Money 'scams' may be losing Treasury billions

by Marc Lopatin

New research exposes how multinationals are shifting funds to avoid tax

Imagine going to a car boot sale where you can pick up a missile launcher for $52 but have to pay $3,000 for replacement nuts and bolts. Or perhaps you spot a brand new toilet for $1.75 but are hit with a $4,000 bill for a kilo of toilet paper.

It may read like a Del Boy scam but these are genuine examples drawn from the murky world of abnormal, or transfer, pricing — a little-discussed aspect of world trade that funds terrorism, abets money-laundering and enables multinational corporations to cheat the UK Treasury potentially out of billions of pounds a year.

The above prices were found on US import and export invoices that show how accounting sleight of hand is responsible for massive capital flight under the cover of banking secrecy and restrictions on freedom of information.

Given that 60 per cent of world trade takes place within multinational enterprises, the importance of transfer pricing becomes clear. A report published this month by two US financial academics examined US import and export data held in public databases and concluded that abnormal pricing of products cost the US Treasury more than $53 billion (£34 billion) in 2001.

This figure is an increase of almost 50 per cent on 1998 and it is no surprise that Paul O’Neill, the US Treasury Secretary, has just handed $2 million to the report’s authors to prepare a more detailed analysis of the problem.

US Senator Byron Dorgan has said of the report: “This is a huge scandal that costs this country billions of dollars in lost revenues. It’s been going on for at least a dozen years, and nobody seems to want to do anything to stop it.”

Transfer pricing is routinely deployed by multinational companies to shift capital, reduce the tax burden and boost profits.

For example, a company might want to move £1 million of revenue out of a high-tax environment to a subsidiary located in a tax haven such as Hong Kong, where corporation tax is half that in the UK.

How is this done? Suppose the UK parent imports 200 “gold” watches from Hong Kong worth just £20 each but pays an inflated import price of £5,000 each. One million pounds is paid to the
Hong Kong subsidiary and £4,000 worth of watches are imported into the UK.

The reverse scenario also holds. The UK company might buy 200 genuine gold watches worth £1 million and export them to a partner in a tax haven for the knockdown price of £20. Again, £1 million is moved offshore as the watches are sold for the genuine retail price in a low-tax jurisdiction.

Transfer pricing is not just confined to the US. In earlier research, the report’s co-author, John Zdanowicz, of Florida International University, uncovered abnormal prices between the US and the UK that saw aluminium cans imported at $8,000 each while military rifles went the other way at just $106.87.

The Inland Revenue says it has no figures to quantify tax avoidance as a result of transfer pricing. Perhaps the deficit can be crudely expressed by the fact that transfer price specialists (accountants and lawyers) are paid six-figure salaries in the private sector — well over twice the amount that senior civil service tax inspectors are paid to unpick their handiwork.

The Organisation for Economic Co-operation and Development publishes guidelines on transfer pricing and admits the issue has the potential to deprive governments of their fair share of taxes from global corporations while exposing multinationals to double taxation.

But Prem Sikka, Professor of Accounting at the University of Essex, sees the issue in starker terms. “Transfer pricing is criminal. The Inland Revenue has full powers to raid companies and accountants operating these scams. Lost taxes should enable the Government to finance public services and pensions but the Government lacks the political will to clamp down on organised corporate tax abuses.”

In essence, transfer pricing is part of a bigger question of global taxation and the ability of governments to finance public spending in a world of footloose capital.

This question holds clues as to why some multinationals are paying way short of 30 per cent corporation tax and why Gordon Brown finds himself nursing a £10 billion budget deficit.