General Aspects of the Effects of Inflation in the Transfer Pricing Determination and Adjustment Processes

On behalf of
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General aspects of the effects of inflation in the transfer pricing determination and adjustment processes

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German Agency for International Cooperation (GIZ)
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Message from the working team.[1]

Inflation is a phenomenon which, through the years and particularly, in certain periods of history has significantly affected the economies of the world. For example, we could mention the hyperinflation that occurred at the end of the First World War in several European countries; in addition to those inflationary processes that unleashed in developing countries in the fifties.

If we focus on the economic history of the past fifty years, it may be perceived that inflationary problems have been well controlled in the more developed economies as of the eighties, while, in general, developing countries have shown no alarming inflation indexes since the nineties.

The most disturbing situation would be that of a "hyperinflation" –in which context the inflation indexes are more than significant -, term with respect to which the international community and experts have not bee able to clearly agree as to when an economy is in a context with these characteristics.

In Latin America, the countries which in the past five decades have experienced and recognized hyperinflation or a significant inflation were, among others, Argentina, Bolivia, Brazil and Peru. If we were to consider more recent works on the behavior of inflation in Latin America, we could include Venezuela in the aforementioned list of countries.

[1] **Sources:**

a. Information obtained from the World Bank data base.
b. "Realidades de las hiperinflaciones modernas", prepared by Carmen. M. Reinhart y Miguel A Savastano (Finanzas & Desarrollo, June 2003).
c. "Inflación ronda América Latina", prepared by Oscar Ugarteche (OBELA, April 2011).

On analyzing the data of five continents regarding the inflation indexes available in the World Bank data base, and considering only those countries with complete information for the anual periods ranging from 2008 to 2012, one may observe that inflation has decreased approximately four and a half points during the aforementioned period. Likewise, based on that same data, it is worth noting that the countries of the Americas, in average have shown inflation indexes slightly lower than those of Africa and significantly lower that those of Asia.

On considering this information, a logical conclusion could be that the economies of the world have managed to permanently eradicate inflationary problems. Nevertheless, such statement could be careless, on being based on statistical data and not on a qualitative evaluation of the potential risks that an inflationary process may occur. For example, the injection of dollars in exchange for U.S. Treasury bonds in October 2010 generated a significant increase in the price of several commodities. Such increase in prices has been further stressed by the conflicts generated in the Middle East, or the high rates of growth being experienced by some countries of the region, such as, for example, Panama.

Based on this approach, although we do not dare speak of a hyperinflationary process, we do believe that a significant inflationary episode could burst at any time and could be extended for a long period, as it has happened in the past fifty years in several countries, where inflation has not been related to war conflicts.

That is why it is deemed timely to examine during this period of relative inflationary stability the effect of inflation when applying the methods most used by the legislations of the Latin American and Caribbean countries for controlling abusive transer pricing manipulation.

Transfer pricing control is a practice that began developing in the region approximately in the mid-nineties and on which most of the countries are beginning to capitalize experience. To date, almost no country of the region or the world has been obliged to deal with the effect of inflation when applying the transfer pricing calculation methods between related parties. Perhaps this is the reason why this matter has not been widely discussed in international forums specialized on the subject.

We endeavor that this study may be the basis of international discussions on the incidence of inflation on transfer pricing, as well as a useful guide for the international tax community, in particular for all those tax specialists whe having to deal with transfer pricing in inflationary contexts.

Finally, we would like to thank all those who contributed to this study, “International Tax Compact” (ITC)[2] and the International Cooperation Office (GIZ) of Germany who provided the funds , as well as all the authorities and officials of the tax administrations who provided information: Internal Revenue Service (SII) of Chile, State Agency of Tax Administration (AEAT) of Spain, Tax Administration Service (SAT) of Mexico, National Superintendency of Customs and Tax Administration (SUNAT) of Peru, General Directorate of Internal Taxes (DGII) of the DomIASan Republic, General Directorate of Taxation (DGI) of Uruguay and “South African Revenue Service” (SARS) of South Africa.

[2] *“International Tax Compact”* is an initiative promoted by the governments of Germany, Spain and France whose purpose is to strengthen tax policy and administration in developing countries in order to mobilize local resources and promote fiscal sustainability.

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I. INTRODUCTION

The purpose of this exploratory study is to analyze whether the methodology –which is mainly based on the 2010 version of the *"OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations"*[3] – used for determining if transfer prices between related parties have been set at market value is appropriate when *"the tested enterprise"* is located in a country undergoing a context of inflationary economy.

