Financial Times
How transfer pricing threatens global tax revenues

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As an investigation by the Financial Times showed on Wednesday, tax authorities have not been altogether successful in their attempts to combat the increased potential for international tax arbitrage arising from the globalisation of capital.

One bulwark against the damage wrought by globalisation on the corporate tax take is the set of rules on "thin capitalisation", designed to prevent parent companies extracting profit from their foreign subsidiaries in the form of interest rather than dividends. But as Wednesday's article indicated, such rules are failing to prevent some of the world's most powerful multinationals from transforming pre-interest profits into pre-tax losses in high tax jurisdictions such as the UK.

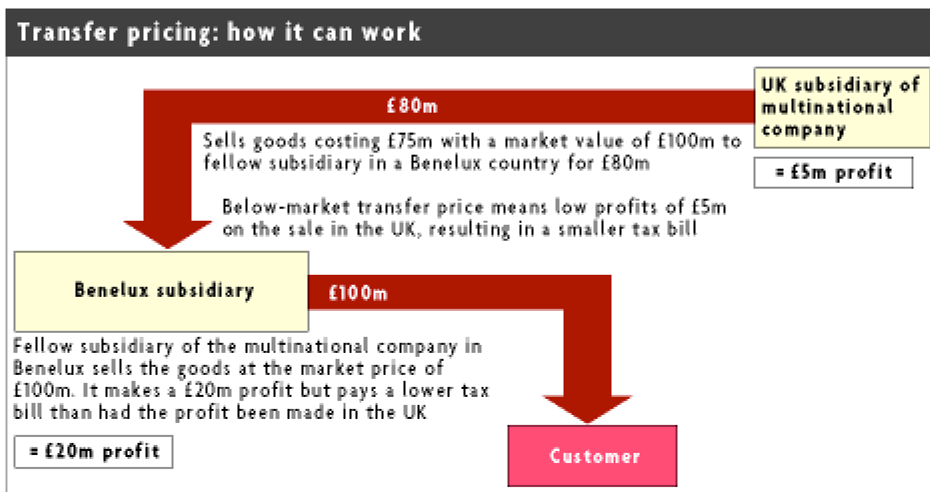
Another bulwark, explored here, is the "arm's length" principle that underpins tax authorities' efforts to police intra-group charges and transfer prices. This addresses the risk that companies may, for example, sell goods to other group companies in low-tax countries at below market prices so that the goods can then be re-sold at market rates, thereby ensuring that the profit attracts less tax. Governments impose rules on the conduct of transfer pricing to establish a fair division of taxable profits between businesses under common control.

Enforcement is difficult. Economists have sought to calculate the cost to US federal tax revenues of over-invoiced imports and under-invoiced exports by looking at manifestly abnormal prices in transactions in the US Merchandise Trade Database. On one estimate, the total tax loss from artificial transfer pricing was $53bn in 2001.*

Scrutiny of potential transfer pricing activity appears to have intensified. In January GlaxoSmithKline, the pharmaceuticals company, was presented with a $5.2bn bill for extra taxes and interest by the US government over revenues dating back to the late 1980s. The case is expected to go to trial next year.

No estimate of the losses caused by transfer pricing exists in the UK. Yet an examination by the FT of accounts at Companies House, the repository of data submitted to the UK registrar of companies, provides a revealing insight into this aspect of the battle between the tax authorities and global business, especially in relation to the big three Japanese motor companies.

Honda Motor Europe distributes manufactured products of the Honda Group, acting as Honda's European re-invoicing centre and selling Honda products in the UK. The latest filed accounts show that Honda Motor Europe made a loss of £6m on turnover of £3.4bn in the year to end-March 2003. The accumulated loss racked up over the years is recorded in the balance sheet at £335m, while in the notes to the accounts Honda discloses a deferred tax asset, in the shape of trading losses carried forward, of £216m. A deferred tax asset is, in effect, a right to shrink future tax bills.



There is, as Wednesday's article demonstrated, a question about Honda Europe's position in relation to compliance with thin capitalisation rules. But that is not the end of the story. Tucked away in the notes to the accounts is a statement that the Inland Revenue, the UK's tax authority, is conducting an inquiry into transfer pricing. Since Honda declined to comment and the Inland Revenue does not discuss individual cases, it has not been possible to establish whether the investigation has been completed and any outcome.

Honda is not alone. Nissan Motor Manufacturing (UK) and Nissan Motor (GB), its marketing and distribution affiliate, have between them £124m of tax losses available to carry forward to offset against future taxable profits. Notes to the Nissan Motor (GB) account reveal that the Inland Revenue has questioned the transfer pricing policy of the company going back to the date of incorporation in 1990.

