IRINA DIAKONOVA

E&Y SURVEY: TRANSFER PRICING RISKS ON THE RISE IN FINANCIAL SERVICES INDUSTRY

The trend toward stepped-up challenges of financial institutions on a wide range of transfer-pricing issues by tax authorities in many countries is expected to continue, according to a recent Ernst & Young survey of over 100 tax departments. Reflecting financial services industry recognition of the difficulty of achieving complete protection against these challenges, 53% of the respondents now calculate transfer pricing risk and set aside some amount of reserve for it in their financial statements.

Conducted by Ernst & Young's Global Financial Services Transfer Pricing team, the survey of transfer-pricing trends drew responses from all sectors of the financial services industry, including insurance (22%); investment banking (22%); commercial and retail banking (21%); asset management (21%); and proprietary trading (14%).

Structure and Approach

A large majority (76%) of respondents said that they coordinate their transfer pricing function on a global basis, and 52% have adopted global policy guidelines. Also, 63% prepare global documentation, while 20% prepare documentation on a two-country basis, and 17% still use a one-country basis.

Some 59% of respondents stated that they have one to three people fully dedicated to transfer pricing, while 27% have less than one person. Apparently this means that the function is addressed by tax department personnel who have broader responsibilities. The resources available within each organization seem sufficient to enable most institutions to keep their transfer pricing current, as indicated by 58% reviewing their transfer pricing methodology every year. At the other end of the spectrum, 29% said that they review their methodology only once every three years or longer. Given the rapid changes in transfer pricing rules and enforcement, such irregular reviews may not be advisable.

Past Experience

When participants were asked which countries have challenged their transfer pricing since 2000, the countries cited included the U.K. (51%), the U.S. (42%), Japan (38%), France (24%), Germany (20%), and Australia (18%). While none of these countries is a surprise, that they were followed by India, Canada, and South Korea may be.

Specific issues challenged. In the countries cited, head-office services was the most active transfer pricing challenge of the past. Notably, however, several Asia/Pacific jurisdictions that are not usually associated with high transfer pricing risk—Singapore, Hong

IRINA DIAKONOVA is a member of E&Y's European Financial Services Transfer Pricing team in Amsterdam.

Kong, Thailand, and the Philippines—were quite prominent in the head office audits. Other surprises included the frequency of transfer pricing challenges of IT services and branding by Canada, and of investment banking and capital markets issues by France.

Expectations

Survey participants overwhelmingly agreed that transfer pricing will present increasing challenges in the future. One-half estimated the likelihood of transfer pricing challenges in the next two years to be at least 60%. This includes 37% of respondents who believe the likelihood of being challenged is very high (80%-100%).

Some 81% of respondents expect to devote more effort to transfer pricing in 2006 compared with 2005. The issues expected to require the most attention include head-office services (70% of respondents), IT costs (61%), and intercompany debt and guarantees (45%). Other issues on which at least 20% of the respondents expect to work in 2006 include fixed income, derivatives, equities, asset management, investment banking, securitization, proprietary trading, insurance, and branding.

This high level of activity reflects the increased sophistication and level of OECD and local tax administration enforcement. In addition, given tax administrations' concern about tax-motivated transactions, 51% of respondents expect challenges related to the attribution of income to permanent establishments.

The countries where respondents anticipate future challenges corresponded with recent experience. Sixty-eight percent expect the U.K. to challenge their transfer pricing in the next two years, followed by the U.S. (49%), Japan (32%), France (27%), and Germany (24%). Next came South Korea, India, Canada, and Australia. Altogether, 28 countries were identified as being somewhat likely to challenge transfer pricing, including several that are not major financial centers.

Conclusion

The survey findings suggest that companies should undertake a review of their material intercompany transactions and update their transfer pricing methods to reflect evolving guidance from the OECD and other tax administrations. Contemporaneous documentation, which is needed to avoid penalties in most countries, also should be updated. In particular, intercompany agreements should be prepared to reduce the possibility that a tax administration may recharacterize an internal arrangement or relationship (e.g., a service-provider arrangement). Finally, as a company's operations become more globally integrated, attention should be paid to developing a global transfer pricing methodology that is as consistent and transparent as possible.

JOIT will be publishing more results of the E&Y survey in future issues. ●