A. Current context.

In this respect, while in several countries of the region specific rules have been established for controlling transfer pricing manipulation, some are undergoing inflationary phenomena (whether serious or not) which justify the analysis proposed in the foregoing paragraph.

In this sense, several are the questions that arise a priori, among them: Is inflation an element to be taken into account in the comparability analysis? If so, could adjustments to comparability correct the effects of inflation? Does inflation likewise influence all methods? Can we speak of tolerable levels of inflation within the methodology? Could it be assumed that as of certain levels of inflation (for example, in hyperinflation situations), the methodology is not appropriate?

B. Importance of the subject.

For this reason, this exploratory study, rather than offering solutions endeavors to call the attention to the problem and eventually, serve as element for creating a debate that may generate proposals since, in the professional practice it has been noted that, vis-a-vis the specific problem and the almost absence of doctrinal background on the subject, the administrations as well as the taxpayers usually have opted for taking the less appropriate of paths: ignore the incidence of the inflationary phenomenon in the transfer pricing analysis.

The pertinence of the proposed questions in inflationary contexts is easily justifiable if one observes that the transfer pricing determination and adjustment methodology is based, mainly, on the comparison of accounting information that could perhaps not be

[3] Hereainafter this document will be identified as OECD Guidelines.

homogenous and which, therefore, may call for considering the possibility of making extra-accounting adjustments in order to carry out the comparability analysis.

There are several reasons that could generate discrepancies with respect to the accounting criteria used, among others, when original accounting measurements are not adjusted for inflation (problem in the unit of measurement). In particular, and as stated in the doctrine[4], the lack of calculation of the effects of inflation (although at times very small) could significantly affect the measurement of the profit for the period and the reason of the net worth's profitability, among others.

C. Purpose of the Study.

As will be analyzed throughout this study, the methodology used for determining whether the transfer prices established by the related companies are similar to those that would have been agreed by independent operators, is mainly based on the methods supported by the quantification of net or gross margins[5] and on the accounting information arising from the tested enterprise as well as from the comparable enterprises.

It is thus that, as previously stated, the main objective of this study will be to try to assess how the fact that the tested enterprise is immersed in an inflationary economy, affects the transfer pricing determination and adjustment processes, to which end the starting point will be the analysis of the methodology and considering, in particular, the aspects to be taken into account in the comparability analysis.

[4] FOWLER NEWTON, Enrique. *Análisis de Estados Contables* (2008). Buenos Aires: La Ley.

[5] Considering the factual difficulties arising from the application of the comparable uncontrolled price method.

II. PREVIOUS CONSIDERATIONS

A. Transfer pricing.

Transfer pricing determination causes concern to enterprises as well as to the tax administrations. Considering transfer pricing as the mechanism whereby benefits are transferred between enterprises of a same multinational group in order to maximize global benefits, the subject becomes an important issue for academic and professional study and/or analysis. For example, in a globalized world businesses are structured in such dynamic forms that it is difficult for the tax administrations to understand and control them.

Transfer pricing control is a challenge for the tax administrations and the main problem lies in the availability of information for analyzing compliance with the arm's length principle. Since said analysis involves several transactions, countries and economic circumstances –such as, inflation, for example -, it is essential to count on numerous sources of internal and external information which, in turn, may be reliable and allow for carrying out a reasonable analysis. Therefore, for an adequate examination or control it is essential to consider all the necessary elements that may affect comparison between margins of profitability or the very prices of the goods or services transacted. In this context, inflation is a variable that should be taken into account to determine how it affects a transfer pricing analysis.

Most of the Latin American and Caribbean countries have adopted rules for regulating transfer pricing, while some others are evaluating their implementation. As evidenced in the Study on *"The Control of Transfer Pricing Manipulation in Latin America and the Caribbean*", published by CIAT, ITC, GIZ and BMZ in 2012, the Region has undertaken transfer pricing control with great interest and strength.

According to the previously mentioned Study over 70% of the countries considered have adopted or are currently developing transfer pricing related regulations. The first legal experiences occurred between 1992 and 1997, with Brazil, Mexico and Chile being the pioneers. Of the fifteen countries analyzed, thirteen have included rules based on the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of the Organization for Economic Cooperation and Development (OECD Guidelines).

