
Transfer pricing audits

Three things that can keep you out of trouble



“Victorious warriors win first and then go to war, while defeated warriors go to war first and then seek to win” – Sun Tzu, The Art of War

By Seun Adu

Last week the Central Bank of Nigeria (CBN) reported that Government revenues had dropped by 53% in May. This report is important for taxpayers considering the fact that the Government is looking more and more to tax as a means of bridging its revenue deficits.

An equally important piece of information that may not have made the news last week is the fact that the Federal Inland Revenue Service (FIRS) has ramped up the pace on Transfer Pricing (TP) audits. More companies are being scheduled for TP audits.

Here are three issues that companies need to remember when preparing for TP audits.

Have a strategy

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The following sums up the tax audit approach for many companies:

Company gets tax audit notification letter.
Company agrees field work date with FIRS. FIRS comes in, audits, and goes away. Several weeks after, company receives a huge tax assessment. Company fights the assessment. Company gets stuck. Company calls for help.

Hardly any thought is given to a strategy before the audit starts. Even though this approach can still give acceptable results during traditional tax audits, it is likely to result in an avoidable adverse outcome in a transfer pricing audit.

You significantly increase your chances of success during a TP audit when you consciously work out a strategy before the audit starts. Your strategy will help you get answers to questions like: what



will be the likely issues during the audit? In what areas is the company most vulnerable? What are the key risk areas? What can I do to manage the risks? What documentation do I need to prove my case? What documentation do I have? What issues are too complex and may lead to confusion? In what areas does the company appear to have erred? Are there valid reasons? What points am I willing to concede on? What will be the impact of any concessions on future periods? If I have to negotiate, on what principles will I negotiate? How much money is at risk? Are there opportunities for corresponding adjustments? Is the company willing to go as far as the tribunals or courts on certain issues? What pitfalls does the company need to avoid during the audit? What are the complex areas and how will they be viewed by a lay man?

Planning plays a much more important role during TP audits than traditional audits. Many companies assume that because they set their prices with the best intentions (and without any profit shifting motives), they will be fine during the TP audit. This is hardly ever the case. Very often, what counts is what you can prove.

With the right strategy, you can win many of your fights long before you get the FIRS audit notification letter; long before their search light turns your way.

When you can; use the K.I.S.S. principle

“It is difficult to get a man to understand something, when his salary depends on his not understanding it” – Upton Sinclair

Like it or not, the FIRS has an incentive to not believe or understand your arguments during an audit. It is the reality and chances are you would act the same if the roles were reversed. This notwithstanding, there are many tax officers who make an effort to be objective. When you find these ones, you need to avoid making the work too complex. Making things simple can help

Researchers Nibert Schwarz et al were able to demonstrate that information that is easy to process is more likely to be accepted as true but there is a lot more scrutiny when information is difficult to process. Companies can leverage on this knowledge when putting together their defence. TP issues can be complex and it will take some effort to simplify them.

I have seen first-hand how simplicity can break deadlocks during tax audits. Sometime ago we got involved in helping a client deal with a tax audit which had dragged for nearly two years. From the correspondence that had been exchanged with the FIRS, the company presented the FIRS with a lot of technical details and arguments to support their position. Although fairly accurate, the complex technical defence had done very little to convince the FIRS. We reviewed the issues and came up with one simple analogy that explained the company’s case in a way that anyone could relate to and once it was clear to the FIRS the issue was dropped. That is the power of simplicity.

KISS stands for Keep It Simple; Stupid! It is counter intuitive and can be a hard thing to do; but more often than not, the payoff is huge.

Recognise that not giving information is no longer a strategy

“He that hides, can find” – French proverb

About two years ago I was given the task of purchasing a woven basket for my engagement ceremony. I found a famous market and got talking with one of the shop owners.

Unfortunately he would only be able to supply the specification I wanted in another five hours. I got his number and “*flashed*” him so he could call me when he had the right basket. He was shocked when I could mention his full names after dialling his number. Apparently, he had never heard about the “truecaller app”. I still get this reaction sometimes when I surprise the uninitiated with the capabilities of “truecaller”. This is the world we live in today. If one or two people have a piece

of information; chances are the whole world can get that information.

Concealing information is no longer a winning strategy. The FIRS has gotten much better at double checking and comparing information from different sources. I know companies that (wrongly or rightly) have gotten TP assessments because the FIRS compared information from within and outside the company. There are often multiple sources of information; and the FIRS is using them.

For cross-border transactions, the age old excuse that the required information is with or relates to a company outside Nigeria and is therefore not accessible is no longer tenable. There are many subscription databases where some of the information can easily be checked by the FIRS. Then you have the BEPS efforts around transparency. I recall leaders in the FIRS' TP team complaining about the unwillingness of companies to provide them with their global TP policies when the requests were first made a few years ago. Since the revised OECD guidelines now require groups to prepare Masterfile documentation for the head office, companies like this will no longer have an excuse. There is also Country by Country (CbC) reporting rules that will compel certain groups to disclose information on their global operations which could then be accessible to the tax authorities in

the jurisdictions where they operate. Nigeria has also signed multilateral agreements that can help the FIRS get information on taxpayers from foreign tax authorities. Again, there are multiple sources of information; and the FIRS is using them. Even if the FIRS does not make use of any of these sources, the current mind-set is that companies should be able to provide the information and if you are not doing so; it is because you have something to hide.

This is the bottom line. Hiding or refusing to provide information is unlikely to get you very far. That strategy is on a sick bed. It is in its final days.

Conclusion

The TP audit is different from the traditional tax audit in many ways. A good starting point when managing TP audits is to realise that the techniques that have worked for traditional tax audits will not necessarily work for TP audits.

We have discussed three important points to consider during TP audits. While there are many more issues to consider, these three are a good place to start.

At our next Tax Academy on Tuesday 16 August, we will be discussing these and many other TP audit issues in more detail.

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