

Ernst & Young's Global Transfer Pricing Survey – Transfer Pricing Documentation and Controversy Risk Management Practices

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In December 2007, Ernst & Young published its 2007/2008 Survey, having once again commissioned Consensus Research International, London, to carry out the study. The report summarises the transfer pricing practice, perceptions, and audit experience of MNEs' tax departments. It also provides insights into how they are dealing with economic, regulatory, and fiscal changes taking place around the world.

The latest study surveyed some 850 MNEs across 24 countries. Of the 850 MNEs, 655 were parent companies interviewed from the MNE headquarters perspective and 195 were inbound subsidiaries interviewed from the local operating company perspective.

Global legislative and enforcement trends in transfer pricing

The degree of transparency in MNEs' tax and transfer pricing positions, largely driven by developments in financial and tax disclosure requirements, has dramatically increased in recent years. Both accounting and tax regulators have intensified the burden on MNEs to actively report and justify the impact of their tax planning. Recent examples include the FASB's June 2006 issuance of FIN 48, which mandates a framework for recognizing, measuring, and disclosing tax positions in US GAAP financial statements, and the IRS's introduction of Schedule M-3, which requires reconciliation of book-tax differences.

New multilateral initiatives – on the other side – focused on cross-border enforcement, particularly as it applies to underreported income, show that tax authorities no longer take a parochial view of administration but are becoming more inclined to consider global consequences. For example, in September 2006, the 39 member countries that compose the OECD's Forum for Tax Administration adopted the "Seoul Declaration". The Seoul Declaration commits the member countries to cross-border information sharing and improved "practical cooperation" to counter non-compliance.

In 1995 Ernst & Young launched the first in a series of biennial surveys interviewing multinational enterprises (MNEs) on international tax matters. Entitled the *Global Transfer Pricing Survey*, a core focus of the research is a topic that continues to be the number one international tax issue of interest to MNEs – transfer pricing. The scope of the research into transfer pricing reflects the growing number of countries that have increased their transfer pricing regulation and enforcement, and reveals also the diversity of transfer pricing issues facing MNEs.

The enhanced disclosure requirements, along with the trend toward tax authority collaboration and information exchange, are putting tax departments under increased pressure to manage transfer pricing risks with greater precision.¹

Risk mitigation is a key priority

Sixty-five percent of the surveyed parent respondents believe transfer pricing is more important now than it was two years ago (fewer than 1% say it is less important). The 2007 Survey also shows that MNEs' priorities for preparing documentation are changing. In our 2005 Survey, "consistency of documentation" was the top priority in preparing transfer pricing documentation. In our 2007 Survey, consistency was displayed by "risk mitigation or reduction" as the top priority.

While priorities for preparing transfer pricing documentation are shifting, actual approaches to preparing it have remained largely unchanged. One-third of respondents prepare documentation concurrently on a globally coordinated basis. The same number said that they prepared documentation on a country-by-country basis, with little coordination. The 2007 Survey results on documentation approaches are nearly identical to those of the 2005 Survey and are only marginally different from those of the 2001 Survey, where 32% took a globally coordinated approach and 37% a country-specific approach. These results suggest that multilateral initiatives intended to harmonize documentation approaches and ease taxpayer burdens, such as those supported by the EU Joint Transfer Pricing Forum and the Pacific Association of Tax Administrators, are having little, if any, effect on tax payers' documentation practices.

Approaches to comparable analyses

There has been significant debate over recent years regarding the use of pan-regional comparable sets. Specifically, different opinions exist as to whether country-specific comparable sets yield meaningfully different results from pan-regional comparable sets. The European Commission has recently adopted a Code of Conduct that calls for a pan-European master-file approach to documentation and has published a white paper on the use of pan-regional comparables sets, indicating that they should be accepted across Europe.

A pan-regional approach to documentation and comparables analysis could potentially lead to significant cost savings for taxpayers, while also eliminating incompatible compliance burdens. There appears to be a general reluctance among taxpayers, however, to take on global or regional approaches to their transfer pricing compliance.

The 2007 Survey results show that 38% of parent respondents opt for local comparables searches for all countries, while only 27% rely on pan-regional sets. Even within Europe, where the urge for a pan-regional approach is perhaps the strongest, most parent respondents (36%) rely solely or primarily on local comparables sets.

