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Reputational risk facing multinational enterprises emanating from transfer pricing practices

In all the publicized cases where the tax strategies of multinational companies have been called into question, transfer pricing is usually presented as the main culprit. The allegations are typically that these multinational companies have shifted profits (using transfer mispricing) from the countries where the business revenues are generated(and therefore avoided tax) to other countries where they will pay little or no tax..

What is it all about?

A business typically faces many risks. A risk is the probability that the actual outcome adversely differs from the expected outcome. Today's businesses face a number of risks. These include those which they can control (internal risks) as well as those which they have little control over (external risks). Some of the more difficult risks to control include political, environmental, macroeconomic risks, natural disasters etc.

There are other risks which a business can influence. One of these is reputational risk. Reputational risk is the risk that a business will lose revenue or incur significant costs as a result of damages to its public image. Although product and service faults are the more common sources of reputational risk, there is another source of reputational risk that has gained prominence in recent times. This is the reputational risk that comes from the public's perception of the appropriateness or fairness of a company's tax practices.

Big corporations are facing enquiries on their tax practices in several parts of the world. In these enquiries, the multinationals are often presented as making use of unfair tax practices. Even though for many of them, the tax practices are not illegal, the publicity associated with these hearings is a source of concern for the organisations. The negative publicity associated with these hearings tends to have an impact on the public's perception of the companies, their brand and the products they offer. There have been cases of decreased patronage in the aftermath of a public hearing or media report. Interestingly, this type of reaction is no longer limited to developed countries. On a recent trip to Uganda, a man told me he has vowed not to buy products of a certain company as he believes it does not pay its fair share of taxes in the country. These and many similar reactions are not isolated and provide a clear indication that reputational risk - arising from tax strategies - traditionally considered more important in the developed world is becoming just as important in Africa.

Declining tax revenues from traditional sources

Most oil producing economies are feeling the pinch of plummeting oil prices. Faced with widening budget deficits, they are desperate for ways to close the gaps. These governments are looking to taxes (specifically taxes from non-oil sources) to solve this problem. This is also the story in Nigeria. Taxes from oil and gas sources have always surpassed non-oil tax revenues in Nigeria. In 2014, oil tax revenues accounted for 56% of the total tax revenues. Nigeria's export earnings from crude oil in 2014 dropped by 13% from the $89 billion (about N19 trillion) it recorded in 2013 to $77 billion (about N16 trillion).The oil revenue figures will even be lower in 2015 given that average crude oil prices have dropped further since the beginning of the year.

Nigeria's tax revenues to rebased GDP ratio is about 8%, which is low compared to the benchmark of about 25%. This is an indication that there is a lot of economic activities which either escape tax illegally or is not being taxed sufficiently. The current feeling within both the state and federal tax authorities is that most taxable entities do not pay the right amount of taxes. With this renewed focus on taxation as a source of funding public goods and services, companies who are perceived as not contributing their fair share of taxes face not only increased compliance risks but also reputational risks.

How does transfer pricing come in?

In all the publicised cases where the tax strategies of multinational companies have been called into question, transfer pricing is usually presented as the main culprit. The allegations are typically that these multinational have shifted profits (using transfer pricing) from the countries where the business revenues are generated (and therefore avoided tax) to other countries where they will pay little or no tax.

Transfer pricing is a normal business practice that could have major tax implications. A Transfer price is the price that members of multinational groups exchange goods and services with one another. A transfer price can have a significant impact on the profits and hence tax payable by a multinational in any particular country. This is because the transfer price will generally impact the revenues or costs recognised in a particular country. To ensure that multinationals do not arbitrarily determine the amount of profits they will recognise and tax to be paid in a country (by manipulating revenues and costs), many governments have put in place transfer pricing legislation. These laws generally require multinationals to price transactions with related companies in a manner that reflects market conditions and the commercial realities of the transactions.

Interestingly, in many of the instances where the tax and transfer pricing strategies of multinationals have been publicly criticised, there have been no emphatic accusations of wrong doing or tax evasion. The multinationals have not been accused of breaking the law and it would appear many of the arrangements may have successfully scaled the examination of the relevant tax authorities. The accusations seem to be more about the morality and fairness of the tax strategies adopted.

Before now, morality was never considered an important yardstick for assessing the appropriateness of a company's tax practices. The fact that it has now taken a prominent position in the tax debate when it comes to big corporations illustrates a key characteristic of reputational risk: it is not static, it changes with time and trends. According to Havard professor Robert G Eccles; the changing beliefs and expectations of stakeholders are a major driver of reputational risk. When expectations are shifting and the company's character stays the same, the reputational risks increase.

Many of the things that were previously considered ethical and acceptable tax practices are now being questioned by the public and other stakeholders. Multinationals who do not adjust to these changing expectations therefore face some degree of reputational risk.

This pressure on multinationals to adopt fairer tax practices is not likely to subside any time soon. Governments around the world are asking multinationals to disclosure more and more information on their tax planning and transfer pricing activities. With increased disclosures, there is also increased reputational risk as the information could be subject to incorrect interpretation particularly from persons who may not be financial or transfer pricing experts.

New developments in the transfer pricing world will soon require multinationals to disclose financial and operational information on a country by country basis. This will include information such as revenues, profits, type of business, number of people etc. in each country of operation.

The Federal Inland Revenue Service (FIRS) and other regulators are closely following the developments in the global space. This has led to the introduction of new regulations (e.g. the Nigerian Transfer Pricing Regulations and the Nigerian Stock Exchange Rules on Interested Party Transactions) and it is likely that we will continue to see more of these global initiatives reflected in the local laws in the near future. This will also increase compliance and reputational risks for multinationals operating in Nigeria.

How do you manage this reputation risk?

Risk can never be completely eliminated but can be managed. It is inevitable that transfer pricing practices of most multinationals will come under the spotlight given the impression that they shift profits to low tax jurisdictions. Such publicity, even when unfounded and ultimately proven incorrect, could be harmful to the reputation of the company and affect its brand and image. A good first step will be to ensure that the company is fully compliant with the requirements of relevant transfer pricing laws. A thorough transfer pricing review and analysis should be performed. This should be backed up with sufficient transfer pricing documentation to demonstrate the appropriateness of the company's transfer pricing practices.

The company will need to strike a balance between the financial gains from implementing aggressive tax planning and transfer pricing strategies and any potential losses that could arise from any reputational damage that may happen as a result.

There is also a need for adequate engagement and communication with all stakeholders to ensure the company's activities are not misunderstood. This is particularly important for listed companies. In fact with the introduction of the Nigerian Stock Exchange's (NSE) Rules on Interested Party Transactions, it has now become a compliance requirement for listed entities to engage their shareholders on their transfer pricing arrangements. The rules require listed companies to make certain disclosures and seek approval from their minority shareholders on their transfer pricing arrangements. Without proper engagement and communication, this process could prove to be challenging.

You need to tell your transfer pricing story to your stakeholders (the tax authorities, regulators, shareholders, the general public etc) in a language that they will understand otherwise they will write the wrong story for you. We all know the risk that comes with the latter.

For further insights, please visit www.pwc.com/taxfunctionofthefuture

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