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Manager
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The Treasury
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Dear Manager,

Submission to the Modernisation of Transfer Pricing Rules Exposure Draft

As a management academic who teaches corporate governance and business ethics at UTS Business School, I fully support the current intention by the Treasury to modernise the Australian transfer pricing rules to reflect and address the issues that have emerged due to the global nature of related-party transactions. For far too long the transfer pricing activities of large commercial entities such as multinational corporations have evaded the scrutiny of, and questions about, their contribution to countries hosting their presence.

This submission will look at the ethics of international transfer pricing to remind such entities that they are not islands that function in isolation. Their operations in Australia go beyond solely supporting their commercial interests but also to positively support wider society as a whole and the interests of other stakeholders in the country.

Ethics of international transfer pricing

In his seminal article, Messaoud Mehafdi[1] states "Unethical transfer pricing behaviour consumes scarce resources, causes costs but does not create value."[2] This is only two-thirds right. Transfer pricing does consume scarce resources and causes costs to host countries that have reduced tax receipts, but transfer pricing behaviour DOES create value for key decision-makers in these commercial entities who seek to maximise profit which has flow-on effects to their own executive remuneration. This perspective is supported by Prem Sikka and Hugh Willmott:

> "…[The] traditional representation of transfer pricing as 'neutral' or as having "no direct effect on the entire company's reported profit" is problematic or, at best, aspirational, as in

[1] Mehafdi, Messaoud (2000) The Ethics of International Transfer Pricing, Journal of Business Ethics, 28: 365-381 http://link.springer.com/article/10.1023%2FA%3A1006353027052 accessed 18th December 2012
[2] Mehafdi (2000: 365)

practice, it can enable companies to report higher earnings to appease stock markets and maximi[s]e executive remuneration, but the loss of tax revenues curtails the ability of the state to provide public goods and alleviate poverty. Faced with corporate resistance some states may assign higher rates of taxes to wages, consumption, savings and less mobile capital, which in turn can breed resentment and undermine the social legitimacy of the state. Thus transfer pricing is at the heart of the debates about legitimacy of the state, social responsibility and accountability of corporations."[3]

Transfer pricing is a method that essentially removes money from the public sphere and places it in the hands of the privileged few. The different techniques and use of tax havens[4] reflects the short-term self-interested behaviour of a few that has caused "the detriment of many."[5]Furthermore, transfer pricing causes physical, economic and psychological harms that affect the decision makers, the company's top management and more pressingly, the host countries. Below is Mehafdi's table summarising the consequences of transfer pricing and the harm caused to the recipients of transfer pricing:

Table 1: Consequences and Recipients of Transfer Pricing Harm[6]

Types of possible transfer pricing harm	Transferor (divisional manager)	Transferee (divisional manager)	Company (top management; shareholders)	Host country (tax authority; workforce; environment)
Physical	-wear and tear of division's assets -depletion of inventories	-wear and tear of division's assets -depletion of inventories	-wear and tear of company's assets -depletion of inventories	-depletion of natural finite resources -environmental damage -health hazards to local workforce and wider society
Economic	-loss of return on assets -loss of sales revenue -loss of cash flow -loss market opportunities	-loss of return on assets -loss of sales revenue -loss of cash flow -loss market opportunities	-legitimacy costs -less value created -reduced profits -loss of cash flow -loss of market opportunities	-loss of tax income -loss of subsidies and other investments in FDI -increased national debt -increased poverty
Psychological	-loss of control -loss of self-esteem -loss of trust in transferee and top management	-loss of control -loss of self-esteem -loss of trust in transferee and top management	-tarnished image -loss of control -loss of trust in divisional managers	-feeling of betrayal -loss of trust in TNCs -feeling of domination by 'economic colonialism'

[3] Page 352 in Sikka, Prem and Willmott, Hugh (2010) The dark side of transfer pricing: its role in tax avoidance and wealth retentiveness, Critical Perspectives on Accounting, 21 (4): 342-356 http://www.sciencedirect.com/science/article/pii/S1045235410000481 accessed 18th December 2012

[4] See Drucker, J. (2010) Google 2.4% rate shows how $60B lost to tax loopholes, Bloomberg, 21st October http://www.bloomberg.com/news/2010-10-21/google-2-4-rate-shows-how-60-billion-u-s-revenue-lost-to-tax-loopholes.html accessed 31st October 2012; Butler, B. and Wilkins, G. (2012) How savvy multinationals curb their tax bills, Sydney Morning Herald, November 17 http://www.smh.com.au/business/how-savvy-multinationals-curb-their-tax-bills-20121116-29hhm.html accessed 19th December 2012

[5] Page 255 in Boddy, Clive (2011) The Corporate Psychopaths Theory of the Global Financial Crisis, Journal of Business Ethics 102 (2): 255-259 http://link.springer.com/article/10.1007%2Fs10551-011-0810-4?LI=true accessed 20th December 2012

[6] Mehafdi (2000: 371)

In particular, I would like to emphasise the consequence of transfer pricing harm to the host country as highlighted in Table 1. According to Mehafdi, the physical harm that arises from unethical transfer pricing generally impacts the "depletion of natural finite resources" as the environmental costs of doing business in this country is not being fully paid for by companies that engage in transfer pricing. The second harm – economic – can be pressingly seen in the immediate loss of tax income. The loss of tax income prevents various arms of government from effective provision of services in the areas of health, education, justice and defence amongst others.

