged benefit to a corporate is "tax certainty". However, in my view, the PBR, FCA and ACA products tend to focus on a specific set of transactions (e.g. goods and services tax) or a finite amount of taxable income and are inappropriate in the transfer pricing context where substantial and reasonable judgment is required.

## **The Need to Document**

From what I trust will become evident, the need for MNE's to document their transfer pricing position has never been more important. The optimum threshold level of documentation has increased.

Whilst it is well understood and recognized that transfer pricing documentation of itself will not preclude an adjustment, if that were necessary, it should hold taxpayers in good stead to negotiate for substantial if not full remission of penalties. That should be a major motivating factor.

Who will remember and contextualize the primary drivers of this state of affairs, such as the massive accumulation, collateralization, sale and insurance of “zombie” US housing loans and their subsequent failure culminating in, among others:

- bankrupt nations;
- collapsed equity markets;
- plunging and volatile commodity markets;
- countless countries with static or negative rates of GDP (China excluded);
- the withdrawal and retreat of finance and credit facilitators;
- United Kingdom (UK) interest rates at 315 year lows;
- interest rates in Japan and the US at virtually zero;
- insurers with unfunded and/or under-reserved liabilities facing diminished income and investment profit streams and declining or flat premium income;
- recapitalized and virtually nationalized banks in the UK, US, Ireland, Iceland, etc;
- seriously insolvent Eastern European banks and economies having a material drag effect on major European banks; and
- international banks, major credit providers and insurers paralysing interbank lending, almost preventing global trade, construction and commerce taking place at any price.

What were the consequences of these facts and their impact on global trade, company balance sheets, cash flows, income statements, asset values and debt covenants? For example, did the fall in the value of underlying security for a loan cause a material breach of covenants sufficient for the lender to call in the loan and/or for it to be reclassified from a non to current liability or will the lender agree that it was an unintended consequence and if so, for how long?

How will a tax authority identify a comparable set of facts and circumstances operating at precisely the same time that this loan was entered into in order to determine an arm’s length rate of interest which it can substitute for the tested party’s rate?

The management of this tax risk would require careful analysis and documentation to ward off an effort to deny entirely or reduce substantially the interest deduction claimed.

Who will articulate the secondary and “knock on” impact broadly and in particular on the MNE? For example, in the above circumstances and at that time it may not be possible to arrange finance with an arm’s length provider therefore, would a comparable arm’s length interest rate be capable of ascertainment?

Who will remember that, less than two years ago there was an actual boom in commodity prices favouring suppliers, China’s economy (Brazil and India’s to a lesser extent) was the global growth engine, global asset values appeared to be on a never ending rise delivering apparent unbounded prosperity and hope, price-earning multiples were at unsustainable levels, and, debt was relatively cheap?

Who will remember that in those “earlier” times, the world was “being held to ransom” over the price of crude oil, resulting in massive transfers of additional wealth to the oil exporting nations, and that derivatives of it (including refined petroleum, aviation fuel, distillate and plastics) were subject to major price escalation and volatility, materially adding to inflation in other nations, resulting in the failure of many forward planning and hedging strategies.

In 2008, for several weeks before mid September, the AUD was trading at almost parity with the USD, having risen progressively through the year. It is now again approximately USD 1: AUD 0.79 having fallen to about 0.61 in late October 2008, which was the level in January 1999. Who has plotted the change and recorded the impact, i.e. short-term cheaper import prices which may or may not have been passed on but increased revenues for our exports impacting demand.

The evaporation of funding sources (especially in the US) for bio-technology and late-stage development pharmaceutical companies has resulted in several of those with promising compounds being unable to complete crucial clinical trials with the result that their promise will never be realized and likely, important new drugs will never be approved for marketing.

All of those events have had an effect, some short-term and beneficial for many businesses. Others have contributed, negatively to their current condition and state of affairs.

Rest assured that the revenue authorities will have access to all the relevant economic information and knowledge, data from lodged tax returns and the traditional databases. Whether they will use it constructively and intelligently in their risk assessment and audit context is open to question. Rather, I would expect that there will be major efforts by revenue authorities to ignore (even deny) events and/or challenge the recall of businesses of these circumstances and “read down” their impact on a particular entity.

Accordingly, the Tax Risk Manager and the Audit Committee will, more than usual, be the keeper of the key to the vault of corporate and global data about the particular and general effects of these times on the entity. What is perhaps different currently is the nature and volume of data which needs to be accessed, assimilated and retained.

## Likely Data Sources

So where might the source of some of this material relating to the operating environment come from? Clearly, the facts and circumstances of every country and company are different. However, the following might provide some useful macro-economic starting points:

- Reports and analysis by international agencies such as the Bank of England, US Federal Reserve, Reserve Bank of Australia, OECD, International Monetary Fund, World Bank, United Nations, briefing papers and communiqués of the G8 and G20 meetings, Organization of the Petroleum Exporting Countries, US Congressional and Senate inquiries; US Internal Revenue Service reports, national GDP rate reports, and analysis by independent global economic “think tanks”.
- Studies of the movements in and performance of foreign currencies generally and with particular reference to the company in question.
- Analysis of the performance by and trends of companies listed on the major stock exchanges of the world.
- Analysis of the performance and trends of global and local commodity and futures markets and the reports of monitoring agencies (e.g. Australia’s Bureau of Agricultural Resource Economics).

