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"Smaller" multinational enterprises & transfer pricing

How saving $20K nearly cost this taxpayer $2.7 million!

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It seems that every day now there is an article of some sort addressing aggressive tax structures, often utilizing offshore entities, and the ramifications of (implied) inappropriate, underlying transfer pricing policies. Recently, this has clearly been due to the news of the "Panama Papers" disclosure or, more generally over the past couple of years, the result of the recently finalized Base Erosion and Profit Shifting Project reforms published by the Organisation for Economic Co-operation and Development.

These articles have tended to focus on very large multinational enterprises (obviously, talking about hundreds of millions of tax dollars tends to be more newsworthy and eye-catching). This targeted focus has, perhaps, given many "smaller" multinational enterprises (and, in instances, their professional advisors) the false impression that they do not have to worry much about their cross-border-related party transfer pricing policies. This is clearly not the case in our experience, which we believe the following client scenario demonstrates.

Transfer pricing legislation was introduced in Canada in 1998. Over the past 18 years we have been told by many taxpayers (and some of their professional advisors) that transfer pricing was not a concern of theirs since they have not been audited in many years. Unfortunately, those clients of ours who have undergone lengthy and costly transfer pricing audits are, for obvious reasons, not looking to volunteer to speak with our potential and/or current clients who have not (yet) been audited.

The following client scenario has been significantly abbreviated, yet is still intentionally lengthy due to all the complexities that arose during the course of the audit. It demonstrates why ***transfer pricing audits can become very time-consuming and costly***, especially when supporting documentation is not prepared in advance.

Numbers overview:

An overview via key numbers:

- **4 Years** – Length of entire CRA audit and subsequent Appeals process
- **5 Mistakes** – Taxpayer's decisional errors negatively impacting the audit process
- **$20K** – Approximate cost to have done proper documentation upfront
- **$170K** – Cost to dispute the reassessment including preparing proper documentation
- **$2.7 million** – Taxes* originally reassessed
- **$200K** – Taxes* ultimately reassessed
- **$2.5 million** – Reduction in taxes* reassessed based on negotiated settlement
  ** Approximate, including penalties and interest at daily compounded prescribed rates*

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Transaction under audit:

During the 2006 and 2007 years the taxpayer had various cross-border-related party transactions between the U.S.-based parent company ("USco") and the wholly-owned Canadian-based subsidiary company ("Canco"), (collectively, the "Group"). Specifically, one of the more significant transactions was a procurement fee charged by USco to Canco, which was approximately $2.0 million per year. The procurement fee was charged on a percentage-of-cost-of-goods-procured basis.

The nature of the transaction appeared reasonable given that USco, in conjunction with its China-based branch office, handled all matters with respect to procuring goods for itself, as well as Canco. The percentage-based fee appeared reasonable given that USco possessed various unique intangibles related to its procurement activities (i.e. it was not just a routine service that should have been compensated on a simple cost-plus basis, which would have resulted in a significantly lower intercompany charge).

Taxpayer mistake #1 – No planning documentation

Prior to our firm's engagement, the owners and management team (the "Original Team") in place during the 2006 and 2007 years made the decision that it was not necessary from a planning perspective to put the legislatively required supporting contemporaneous transfer pricing documentation in place. Apparently, their sentiment was that they had significant years of industry experience amongst themselves, and ***they thought they "could just easily explain things" to the tax authorities*** if they were ever audited.

Taking such a position never leads to a positive audit outcome in our experience. Even if no material reassessment is ever raised by the tax authorities, it still results in a much more time-consuming and costly audit since there are typically many more queries issued and documents requested by the auditor.

Taxpayer mistake #2 – No historical documentation

At the end of 2007, the Group was then sold to another U.S.-based company. As with many such purchase/sale transactions, there were many personnel changes at the management level throughout the Group. Therefore, combined with the natural attrition of personnel over the years, it left very few original management level personnel in the Group who were familiar with the years and transactions under audit. The new owners and management team (the "Second Team") oversaw matters from this point onwards.

