

Chapter 2

Economic vs. Accounting Profit Rates

This chapter contains a brief overview of the key differences between economic and accounting measures of profit rates, and the “big picture” practical implications of substituting accounting measures for economic measures in the transfer pricing regulations.

The transfer pricing methodologies written into the U.S. and OECD regulations and guidelines are loosely founded on economic concepts of equilibrium under specific competitive conditions. These concepts are taken to justify comparisons of rates of return (and other “profit level indicators”) across firms. Such comparisons are the cornerstone of our current transfer pricing regimes. More particularly, individual members of a multinational firm are generally likened to a set of quasi-comparable standalone companies, and their gross or operating profits are determined, for tax purposes, by imputing the independent sample companies’ rates of return, gross margins, operating margins or other measures of profits thereto.

In theory, economic rates of return in product markets *are* equalized (albeit only in the infamous “long run” under competitive conditions). However, as noted, the U.S. and OECD transfer pricing regulations and guidelines substitute accounting measures of profit, rates of return and asset values for economic profits, rates of return and asset values. As described below, accounting measures do not play the same signaling and resource allocation roles that economic rates of return play in an economy. Therefore, they would not be equalized even in competitive markets poised in long-run equilibrium, much less in the imperfectly competitive markets in various states of disequilibrium that are the norm. Stated differently, there is no reasonable basis for assuming that one firm will earn the same accounting rate of return as a similarly situated competitor. This observation applies equally to other accounting measures of profit.

The fields of economics and accounting serve very different purposes. Microeconomic and financial theories seek to explain the allocation of resources in an economy through firm, consumer and investor behavior and market mechanisms. Economic profits drive firm behavior and lead to the maximization of shareholders’ wealth (and, thereby, their lifetime consumption). The calculation of such profits reflects the actual timing of investments (rather than smoothing out periodic capital expenditures via depreciation) and incorporates *all* costs, including the cost of

equity capital (and, potentially, other opportunity costs). The economic profit *rate* is defined as that rate which equates (a) the discounted present value of forecasted after-tax free cash flows generated by a given investment project with (b) the initial outlays required.¹ It is extremely difficult, if not impossible, to quantify a firm-wide economic profit rate as a practical matter.

Under conditions of free entry and exit, and absent financing constraints, firms will continue to enter a given market until the net present value of market participation (that is, the present value of projected after-tax free cash flows, discounted at the opportunity cost of capital and reduced by the initial investment required) is driven to zero. Until this point is reached, incumbent firms will earn positive economic profits (i.e., profits in excess of a “normal” return), and shareholders’ wealth will be increased thereby. Through the process of market entry, additional resources are dedicated to the manufacture of those products that consumers value more highly than the resources necessary to produce them.

Accounting analyses present a snapshot of firm performance at a point in time, or generally over a relatively short period of time, to facilitate “mid-course corrections” and incremental decision-making on the part of management and shareholders. Accounting rates of return are computed as the ratio of operating profits to total assets, fixed assets or some other measure of the book value of resources committed by the firm. Costs are measured by explicit expenditures only, and one attempts to match revenues and the expenditures necessary to generate them on a year-by-year basis. As such, assets are depreciated over their useful lives, in lieu of deducting investment outlays in full when they are made. Firms generally do not maximize their accounting rates of return (or their ratios of operating profits to revenues or costs, or gross profits to cost of goods or operating expenses), because such courses of action will not result in the highest possible shareholder value. Therefore, as noted, there are no market mechanisms at work to equalize these profit level indicators across firms, and, by implication, no particular reason to expect similarly situated firms to earn the same accounting rates of return, operating margins or operating markups, as noted.

The use of accounting measures of profit to determine multinational firms’ country-specific income tax liabilities under profits-based methods has several important practical implications, enumerated below.

- (1) *Tax authorities in different jurisdictions are likely to allocate individual multinational firms’ consolidated income across countries in different ways.* This statement would be true even if tax authorities utilized the *same* transfer pricing methodology, given the sensitivity of one’s results to the particular “comparable companies” included in one’s sample (and, in the case of the CPM, the particular profit level indicator used). However, as a practical matter, tax authorities are likely to use different transfer pricing methodologies in analyzing a given case.

¹ In this context, free cash flow, constituting income that actually accrues to investors, is defined as the after-tax cash flows earned by the legal entity under consideration, assuming that it had no debt.

Most countries endorse the arm's length standard in principle, and the U.S. and OECD provisions contain the same specific set of transfer pricing methodologies (discussed at length in Chapter 3). However, the IRS has a clear predilection to use one particular profits-based method (the CPM), while OECD countries prefer transactions-based methods. Different approved methodologies will generally produce different allocations of income, because the assumed unifying foundation across methods—primarily the basic concept of market equilibrium—does not in fact apply. The large number of cases handled by the competent authorities of different countries attests to this conundrum, which in turn creates the potential for double taxation on a significant scale.

- (2) *Individual multinational corporations cannot accurately anticipate their country-specific tax liability in the absence of an Advance Pricing Agreement.*² Corporate taxpayers and tax authorities, respectively, also frequently utilize different firm samples and/or transfer pricing methodologies to determine their tax liability (taxpayers before an audit and tax authorities during an audit). Because the use of different samples and/or methods will often produce inconsistent results, firms acting in good faith may report substantially less income in a given jurisdiction than the tax authority in that jurisdiction believes is warranted.
- (3) *The current transfer pricing regime produces inequitable results.* Because the existing transfer pricing laws and regulations are not based on defensible economic principles, or on transparent rules that all countries apply uniformly, they produce arbitrary results. Arbitrary apportionments of multinational firms' income across the countries in which they operate are inherently inequitable.
- (4) *Multinational and domestic firms are not treated uniformly for tax purposes.* In the abstract, the arm's length principle appears to ensure that domestic and multinational firms will be treated uniformly for tax purposes, essentially by definition. However, individual standalone competitors in a given market often report markedly different operating results in the same reporting period. By requiring individual members of a multinational group to report gross margins, markups or accounting rates of return that are contained in the interquartile range of third parties' results (a U.S. regulatory provision that the OECD Guidelines do not endorse), multinational firms are treated more favorably for tax purposes than a subset of their domestic counterparts, and less favorably than others.

Inequity is inherently problematic, and uncertainty is costly, both for tax authorities and individual corporations and from an economy-wide perspective. Explicit costs, from tax authorities' perspectives, include costs incurred in conducting audits and analyzing transfer pricing issues, and in resolving conflicts over income allocations with their opposite numbers in other tax jurisdictions. Moreover, to reduce the

² An Advance Pricing Agreement, as the term suggests, is a vehicle for tax authorities and firms to agree well in advance of an audit on a particular transfer pricing methodology and the way that it will be applied, thereby minimizing disputes at a later date.

likelihood of penalties, firms generally commission costly transfer pricing studies, and, as part of this process, make their personnel available to respond to analysts' questions and requests for documentation and information. Inasmuch as uncertainties regarding tax liability require firms to set aside funds that would otherwise be invested productively, they also entail substantial opportunity costs. Lastly, firms maximize their *after-tax* free cash flows. Their inability to accurately anticipate their effective tax rates in individual countries, whether due to double taxation or simply to inconsistent allocations of income across jurisdictions (that are subsequently adjusted without penalties), may distort investment decisions.

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