Thus, there are two competing ideologies with the economic harm of transfer pricing: the public sector tries to maximise social services with tax receipts; while the private sector seeks to maximise profits by actively seeking to minimise tax through engaging in transfer pricing.

Furthermore, Mehafdi states transfer pricing also contributes to increased poverty of the population which leads to what he terms the psychological harm of transfer pricing. This psychological harm includes a loss of trust and feeling of domination by 'economic colonialism'. To this I would add the loss of the corporation's societal legitimacy which undermines their credibility and social licence to operate. When well-known, highly-regarded corporations enter a host country, there is a hope and belief that they will contribute (as opposed to 'doing evil') to the host by transferring their best practices in services, innovation and talent to the recipient nation.

However, when these corporations are shown to have heavily engaged in transfer pricing, the immediate feeling is that of betrayal, as 'doing evil' manifests itself. Indeed, it is ironic that Google's company philosophy of 'mak[ing] money without doing evil'[7] has unravelled as its ideals have been compromised morally[8] as it dealt with censorship in China but also now with its extensive transfer pricing practices committed not only in Australia, but worldwide.

In a December 13th 2012 article, the UK's Independent newspaper reported Google's executive chairman, Eric Schmidt, as dismissive of the transfer pricing criticisms directed at his company stating this was merely 'capitalism'.[9] What Schmidt conveniently overlooks is that capitalism and market-based systems require effective public sector institutions in order for publicly-listed companies to thrive and flourish[10]. One of Google's founders, Sergey Brin, knows only too well the necessity of an environment that allows commercial freedom to foment and institutions that serve the public's interest and not the interests of a few.[11]

The weaknesses of public sector institutions and corruption in Brin's native Russia continued to be an important obstacle in that country's economic development as it transitioned from a state-based to a

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[7] Google (2012) What We Believe – Ten Things We Know To Be True, Company Philosophy http://www.google.com.au/about/company/philosophy/ accessed 18th December 2012

[8] Brenkert, George G. (2009) Google, Human Rights and Moral Compromise, Journal of Business Ethics, 85 (4): 453-478 http://link.springer.com/article/10.1007%2Fs10551-008-9783-3?LI=true accessed 18th December 2012

[9] Kumar, Nikhil and Wright, Oliver (2012) Google Boss: I'm very proud of our tax avoidance scheme, The Independent, 13th December http://www.independent.co.uk/news/uk/home-news/google-boss-im-very-proud-of-our-tax-avoidance-scheme-8411974.html accessed 18th December

[10] World Bank (2001) World Development Report 2002 – Building Institutions for Markets, Washington DC: World Bank Group. http://publications.worldbank.org/index.php?main_page=product_info&cPath=0&products_id=22407 accessed 19th December 2012

[11] In a 2002 interview with the now-defunct Silicon Valley magazine, Red Herring, Brin was quoted comparing Russia to "Nigeria with snow" to emphasise the oppressive political environment of the country. From Pontin, Jason (2002) Dinner with the mind behind the mind of God: A meeting with Sergey Brin, co-founder of Google at the Russian tea room in San Francisco, Red Herring, 16th July edition.

market-based system.[12] It is difficult to imagine a start-up such as Google was; establish, develop and flourish in today's Russia. Google has managed to be most profitable in markets where there are strong public sectors institutions in place. Institutional capacity and efficacy has a strong link to sustainable economic development[13].

A strong private sector requires a strong public sector.

It is disappointing and unfortunate that Google has been playing a zero-sum game and avoiding paying the costs of the privilege of operating in countries such as Australia, France and the UK. These countries have accorded them an investment environment with strong regulatory institutions that recognise and enforce property rights. As Margaret Hodge, the chair of the UK's House of Commons Public Accounts Committee into the transfer pricing activities of American multinationals Starbucks, Google and Amazon in the UK, stated, transfer pricing may not be illegal but it is immoral[14]. In the press release to the report published by the committee, Hodge encapsulates the psychological harm caused by the transfer pricing of such corporations:

> "Corporation tax revenues have fallen at a time when securing proper income from taxes is more vital than ever. There is little credible information about what is going on. The evidence we took from large corporations was unconvincing and, in some cases, evasive… We consider that paying an appropriate amount of tax in the country in which profits are made is not only a matter of basic economics. It is also a matter of morality."[15]

Business ethics deals with issues where activities may not be technically illegal, but by any social yardstick, are indeed highly unethical. Unfettered use of transfer pricing is one such activity.

