Transfer Pricing: A World of Pain

Yet another unwelcome side effect of the global recession: hungrier international tax authorities. Experts say that officials in previously tax-friendly countries, including China and India, are looking to fill their coffers by extracting more from U.S.-based multinationals. Among their favorite areas to probe: transfer pricing, or the pricing of sales between subsidiaries and subsequent allocation of taxable income among various countries. Long a focus of the U.S. Internal Revenue Service, transfer pricing is “the lowest-hanging fruit, because it’s very subjective and most companies don’t have adequate documentation to back up their assertions,” says Larry Harding, CEO of High Street Partners, an international business-expansion consultancy.

Changes are perhaps most dramatic in China, where foreign businesses enjoyed favorable treatment (even surpassing that of local companies) until last year. In January, China’s tax authorities issued new rules requiring foreign multinationals to submit extensive transfer-pricing documentation by year-end. More recently, they circulated a notice to local tax authorities urging rigorous enforcement on a variety of business-tax issues, including transfer pricing. “A lot of U.S. companies will be exposed,” predicts Harding.

China is hardly alone. “There’s an explosion of transfer-pricing controversies out there,” says Garry Stone, global transfer-pricing leader for Pricewaterhouse Coopers. The number of such disputes among his clients doubled over the past year, he says, with India, Canada, Turkey, and Greece among those bringing more scrutiny to bear. The areas that often lead to controversy include intellectual-property values, costs of back-office functions, and losses of any type, he says.

Meanwhile, the IRS is maintaining its aggressive approach to transfer pricing. The agency recently fought through the courts to force semiconductor company Xilinx to allocate stock-option expenses to its Irish subsidiary, boosting the company’s U.S. tax bill by about $40 million and leading many other tech firms, including Apple, Cisco, and Cadence Design Systems, to take additional income-tax expenses. Stone says he understands that the IRS is adding 1,200 people to its international staff this year; the 2010 budget calls for another 800.

How to cope? Stone says more companies are seeking advance pricing agreements in which a company gets preapproval for its transfer-pricing methodology from tax authorities. Failing that, updated documentation and clear explanations of methodologies are critical. Despite such efforts, in some cases it may be impossible to avoid a penalty. “Even if you have the documentation and it is perfect, it could be challenged,” says Harding. “A lot of governments go in there planning to get something.” —A.S.