The directors considered that there were strong commercial arguments in defence of the company's transfer pricing policies. Nissan Motor (GB) said: "The situation has been resolved." But it would not say on what basis.

A surprise here is that there is no comparable reference to Inland Revenue interest in transfer pricing in the accounts of Toyota Motor Manufacturing (UK). In the year to March 31, 2003, the company made a pre-tax loss of £116m on sales of £1.4bn, while Toyota (GB), a sales and distribution fellow subsidiary, made a profit of £3m on sales of £1.5bn. Toyota, whose manufacturing operations in Europe are concentrated in the UK and France, declares a profit on its European operations in its group accounts in Japan over the same period. But the profit is clearly not arising in the UK, one of the highest corporation tax jurisdictions in Europe.

It needs to be emphasised that all these figures from Companies House must be treated with some caution. The absence of a requirement for foreign parent companies to put UK subsidiaries into a single UK holding company means that the numbers may not capture the complete picture and may contain an element of double counting. Yet there is no reason to doubt the accuracy of the specific figures for tax losses carried forward in the accounts of the big manufacturing subsidiaries.

Toyota Motor Manufacturing (UK) shows in the notes to its accounts that it has a remarkable £716m of tax losses available to carry forward. Interestingly, it adds that this is subject to agreement with the Inland Revenue.

The sums potentially available at these companies - Honda, Nissan and Toyota - to offset against future trading profits amount to more than £1bn. So there is a great deal at stake for both sides.

It is worth noting, in passing, that the motor industry has been a disaster area for the Inland Revenue. This is as much, or more, a reflection of poor trading conditions in the European car market as of transfer pricing. The historic profit record has been so poor at Ford Automotive Holdings that this UK subsidiary of the US car giant has deferred tax assets of £813m, representing £389m of unused capital allowances (depreciation for tax purposes), £341m of tax losses and £83m of other assets such as prior year adjustments. Only £274m of

this is treated as a deferred tax asset on the face of the balance sheet, which points to an element of caution on Ford's part as to the recoverability of the full sum.

At General Motors Holdings (UK) the tax losses are smaller, though not unimpressive, at £158m. The company has shown tax credits in its profit and loss account for all of the past three financial years for which accounts have been filed at Companies House.

And at Volkswagen Group United Kingdom the £192m pre-tax losses of its Bentley Motors subsidiary for the year to end-December 2002 result in a tax credit of £42m that is not far short of the combined tax charges of Volkswagen Group and its affiliates Volkswagen Financial Services and Cosworth Technology.

For tax authorities there is great difficulty in policing transfer prices because of the complexity of the operations of global companies. This can be seen by looking at the accounts of Procter & Gamble Ltd, the UK subsidiary of the manufacturer of detergents, healthcare and other consumer products.

For any tax inspector the annual report raises a number of questions. The ownership of Procter & Gamble Ltd changed hands four times between January and May 2003. It was sold to Procter & Gamble Eastern Europe; then to Procter & Gamble Investments, a company incorporated in Ireland; then to Procter & Gamble Luxembourg Investment; and finally to Procter & Gamble Luxembourg Holdings. Ireland and Luxembourg are, of course, notably low-tax jurisdictions.

The balance sheet of Procter & Gamble Ltd shows no finished stocks and trade debtors to speak of, which raises a question about where the balance sheet in which the stocks and debtors do appear might be located. And the operating profit margins on sales of £2.2bn in the accounts to the end of June 2002 are, at 3.7 per cent, extraordinarily low relative to the operating margin of 16.6 per cent in the US group accounts for the same year, which raises the question of transfer pricing.

The FT's research threw up other such examples. They included Effem Holdings, UK parent of the Mars food group's British operations, along with the UK subsidiaries of Merck, the US drugs group, Valspar, the US-owned coatings concern, and Henkel, the German chemical company. In these companies operating margins in the UK were significantly low compared with the group accounts of foreign parent companies or local competitors.

Procter & Gamble said the points raised about its ownership and operating profit margins reflected recent changes to its business structure, based on product groups rather than local geographies. "The figures quoted from the 2002 accounts obviously represent an aggregation of the results of various different parts of the P&G group. In common with many other multinational companies different parts of the group have significantly different roles and responsibilities," the company said.

"The figures shown in the UK group accounts (both the balance sheet and the profit and loss account) reflect the activities performed by the UK organisation under the new business structure. The P&G group has not reported separate regional profit information since 1999 and we are therefore unable to comment further on the figures quoted or on specific company results.