As is the norm with such purchase/sale transactions, the Original Team signed an indemnity agreement which made it responsible for any historical pre-disposition tax exposures. Again, still prior to our firm's involvement, the Second Team apparently made the decision that it was not necessary to put any supporting transfer pricing documentation in place for these pre-acquisition historical years. Apparently, the sentiment was that ***since they had the indemnity in place, they thought it was not their responsibility or concern.***

Taxpayer mistake #3 – Handled the CRA transfer pricing audit themselves

In January 2012, still prior to our firm's involvement, the Canada Revenue Agency ("CRA") initiated a transfer pricing audit. The Second Team ***made the decision that they would handle the CRA audit themselves*** and, following the sentiment of the Original Team, felt they "could just easily explain things" to the tax

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auditors. Long story short, this did not work out well, and generally never does if a management team does not have supporting documentation in place and also does not possess significant transfer pricing dispute resolution experience.

In April 2012, the result of the audit was that the procurement fees were denied 100 per cent in each of the 2006 and 2007 years, since the Second Team was not able to support the justification for the procurement service fee nor the nature of the percentage-based fee charged. This led to taxes (at approximately 34 per cent in those years!) and penalties owing of approximately $2.0 million. *Note: If the reassessment was not eventually overturned, with corresponding penalties and interest (compounded daily at the prescribed rate in the range of 7-9 per cent in those years) to the current time it would have equated to approximately $2.7 million.*

Taxpayer mistake #4 – Missed competent authority notification deadline

In July 2012, the Second Team then finally realized that they needed some professional assistance in order to deal with the reassessment. Our firm was then engaged (only a week before the deadline!), but only to submit the Notices of Objection, which needed to be filed within 90 days of the Notices of Reassessment. The objection was filed on the basis that a comprehensive transfer pricing study would be completed and submitted to support the procurement fee charges.

Although the Notices of Objection were acknowledged as having been received by the CRA's Appeals Department in a timely fashion, the department indicated that the file had yet to be assigned to an Appeals Officer. This process generally takes a fair bit of time, and thus, perhaps, it gave the Second Team some unjustified comfort that they could take their time in deciding how they were going to deal with getting the comprehensive transfer pricing study completed.

In October 2012, our firm was finally requested to provide a fee estimate to the Second Team for preparing the transfer pricing study and handling the Appeals process. As part of our fee estimate we addressed the recommended filing of Competent Authority Notifications to the USA and Canadian Competent Authorities, stressing that for the 2006 year it was due by Dec. 31, 2012 (i.e. due within six years from the end of the tax year). Briefly, these notifications are required so that if the taxpayer does not achieve the result they were hoping for through the unilateral Appeals process, then they could pursue the matter through the bilateral Competent Authority process (i.e. effectively, a process wherein the IRS and CRA try and resolve the double tax issue).

In the interest of trying to save a few thousand dollars in professional fees, the Second Team sought out competitive bids for the transfer pricing study. These competitive bids all ended up being higher than our fee estimate (not to mention failing to even raise the Competent Authority Notifications requirement), and thus our firm was finally engaged in late January 2013.

However, ***by this time the 2006 Competent Authority Notification deadline had been missed.*** Therefore, given that the transaction in 2006 represented half of the total amount reassessed, the Second Team's desire to save a few thousand dollars had effectively set them up for a potential million-dollar-plus tax exposure, since they would not likely be able to obtain double tax relief for 2006 (based on our firm's recent experiences, as well as those of various tax lawyers we consulted with).

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Taxpayer mistake #5 – No historical record retention

In February 2013, we initiated the process of completing a comprehensive supporting transfer pricing study. The study ultimately contained a detailed assessment of the functions performed, risks assumed and assets utilized by the parties to the procurement transaction, as well as the results of an extensive third party procurement fee agreement search and assessment.

However, this process was ***significantly complicated*** given the lack of original management level personnel still employed (as previously mentioned), but also ***due to the lack of proper retention of historical financial records***. As noted earlier, the Group was sold at the end of 2007. Unfortunately, the transfer and storage of historical records was not handled very effectively. The original accounting software to access the historical financial records was no longer being utilized, and hence even when electronic records were located they could not be easily accessed. Further, many hardcopy records were not able to be located. It should be noted that the CRA generally requires taxpayers to maintain all financial records for six years after the tax year.

