

News Release

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Tax policy under the microscope as authorities increase enforcement efforts

- **Multi-national companies devote more resources to compliance**
- **Two-thirds of global companies undergo transfer pricing audit**
- **Tax authorities in emerging markets gear up transfer pricing enforcement**

Kuala Lumpur, 16 February — Even with an improving global economy, governments facing daunting deficits remain focused on raising revenues through taxation, with transfer pricing being a key instrument. As a result, the world's leading companies expect to devote far more resources to transfer pricing compliance: 31% report an increase in internal head count. Sixty-two percent note an increase in the use of external consultants and 23% report an increase in the use of software or similar tools. This is according to the Ernst & Young *Global Transfer Pricing Survey*, a survey of 877 multinationals from 25 countries, released recently.

Heavier regulatory hand

Since the 2007 Ernst & Young *Global Transfer Pricing Survey*, revenue authorities in several jurisdictions have significantly increased their staffing in this area, adopted more centralized approaches to managing inquiries and established a more strategic, risk-based approach to prioritizing transfer pricing reviews. In the US, for example, the Internal Revenue Service added 1,200 employees in 2009 to deal with international issues, with another 800 expected to be added by the end of 2010. In the UK, Revenue and Customs issued guidance in late 2010 on

more extensive use of penalties in transfer pricing cases. In China, the State Administration of Taxation has adopted a targeted approach, designating 30% of Chinese taxpayers as key audit targets based on selected criteria.

John Hobster, Ernst & Young's Transfer Pricing Global Accounts Leader, says: "It's clear that the regulatory environment has got much tougher, and companies will need to adjust accordingly. They will need to devote resources to understand, catalogue, and document thoroughly their transfer pricing policies in an ever increasing number of countries."

Janice Wong, Ernst & Young Malaysia's Transfer Pricing Leader agrees, "In Malaysia, the Government has since introduced specific transfer pricing legislation requiring taxpayers to determine and apply arm's length pricing. Additionally, with a clear view towards increased enforcement in this area, the tax authorities have established a multinational tax department to focus on, amongst others, transfer pricing compliance audits and advance pricing arrangements. Indeed, these days, Malaysian corporate taxpayers are much more conscious and aware of the need to address transfer pricing issues."

Tougher enforcement

Thirty-two percent of tax directors identify transfer pricing as the most important tax challenge their organization faces, and three-quarters of tax directors believe that transfer pricing will be "absolutely critical" or "very important" to their organization over the next two years. This feeling was strongest in Europe, followed closely by the US and Asia. There were also differences by sector, with pharmaceutical and biotech companies far more concerned about transfer pricing than telecoms or financial services companies.

"Tax authorities typically target industries with high-value, portable intellectual property, and those that generate high margins," Thomas Borstell, Global Director of Ernst & Young's Transfer Pricing group says: "This might explain why pharmaceuticals top the ranking. Multi-nationals need to self assess their transfer pricing profile and manage the risk of aggressive audits and potential double taxation."

Audit experience

Two-thirds of the respondents in the 2010 survey say they have undergone a transfer pricing audit, compared with 52% in the 2007 survey. Further, one in five audit adjustments triggered a material penalty, compared with one in 25 in 2005.

Hobster says: “We are seeing increased audit activity and evidence of increased penalties, with a particularly marked increase in audits in emerging markets such as China and India.”

According to Janice Wong, in practice, the Malaysian tax authorities apply a lower penalty rate on the tax undercharged arising from transfer pricing adjustments when taxpayers can demonstrate that contemporaneous transfer pricing documentation has been prepared.

The survey reveals that authorities are placing greater emphasis on inter-company financing transactions and service transactions, along with an ongoing interest in transactions relating to intellectual property. Reviews of inter-company financing transactions increased dramatically to 42% in 2010 from 7% in 2007, and respondents indicating that service transactions had undergone review increased to 66% in 2010 from 55% in 2007. This trend is clearly reflected in other emerging markets such as Malaysia, where audits have been expanded to encompass or have been shifted to focus on inter-company financial transactions, services and intangible property from the traditional tangible goods transactions.

Attacked from all sides?

Hobster concludes that multi-nationals must take a more proactive approach to transfer pricing as the risk of challenge by the authorities continues to increase.

“The transaction types companies have to cover are increasing, and the emphasis is changing. Tax controversies are on the rise as increasingly well-staffed revenue authorities apply more sophisticated and sweeping transfer pricing tools. And all of this is occurring in a wider range of geographies. At the same time, fortunately, a wider range of dispute resolution options, such as advance pricing agreements, are now available and actively being used.”

“It is evident from global trends that transfer pricing will be the issue of the millennium and corporations need to continue to be vigilant in ensuring that their transfer pricing risks are well-managed,” concludes Janice Wong.

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Methodology:

Consensus Research International conducted a series of independent interviews of 877 companies across 25 countries to investigate the transfer pricing practice and strategy among multinationals. In effect, there are two surveys, one of parent companies interviewed from the MNE headquarters perspective, and one of inbound subsidiaries, interviewed from the local operating company perspective. The 2010 Survey encompassed the same 24 markets researched in 2007 plus South Africa. All interviews were conducted by telephone.

Transfer pricing definition: Setting, analysis, documentation, and adjustment of charges made between related parties for goods, services, or use of property (including intangible property).

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