As a nation, Australia's competitive advantages are apparent in its strong institutional and regulatory bodies, the rule of law, the separation of powers between government and the judiciary, and an environment that attracts foreign direct investment. It has also achieved a high ranking of 10 out of 185 economies in the World Bank's 2013 Doing Business Report which lists the business-friendly criteria of a country's environment.[16]

We are an attractive country economically, having weathered the global financial crisis relatively unscathed. We are investor-friendly, open for international business and are firm supporters of the World Trade Organisation and its mandate. As a host nation, we must ask whether we should openly welcome companies that engage in transfer pricing that artificially inflate their profitability while penalising businesses that are competitively disadvantaged because of their proper observance of their tax obligations in this country.

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[12] See Levin, Mark and Satarov, Gregory (2000) Corruption and institutions in Russia, European Journal of Political Economy, 16 (1): 113-132 http://www.sciencedirect.com/science/article/pii/S0176268099000506 accessed 19th December 2012

[13] See Lin, J.Y. and Nugent, J.B. (1995) "Institutions and Economic Development", p.2313 in Behrman, J. & Srinivasan, TN (eds) Handbook of Development Economics Volume 3A, pp.2303-2370, Amsterdam: Elsevier Sciences; Chang, H-J. (2005) Understanding the Relationship between Institutions and Economic Development – Some Key Theoretical Issues, Paper presented at the WIDER Jubilee Conference, p.7, 17-18 June, Wider: Helsinki.

[14] Skapinker, Michael (2012) Politicians can only do so much, Financial Times, 21st November http://www.ft.com/intl/cms/s/0/907c3e2e-3306-11e2-aa83-00144feabdc0.html accessed 18th December 2012

[15] UK House of Commons Select Committee (2012) Committee publishes findings on HMRC's Accounts 2011-12, UK Parliament http://www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/news/hmrc-accounts-2011-12-report/ accessed 18th December 2012

[16] World Bank (2012) Doing Business http://www.doingbusiness.org/data/exploreeconomies/australia/ accessed 18th December 2012

Transfer pricing is a successful business strategy for companies that have used them extensively. Rohan Lund, the CEO of Yahoo7 (a 50:50 joint venture between an American company, Yahoo, and an Australian company, Seven Network Limited)[17] expressed the competitive disadvantage his company has suffered as a result:

> "It is frustrating to face competitors with no geographic borders, who are advantaged by paying less tax and may not be as regulated."[18]

Despite attempts to nurture a home-grown technological start-up industry[19], the extensive transfer pricing activities undertaken by global technological behemoths penalises other, smaller players that want to 'do right' to the host nation and hanker for a level-playing field where they are judged on the merits of their products and services, and not the army of transfer pricing legal and tax professionals and political lobbyists that they cannot afford – nor in principle wish – to hire.

The momentum is with the Treasury to harmonise our transfer pricing laws and proper recognition of the arm's length principle with other OECD member-states to ensure global regulatory coordination and action. This will be an important step towards ensuring multinational corporations pay their proper dues to societies where they operate globally as part of their "corporate citizenship"[20]. Private acquisition of rightfully public money must be prevented.

I look forward to a positive outcome towards the modernisation of transfer pricing rules which recognises the ethical duty of all companies to pay their proper share of tax in this country.

Kind regards,

Marie dela Rama

Dr. Marie dela Rama

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[17] Yahoo7 Press Room (2012) Company Overview http://au.docs.yahoo.com/info/pr/ accessed 18th December 2012

[18] Holgate, Ben (2012) Make Google pay more tax: Turnbull, Australian Financial Review, 21st May http://afr.com/p/technology/make_google_pay_more_tax_turnbull_EwlvkZxOEGtqNEpV9JlknM accessed 18th December 2012

[19] See Morle, Phil; Kitschke, Zach; Jones, Alan and Tanchel, Joshua (2012) Silicon Beach: Building Momentum – A study of the Australian Startup Ecosystem, Deloitte Australia http://www.deloitte.com/assets/Dcom-Australia/Local%20Assets/Documents/Industries/TMT/Deloitte_Silicon_Beach_Australian_Startup_Ecosystem_November2012.pdf accessed 18th December 2012

[20] This phrase appears on page 62 of the OECD (2011) Guidelines for Multinational Enterprises, Paris; OECD http://www.oecd.org/daf/internationalinvestment/guidelinesformultinationalenterprises/48004323.pdf accessed 18th December 2012

Addendum

Below are other academic articles that look at the ethical issues of transfer pricing (all URLs accessed on 18th December 2012):

Borkowski, S.C. (1997) The transfer pricing concerns of developed and developing countries, *The International Journal of Accounting*, 32 (3): 321-336 http://www.sciencedirect.com/science/article/pii/S0020706397900145

Hansen, D.R., Crosser, R.L. and Laufer, D. (1992) Moral ethics v tax ethics: The case of transfer pricing among multinational corporations, *Journal of Business Ethics*, 11 (9): 679-686 http://link.springer.com/article/10.1007%2FBF01686348?LI=true

Sikka, P. (2010) Smoke and mirrors: Corporate social responsibility and tax avoidance, *Accounting Forum*, 34 (3/4): 153-168 http://www.sciencedirect.com/science/article/pii/S0155998210000244