Appeals – Study submission

In May 2013, we were able to finalize the transfer pricing study and were ready to submit it to the Appeals Department. However, since the file had still yet to be assigned to an Appeals Officer we just had to wait; and wait we did.

In July 2014, two years after filing the Notices of Objection, the file was finally assigned to an Appeals Officer. The long wait apparently had to do with the volume of matters before the Appeals Department but also that, given the nature and magnitude of the transactions, the file apparently had to be assigned to an Appeals Officer of a particular grade/experience level.

In August 2014, just one month later, the assigned Appeals Officer simply assigned the file back to the Audit Division. This was apparently their standard protocol since the original Field Auditor had obviously never seen the study (or any other supporting documentation for that matter). The unfortunate part was that the original Field Auditor was not able to be reassigned to the file, apparently due to a realignment of auditors within the regions, so we were starting fresh with a new auditor who had no history on the matter.

Appeals process

Note – There were numerous complexities that arose during the Appeals process. The following has been significantly abbreviated for this article, with only the most significant key events highlighted.

In May 2015, after nine more months, we finally received the first queries from the newly assigned Field Auditor. The queries were largely factual, with the auditor simply trying to understand granular financial facts. We spent the next month working with our client in order to respond to these queries. Unfortunately, this was a difficult exercise for the reasons mentioned earlier with respect to there no longer being any original management level personnel familiar with the years under audit and the lack of access to complete historical financial records.

In October 2015, we received additional final queries focusing heavily on two key issues, as follows: (i) nature of unique intangibles related to the procurement services being provided to justify the percentage-of-cost-of-goods-procured based fee, and (ii) rationale for our set of comparable third party procurement agreements. Briefly, we needed to fully elaborate on the related procurement intangibles that USco and its China-based branch office had developed over the years, as well as to emphasize that

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our set of comparable benchmarks were directionally reflective of an appropriate procurement rate. The benchmarks were appropriate, notwithstanding that there were minor differences in the terms and conditions of the related party arrangement versus the third party agreements (i.e. there is never a "perfect comparable," and oftentimes it is not possible to, pragmatically and cost effectively, obtain the necessary information on the third party agreements to make accurate adjustments to account for these minor contractual differences).

It should be noted that the situation took another interesting turn during the course of the Appeals process when the Group was sold, yet again, to another U.S.-based company. As before, senior level management changed (including the vice president of taxation with whom we had been working closely over the past year or so), historical records became even more remote to current management and another indemnity agreement came into play. The new owners and management team (the "Third Team") was obviously mystified how this matter had been going on for so long and clearly ***happy that we were involved as we were the only constant in the equation.***

Appeals resolution

In February 2016, the Audit Division provided their opinion to the Appeals Department.

In April 2016, nearly four years after the Notices of Objection were filed, we were finally able to meet with the Appeals Officer and Appeals Team Leader to negotiate a final settlement. Although this meeting was lengthy and recounted numerous economic arguments previously raised with the Audit Division auditor, the Appeals Officer and Team Leader were (fortunately) most understanding and pragmatic in their settlement approach.

The final settlement resulted in taxes, interest and penalties of only $200K, a savings of $2.5 million from the $2.7 million that would otherwise have been due. Although we felt that there should have been no final partial reassessment, with all of the above issues considered, it was necessary to accept some concessions to finally bring the matter to a close after four years. This was a relief for the Third Team and the Second Team, largely due to the indemnities in place. However, this was ultimately a huge relief to the Original Team since they were the ones ultimately liable for the amounts owing.

Lessons to be learned:

- Taxpayers should put the legislatively required planning transfer pricing documentation in place upfront;
- Taxpayers should put historical transfer pricing documentation in place if it is identified that the proper planning documentation was not originally done;
- Taxpayers should obtain the necessary professional transfer pricing assistance (i.e. not just a tax generalist) in the course of a CRA transfer pricing audit; and
- Taxpayers should ensure to adequately maintain their books and records for the required six years.

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