Transfer pricing for improved business outcomes

Changing platforms and fast-moving technologies are having a significant impact on value creation in many areas of banking and financial services. This is one of the most interesting and important elements of transfer pricing for financial services in a post-BEPS (Base Erosion and Profit Shifting) world, since the BEPS project aligns profits with value creation. With the current pace of commercial change, if a financial institution's transfer pricing does not properly reflect value creation now, this misalignment is likely to increase in the years ahead.

Transfer pricing for banks

Saudi Arabia has always adhered to the arm's length principle while dealing with group entities under its income tax laws. This means that multinational enterprises should deal with a related party as if they are dealing with an unrelated/third party in their conduct and business outcomes. Saudi Arabia further introduced comprehensive Transfer Pricing Regulations in February 2019 legislating transfer pricing compliance obligations for taxpayers in Saudi Arabia.

The tax profile of financial institutions and banks in Saudi Arabia is varied and ranges from 100% Zakat entities, to mixed companies, and branches of foreign banks. The introduction of the comprehensive new regulations means that, depending on their tax profile, banks need to prepare four transfer pricing documents and file them with tax authorities in Saudi Arabia.

These four documents are: a disclosure form and affidavit, a local file, a master file, and country-by-country reporting, including notifications. In the case of 100% Zakat entities, they are only subject to country-by-country reporting including notifications.

For banks, critical transfer pricing considerations fall under two categories of income and expense: interest and non-interest. For interest, it is important to consider the booking of loans under syndication, loan transfers, and sales credit. For non-interest, considerations include the booking of upfront non-interest income, like upfront fees in relation to advisory projects, which may include project finance, mergers and acquisitions, equity capital market, and debt capital market.

Using transfer pricing for optimal business outcomes

While transfer pricing compliance is backed by regulatory requirements, leaders of financial institutions and banks must consider the broader picture and use transfer pricing to ensure that standalone Income Statements reflect optimal business outcomes. This can be achieved by deploying arm's length principles as an instrument to ensure related party transactions between group entities are dealt with arm's length outcomes. This could begin by simply understanding the fact pattern on management and head office costs incurred by the ultimate parent company benefitting broader group companies yet never expensed to benefitting group entities.

In the event where any group entity procures services from a third-party vendor, such as human resources, legal, business controls checks, they invariably would have paid for such services and expensed them in their Income Statement. This practice can be extrapolated to the instance when one group entity seeks such services from another group entity.

Business	Item of income and expense	Transfer pricing considerations
Banks	Interest	Booking of loans under syndication, loan transfers, and sales credit.
	Non-interest	Booking of upfront non-interest income like upfront fees in relation to advisory projects (project finance, mergers and acquisitions, equity capital market, debt capital market).
Cost recharge	Operating income / expense	Management and provision of service cost recharges. Shareholders cost versus globally benefitting versus regionally benefitting versus locally benefitting.

In their considerations, banks also need to account for operational aspects like tranfer pricing governance and risk management, which include withholding tax, VAT, inter-company billing, settlements, and reconciliations arising by virtue of related party transactions.

While such related party transactions will be a zero-sum game at the consolidated financial levels, at the standalone level they will reflect the cost base incurred to generate commensurate revenue and the margins will incrementally align with business outcomes. This concept complements the basic principles of accounting of a "separate entity."

In addition, tax transfer pricing can be further applied to the following areas of income and expense streams, as demonstrated in the table below.

These considerations can be initiated through the following simplified steps. First, obtain the entire cost base of the bank. Secondly, connect with a business or department leader to understand the fact pattern on the cost base versus the portion of such a cost base incurred to benefit other group entities. Thirdly, establish an internal framework and policy to ensure cost recharges take place commensurately to benefitting group entities based on aligned cost allocation keys and backed by inter-company agreements.

In their considerations, banks also need to account for operational aspects like transfer pricing governance and risk management, which include withholding tax, VAT, inter-company billing, settlements, and reconciliations arising by virtue of related party transactions.

Transfer pricing can be a meaningful instrument to ensure that standalone Income Statements reflect optimal business outcomes. These considerations work in tandem with seamless compliance with Saudi Arabia's transfer pricing arm's length principles and the maintenance of supporting documentation to comply with transfer pricing obligations.

It is recommended to follow a simplified approach that includes fit-for-purpose inter-company frameworks, policies, and execution strategies.

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