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Tax Enforcers Intensify Focus on Multinationals

By MATTHEW SALTMARSH

While the recession may be ending across much of the world, its effect on revenue collectors and corporate tax returns will last much longer.

Tax inspectors had already been increasing their focus on multinational businesses, specifically taking aim at an arcane area of international accounting called transfer pricing. Such scrutiny is intensifying, according to tax experts, as governments seek ways to close their growing budget deficits.

The potential for friction was emerging before the financial crisis, and “the current recession has increased that potential dramatically,” according to a recent paper by the auditing firm Grant Thornton.

Companies like Microsoft and Google have long pushed their effective tax rates down by moving functions to lower-rate jurisdictions like Ireland, which has a low tax rate on royalty income — as low as zero — and a 12.5 percent corporate tax rate, against the 35 percent rate in the United States.

Transfer pricing involves calculating how much profit is made by a company in each country in which it operates, when contributions to the final product — be it parts, patent rights, services or funds — may come from one or more affiliates abroad.

A report from the charity Christian Aid, which is concerned with the effect on developing countries, estimated that governments lose \$160 billion a year when companies working across borders misapply the rules.

To ensure that multinationals pay governments what they owe, the authorities have for some time been sharing more information, adding staff members and using more sophisticated techniques to track and correctly tax within-company transfers, which, according to one estimate by the Organization for Economic Cooperation and Development, may account for 60 percent of global trade.

During downturns, however, governments tend to monitor accounts even more carefully, said Caroline Silberztein, a tax specialist at the organization.

Revenue and Customs, the British tax agency, changed its rules on transferring profits across borders last year, to ensure “consistency for businesses” and to focus on the “issues of greatest risk,” a spokesman said.

In the United States, the Internal Revenue Service is opening additional foreign offices and adding staff members this year and next. Last March, the I.R.S. had 475 international examiners supported by 120 economists, and 10 lawyers, according to the most recent data.

Spain has added new requirements and expanded investigations, shifting the burden of proof to taxpayers, according to advisers, and France is setting shorter audit response deadlines.

Finland has assembled approximately 45 experts in just over two years. It currently has two cases in European arbitration, but declined to provide details.

The accounting firm Ernst & Young estimates that since 2006, at least 10 jurisdictions have introduced tougher requirements on transferring profits across borders, with China, Slovakia and Greece among the most recent. A KPMG study found that China, India, Australia, South Korea and Japan in particular have intensified audits.

John Hobster, a director at Ernst & Young, said he expected to see more activity. "There's a major potential for more conflict with companies as tax returns from the start of the recession start coming in," he said. The burden of proof is with the companies, he added.

The companies with the most at stake are those with difficult-to-assess assets like intellectual property and patents. That puts the spotlight on automakers, consumer products specialists, financial services companies, natural resource groups and pharmaceutical giants.

Few companies will discuss the subject. Also, tax collectors are reluctant to speak publicly as well, in part because of confidentiality rules and in part to keep companies on their toes.

Recently, a dispute between Ottawa and Chrysler Canada over the price of automobiles and parts crossing from Detroit to Canada nearly derailed Fiat's investment in Chrysler. The case has reportedly gone to arbitration; the Canada Revenue Agency declined to comment.

In May, the United States Court of Appeals for the Ninth Circuit, based in San Francisco, ruled against Xilinx, a chip maker, in a case related to tax deductions from the allocation of stock options to employees in an Irish subsidiary. Xilinx has requested a rehearing.

The British electronics retailer Dixons paid \$84.8 million to British authorities this year in a case related to the insurance of extended warranties originating on the Isle of Man.

The Organization for Economic Cooperation and Development and the International Accounting Standards Board are looking into different models for simplifying the system, like devising formulas to use for allocating taxes for each country a company operates in.

But for now, multinationals still need to adjust their practices based on the latest official guidance, advisers say.

Contested cases can be solved under bilateral tax treaties. But some treaties assign no obligation for governments to reach a deal and eliminate double taxation.

The United States has been adding arbitration clauses to new treaties.

“These are extremely encouraging signals,” said Ms. Silberztein. The Organization for Economic Cooperation and Development and the European Union also have arbitration procedures that apply when the authorities are deadlocked. According to a European Union forum, the number of cases has been rising each year, to at least 146 cases in 2007, the latest data available, up from 112 in 2006.

