USE OF TRANSFER PRICES FOR INTRA-COMPANY TRANSACTIONS

Dr. Thorsten Fischer, Saudi Arabian Oil Company (Saudi Aramco)[1], +966(0)13 873-1166, thorsten.fischer@aramco.com

Overview

Integrated oil and gas companies face issues when calculating transfer prices for intra-company transactions. The general approach is to base the transfer price on an arm's length transaction. The choice of transfer pricing method has to meet a number of competing objectives, such as optimizing the tax burden, aligning incentives between different parts of the business, and generating accurate segment reports.

If tax optimization were the only objective the solution would be straightforward. Profit should be allocated to the lower-taxed activities as much as the tax authorities will allow. Evidence will then be gathered from comparable arm's length transaction to justify the choice of the method that results in the lowest tax bill.

In principle nothing forces the integrated oil and gas company to use the same methodology for all purposes. In practice, however, the tax authorities will look with suspicion at any significant discrepancy between the financial accounts and the returns prepared for the taxman. Thus, a unified approach is generally preferred.

Not only does such a unified approach reduce complexity and eliminate duplication, it may also avoid establishing an unfortunate precedent whereby whatever method has been chosen ad hoc to minimize the tax liability of the day will commit the company to using the same method in the future, even as business conditions and the structure of the business change, and other methods would have resulted in a lower tax liability. Much better then to adopt a robust methodology that can be defended on conceptual grounds and is equally well suited to decision making and financial reporting as is it to minimizing tax liabilities.

Methods

This paper reviews and evaluates the five methods accepted by the Kingdom's transfer pricing bylaws, which in turn rely on the OECD guidelines. Summarized under traditional transaction methods we find Comparable Uncontrolled Price (CUP), Resale Price (RP) and Cost Plus (C+). Separately, there are the transactional profit methods, including Transactional Net Margin (TNN) and Profit Split (PS).

Despite the focus of the OECD guidelines on tax, the arm's length principle is extremely powerful and as we have seen can also be used for management purposes. The arm's length principle aims to ascertain the price of a transaction that would prevail between independent companies. Such a price, if freely and voluntarily agreed by these companies, will mimic the outcome of a market transaction and therefore has some of the attending benefits. In particular both parties to the transaction must be assumed to be better off, and the mutual gains from the transaction fairly distributed.

It is convenient to interpret the transfer pricing methods as either yielding economic measures or accounting measures. The methods summarized under traditional transaction methods fall into the former category, while the transactional profit methods fall into the latter. The evaluation will proceed along these lines.

Results

Transfer pricing methods that yield economic measures are strictly preferred to those relying on accounting metrics. Franklin M. Fisher and John J McGowan put it most succinctly in their seminal article:

The appropriate return metric for investment evaluation is the economic rate of return. In contrast, accounting rates of return are not suitable for the analysis of future investments.

It is economic rates of return that are equalized within industries in long-run industry competitive equilibrium and, after adjusting for risk, are equalized everywhere in a competitive economy in long-run equilibrium. Likewise, it is an economic rate of return above the cost of capital that promotes investment in an industry and above the (risk-adjusted) cost of capital that promotes expansion and investment in a competitive economy. Perhaps most importantly it is economic rates of returns, and expected future cash flows that determine the value of the company.

[1] The views expressed herein are solely the author's and do not necessarily reflect the views of the Saudi Arabian Oil Companies or its affiliates.

Accounting rates of return are useful only insofar as they yield information that can be used to calculate economic rates of return. It should go without saying that the accounting rate of return on a given investment, which is defined as the net revenue to book value in a given year, will be equal to the economic rate of return, which is defined as the rate which makes the present value of the entire stream of net cash flows equal to the initial capital cost, only by coincidence. Indeed, there is no reason for us to expect these rates even to be close. Profits as reported by accountants may differ from firm to firm and industry to industry and they are not consistent with economic concepts of profits, which include the opportunity cost of all inputs in the production process, including of capital. Thus, even if properly and consistently measured, accounting rates of return provide almost no information of economic rates of return.

Worse, it is easy to construct cases where firms with higher accounting rates of return have lower economic rates of return and vice versa. Moreover, accounting rates of return on individual investments generally vary from year to year and depend crucially of the time shape of the investment. Only if such fluctuations are averaged out by combining different investments over time will a firm's accounting rate start to be roughly constant, yet still not approximate the economic rate of return. If firms do not show the very substantial variability in accounting rates of return of single investments in practice, it is because they are growing and attribute profits from past investments to the book value of new projects whose profits are yet to materialize, rather than to the declining book value of such past investments. While this sort of averaging stabilizes accounting rates of returns it also makes them less comparable conceptually to the economic rate of return.

While the RP method is well-suited for the simple exchange of goods, the CUP method or the C+ method, the latter especially in the guise of the ROR method, are best suited for transactions that resemble longer term relationships or the provision of a service well into the future.

For the CUP method the accuracy of the transfer price stands and falls with the choice of suitable comparable transactions. In practice, the analyst will have access to bespoke databases. The advantages of the methodology are twofold: First, given a sufficient number of observable transactions, the estimate is very reliable. Second, because the transfer price is independent of the conduct of the controlled parties, the method does not distort incentives. The downside is that adjustments to the observed prices for special circumstances are difficult. For example, to establish a transfer price in Saudi Arabia may be difficult if most comparables are based on the U.S., which is often the case given that the U.S. often represents the most liquid, active and transparent market.

The ROR method can best be understood as the approach adopted by most regulators of natural monopoly. ROR regulation seeks to allow the regulated entity a rate of return close to its cost of capital, which is what the utility would stand to achieve in long-run competitive equilibrium. The rate has to be an economic rate of return as explained by Fisher and McGowen, it is useful to think of a target IRR. While simple cost-plus regulation may create perverse incentives by enticing the regulated entity to inflate its capital base, there are ways to mitigate this tendency. These include redetermination periods of several years during which the regulated entity will benefit from any outperformance, efficiency factors requiring the regulated entity to improve operations or profit-sharing mechanism if certain targets are exceeded. Just as the regulator can achieve an alignment of incentives, so the proper use of transfer prices between different entities in controlled transactions ensures overall alignment of incentives at the company level. An added advantage is that projections may be based on a company's business plan, and the target return on the Weighted Average Cost of Capital, adjusted for industry and jurisdiction, for example by using an asset pricing model such as CAPM.

Conclusions

If the objective of the choice of transfer pricing method is a mere minimization of the tax bill, any method that achieves the task will do. However, if the objective is more ambitious and includes an alignment of incentives and the efficient running of operations, economic metrics are vastly superior. Indeed, the added benefits from efficient and incentive-compatible transfer pricing may result in benefits that outweigh tax savings. This is ultimately an empirical question, which awaits further investigation.

References

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