- Domestic assessments of Federal Budgetary positions as likely contained in Australia's Budget Papers and Treasury Estimates, Australian Bureau of Statistics analysis, Senate Estimates Committee reports, submissions to Government for assistance to particular industry and Reports by the Productivity Commission (such as the future of the automotive sector in Australia), Annual Reports by the Commissioner of Taxation, Explanatory Memoranda of Bills for an Act of Parliament, etc.
- Analysis and reports by the various industry bodies such as the Australian Industry Group, Medicines Australia, industry data collected by various database providers (e.g. IBISWorld and VFact), submissions to Government by various professional bodies (e.g. Taxation Institute of Australia), etc.
- Performance and benchmarking data assembled by the various international database providers including Bureau van Dijk, Standard & Poor's, Thomson and the ATO through its Taxation Statistics series.

Apart from identifying and recording the facts and implications of the foregoing matters, I believe there are other macro economic factors which have influenced global activities, markets and consumer sentiment and behavior, each of which directly or indirectly need to be considered in a transfer pricing context, at least for their impact on margins. That is, MNE's, by definition operate globally and therefore are not immune to one or other of the following market and "societal" influences:

- National political issues including the impact of changes in governments (e.g. Australia, France, Germany, New Zealand, Pakistan and the US) and changes in national leaders (e.g. Israel, Italy, Japan and the UK).
- National physical issues such as hurricanes (e.g. Hurricane Katrina in the US), tsunamis (e.g. the Indian Ocean tsunami), earthquakes (e.g. China's Sichuan Province earthquake), etc.
- National "societal" issues including terrorist attacks and major civil unrest.
- National geo-political issues including changes to laws (e.g. changes to the Australian Industrial Relations and Work Place laws and Occupational Health and Safety Laws), lack of spending on infrastructure causing port and transport capacity constraints, shortages of skilled labour placing upward pressure on wage levels, and the multi-cultural, ageing and shifting population.
- International economic issues including increasing numbers of free trade agreements and emergence of trading blocs, protectionist campaigns, etc.

## Operational Issues

The financial analysis section of the transfer pricing documentation is often not well undertaken or presented. There are many factors which influence that decision. However, in this climate, the threats to corporate memory are significant and there would appear to be a strong present need to develop and record reasons for, amongst others, changes in:

- sales/purchases volumes;
- unit sales/purchase prices;
- customer/supplier mix;
- terms and conditions of trade;
- competition;
- gross and operating margins;

- cash flow and funding options;
- levels of particular or key operating expenses (e.g. labour, general and administration costs, occupancy, research and development, etc.); and
- levels of interaction (if any) with government and its bureaucracy.

It is important that the key business drivers be identified and analyzed, especially so when the MNE is a multi-faceted business with different lines of business units and divisions, the results of which are all consolidated into a single corporate result.

Retrieval of this data when the MNE is under audit or other pressures is not ideal.

## Changed Fundamentals

If the fundamental basis for determining the economic worth, value or consideration for performance of a function (e.g. manufacturing or distribution) or the provision of a service (e.g. commissionaire and/or commission agent) is to have regard respectively, for the functions, assets and risks undertaken, deployed and assumed by the provider, then arguably nothing has changed. Until now there probably was a minimum (but relatively quite high) level of gross margin which a provider would likely accept. That market was fuelled by a powering global economy. However, facts and circumstances have changed. Many asset values have deteriorated, cost of capital and debt has risen and business risk profiles have been realigned. In the current circumstances it is likely that some arm's length parties, due to pressure from stressed customers may be willing to accept, voluntarily or otherwise, less margin, even losses to stay in business, service, retain or grow market share. This may be a temporary position taken in the hope that the circumstances will reverse in the short to medium term. However, if these are "seismic" shifts in market pricing, gross and net margins may well become lower. A new arm's length range might be established or at least, the lower quartile band may be reduced. Consequently, there may well be a very real need to review and refresh the prior year comparability analysis at the same time as the current year's review. At least arguments need to be developed for the possible excision or exclusion of some otherwise "accepted" comparables and the inclusion of others.

In these circumstances, who will remember the facts of a particular related parties' transfer price setting strategy and from where the comparables were derived (if at all)? Most importantly who will remember, if the margins are not reduced, why this was so.

As has always been the case, it would not be difficult for a determined revenue authority to go into the market place and ascertain general current market conditions, rates and trends from which it would hope to "construct" an arm's length consideration or a level of profit which, were it not for a special relationship, might have been achieved.

Equally, the MNE has the facts and incentive to establish its position and where necessary take appropriate action to bring the results within the arm's length range.

## Conclusion

Unquestionably, it is more difficult currently to dedicate scarce resources to transfer pricing and to thinking about what might be around the corner. Clearly, it would be easier not to have to engage with the subject, and it may be that a return on this "investment" is never called in. However, the holder of all the relevant information can only be in the preferred position should a revenue authority question arise. Remember that it may be that the "payback" comes from the ability of being able to protect a foreign parent.

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Stephen heads the Australian transfer pricing practice at Baker & McKenzie.

From 1977 to 2001, he was a tax partner at KPMG in Sydney. Stephen has a particular focus on international transfer pricing, tax audit management, advanced pricing arrangements, corporate tax advice and due diligence for mergers, acquisitions and divestments.

Between 2001 and 2004 and 2007 to 2009, he operated his own accounting practice providing transfer pricing, corporate tax and management advice to Australian and foreign controlled multi-national, listed companies and SME's.

In the intervening years, Stephen was with Baker & McKenzie heading up its transfer pricing practice and has recently returned to the firm in that role again.

Stephen has provided transfer pricing advice to a wide range of industries including pharmaceuticals, bio-tech, chemicals, motor vehicles, mining/oil and gas, property and construction, software, banking and financial services and electrical manufacturing.