The general reluctance to use pan-regional approaches is perhaps explained by several factors. Many taxpayers, for example, are more comfortable disclosing only what is absolutely necessary to local tax inspectors. Pan-regionally focused documentation and comparable sets necessarily involve disclosure of operational and tax information related to operations outside the local jurisdiction. Audit experience also suggests that pan-regional approaches may not be well-embraced by tax authorities either. The most common reason given by parent companies for their transfer pricing documentation being rejected on audit is that the economic analysis was not accepted. Moreover, 26% of parent respondents indicated that they had to perform additional analysis to identify local comparables during their transfer pricing audits. By adopting a locally focused approach at the outset, many taxpayers likely believe there is less risk of disputes with tax authorities.

Transfer pricing methods

In managing transfer pricing risks, it is helpful to have a general sense of the transfer pricing methods commonly applied by other taxpayers for the various types of transactions. For benchmarking intercompany services, for example, the cost-plus method is the most commonly used method, not surprisingly. The CUP/CUT method remains the most popular method both for financing and intangible property transactions. The popularity of the CUP/CUT method for intercompany financing transactions is perhaps explained by the availability of data regarding what are largely commoditized transactions. However, the inherent uniqueness of intangible property raises the questions as to whether, in practice, taxpayers are adhering to the fairly strict comparability criteria associated with qualifying intellectual property transactions as CUPs/CUTs.²

Controversy management

After exhausting the domestic appeals procedures, taxpayers generally have three alternatives when it comes to managing and resolving transfer pricing disputes with the tax authorities. These are Advance Pricing Agreements (APAs), Competent Authority relief via the Mutual Agreement Procedure provisions of the relevant treaty and Litigation.

The Survey shows that twenty-one percent of parent respondents have used an APA as a controversy management tool and, since 2003, 17% have referred a transfer pricing matter to Competent Authority and only 4% have litigated a transfer pricing issue.

APAs

Countries worldwide have increased their investment in the APA process in recent years, which appears to be reflected in the 2007 Survey results. Despite the increasing number of taxpayers applying for APAs, the time taken from submission to approval has decreased significantly since 2005.

Fifty-one percent of parent respondents who applied for unilateral APAs, for example, said the process was complete within 12 months. In our 2005 Survey, only 32% of parent respondents completed their unilateral APAs within 12 months. With respect to bilateral APAs, only half about the number of respondents said the process took more than three years than it did in the 2005 Survey (11% compared to 21%, respectively).

The number of countries in which MNEs seek APAs is growing as well. Parent respondents collectively named 28 different countries in which they have some form of APA, which is up from 23 in 2005 and 13 in 2003. The US, UK, and Australia have remained the top three most popular jurisdictions for MNEs to conclude APAs with since our 2003 Survey.

Seventy-eight percent of parents reported that they were generally satisfied with the APA process. However, many remain unconvinced (or unaware) of the benefits of APAs, with fewer than half (47%) of parent respondents not currently using APAs saying they would consider doing so in the future.

Competent authority

Globally, there appears to be a moderate trend for both parent and subsidiary respondents to rely less on the Competent Authority process. This may be a result of the increased availability of APAs and perhaps a general desire by taxpayers to manage controversy risks prospectively

as a means to achieving financial statement certainty. Despite the slight decline in the use of the Competent Authority process, it is the clear preferred method among parent respondents for resolving their transfer pricing disputes.

As with APAs, resolution times for Competent Authority cases have generally decreased, which may also be reflective of increased investments and improved procedures on the part of tax authorities. The number of parent respondents reporting that the process took fewer than 12 months increased to 38% from 21% in our previous survey. The number of cases taking longer than three years to resolve has fallen from 28% in 2005 to 13% in 2007.

Litigation

Overall, taxpayers have very limited experience with transfer pricing litigation. Only 28 instances of litigation (since 2003) were reported by the 850 respondents included in the 2007 Survey. Of the few cases reported, however, a disproportionate number occurred in Germany and Canada, with each having five cases reported (collectively accounting for 36% of the total).³

Fewer than half (43%) of those having experience with litigation indicated they were satisfied with the process, which is considerably lower than the satisfaction level for APAs or Competent Authority. ■

1. Ernst & Young, *Global Transfer Pricing Survey 2007/2008*, p. 3

2. Ernst & Young, *Global Transfer Pricing Survey 2007/2008*, p. 15-16

3. Ernst & Young, *Global Transfer Pricing Survey 2007/2008*, p. 17-18