"As with any large company, the UK operations of P&G and the tax consequences thereof are subject to ongoing Inland Revenue review. This includes both an annual review of its tax returns and regular updates on the UK business in general. As such, a full explanation of the new business structure has, of course, been provided.

"As would be expected it is P&G's global policy not to disclose any specific discussions it has with revenue authorities regarding its tax affairs . . . In common with many other US and non-US multinational groups, P&G has chosen to hold the majority of its international operations via a common holding company. The shareholder changes disclosed in the accounts of P&G Ltd were a consequence of the transfer of P&G Ltd to the holding company."

This fails fully to address the disparity in operating margins. But it does underline the difficulty that the tax authorities have in dealing with big multinationals. Any comparison of margins between the subsidiary company and its competitors or its parent is muddied by different regional structures and different mixes of product.

The conclusion must be that the twin bulwarks against the erosion of the corporate tax yield - transfer pricing and thin capitalisation rules - are not robust.

One possible solution on thin capitalisation would be to move to an "interest allocation rule", whereby interest would only be tax-deductible if borrowings could be shown to be financing activities in the country where the foreign-owned subsidiary operated.

But in the European Union this may be difficult. According to Steve Bond, a research fellow at the Institute for Fiscal Studies and at Nuffield College, Oxford, such rules could fall foul of the European Court of Justice's recent rulings, which have shown that the ECJ will challenge any tax rule that treats domestic transactions differently from international ones.

As for transfer pricing, which operates on a self-assessed basis, it is hard to believe that rules will ever be fully effective when the tax authorities are at a marked disadvantage relative to their multinational clients in terms of the information they possess.

What is clear is that the potential for tax arbitrage that results from globalisation creates a considerable and continuing incentive for domestic companies to internationalise their business. The pressure on the global corporate tax base can only increase.

It seems likely that many national governments will be severely disappointed if they look to the corporate sector to mitigate their mounting fiscal problems.

* *US Trade With The World: An Estimate of 2001 lost US Federal Income Tax Revenues Due To Over-Invoiced Imports And Under-Invoiced Exports. Simon J. Pak and John S. Zkanowicz (2002)*

Tardy reporting, derisory punishment

Foreign direct investment is widely recognised as having raised productivity in the UK and encouraged the development of world-class managerial practices. But there is also a cost, in the shape of diminished transparency, which can reduce competition.

When a listed company is the object of a foreign takeover, half-yearly or quarterly reporting via the UK stock exchange ceases and important changes in the operatio ns of the business are not necessarily reported publicly as soon as they occur. Segment reporting, which reveals the split of turnover and profits between different classes of business, is often dropped on the ground that disclosure would damage the company's competitive position.

The 1985 Companies Act leaves this to "the opinion of the directors". The parent company must still, of course, produce group accounts according to the rules of its own jurisdiction.

Companies House provides a window on reporting practices in the foreign-owned UK corporate sector and offers many examples of poor transparency.

Effem Holdings, the UK subsidiary of the private US food group Mars, for example, offers no breakdown of its £2.4bn of sales in 2002 between its confectionery, ice cream and pet food products.

Yet from the accounts of the underlying subsidiaries, it is possible to establish that the non-confectionery businesses account for £517m of those sales.

The directors' decision to claim exemption from disclosure for the holding company has the effect of making life difficult for competitors, who have to dig deeper for the data.

At Procter & Gamble's UK subsidiary, with a turnover of £2.2bn in the year to end-June 2002, no split is provided of washing powders, cosmetics, baby and family care, although such information for the group routinely appears in the annual report of the US parent (see above).

The Companies Act timetable for filing accounts at Companies House does not make for timely reporting. Private companies are required to deliver their accounts to the registrar 10 months after the end of the financial year. Not all comply.

The US-based Valspar Corporation, ranked number six in the global coatings business in terms of sales, is a serial late reporter, as is International Flavors & Fragrances, another New York quoted company that ranks among the global top three in its field.

It is noteworthy that the fines payable by the company for late under the Companies Acts are derisory. A three-month delay costs just £100.

The 2002 accounts of Credit Suisse First Boston (UK) Investments were not signed off until November 20, 2003, while at General Electric's IGE USA Investments subsidiary KPMG signed its audit report for the 2002 accounts at the remarkably late date of February 28, 2004.

Given the tougher reporting and auditing requirements introduced in the US under the Sarbanes-Oxley Act, which has extra-territorial reach, this tardy reporting may expose directors and auditors to greater legal risk than in the past.

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For Wednesday's article, go to www.ft.com/taxation