Although inflation is a problem that could affect any country to a greater or lesser extent; many have been able to maintain it at controllable or low levels for long periods of time, especially the developed countries. The main guidelines on transfer pricing originated from forums mainly consisting of developed countries. Therefore, its treatment has not

been evaluated from where it actually affects and involves many Latin American and Caribbean countries. The latter indeed have had several significant inflationary experiences due to varying reasons, such as unbalances in their trade balances and monetary policy affairs.

Although not many countries of the region currently handle significant inflation indexes, based on the economic history, it may be said that the existence of inflationary processes is imminent. It is thus that this risk variable becomes, in our opinion, a valid reason for considering and examining its incidence when undertaking the transfer pricing analysis.

B. Inflation and considerations of an inflationary economy.

Inflation is commonly known as a generalized and sustained increase in the level of prices paid for goods and services during a specific time frame.

In other words, if an increase in the level of prices is not generalized or sustained, it should not be considered as inflation, but only as an increase in the level of prices.

Therefore, one cannot speak of inflation if prices increase in a single sector of the economy, or, although being in all sectors, such increase is not sustained.

Inflation reflects a reduction in the purchasing power of consumers since, in an inflationary process equal monetary values allow for obtaining a lower amount of goods and services.

On their part, the International Financial Reporting Standards[6] explain the inflationary process to the extent prices change through time as a result of various economic and social forces; since the specific forces acting in the market may cause significant increases or decreases in individual prices, regardless of the behavior of other prices. Besides, the general causes may result in a change in the general level of prices and, accordingly, in the currency's general purchasing power.

[6] Paragraph 5 of the International Accounting Standard IAS 29, Financial Information in Hyper-Inflationary Economies.

1. Economic theories.

Inflation may be considered from different standpoints. To this end, we will basically deal with it especially from the accounting standpoint. However, within this same framework it is important to briefly provide the different explanations of inflation which have been the source of various economic theories:

a) Inflation of demand. In the assumption that the economy is in a full employment situation, increases in monetary offer lead to increases in the prices of goods and services. If the amount of goods and services produced is maintained and the amount of money increases, with its circulation speed remaining constant, there will be an increase in the prices of those goods and services.

b) Inflation of costs. Results from the increase of the cost of goods and services produced, when the economic interest groups attempt to increase their relative participation in the distribution of the national income, above the increase of the value of its marginal productivity.

   Everyone wishes to increase his benefits, workers earn higher salaries and the producers greater benefits through prices, with the subsequent repercussions in the price of the end product.

c) Structural theory. Price increase in underdeveloped countries is basically explained through the structural inefficiencies of the productive system and market in said countries.

2. Calculation methods.

Not all the countries in the world use a standard method for calculating inflation, nor do all use the same indicator. Nevertheless, the most generalized indicator is the consumer price index, normally represented by the CPI acronym.

The CPI is a measure of the average change in time of the prices paid by the urban consumers for a basket of consumption goods and services. The CPI is frequently called the *"cost of living index",* but differs in very important aspects from what would be a complete measure of the cost of living.[7]

[7] http://www.bls.gov/cpi/cpifaq.htm#Question_1

It is important for comparability purposes, to bear in mind what is considered a basket of goods and services used by an average family in a country. For example, there is no differentiation as to whether it is high, middle or low class and, what is even worst, if one wishes to compare the CPI of one country with that of another, there will certainly be differences in the components of the basket used by each country.

There are many international guidelines for its calculation, such as, for example, the United Nations guidelines from the 1993 National Accounts System, the Special Data Dissemination Standards (SDDS) of the International Monetary Fund (IMF), the methodological contributions relative to Index Numbers of the European Community: EUROSTAT, INSEE-France, INE-Spain; and in the South American region, the contributions of the Andean Community and MERCOSUR.

Within the context of this Study, it is important to clarify that since it is a general price index there could be cases where the prices of a good or service in particular, might have had a totally different behavior to that of the CPI. This could be so because said good or service could have had a very low weight within the basket of goods or services used or perhaps, not even be a part of it.

The methodology generally used consists of assigning a base year for the calculation, wherein the monetary value of the basic basket corresponds to a CPI of 100. As of that year, the CPI is modified according to variations in the prices of goods or services included in the corresponding basket, with the corresponding weight for each good or service, according to each one's importance.

Given that it is a general indicator, the entities in charge of their calculation normally calculate item by item in the main zones or cities of the country, to then generate aggregated indexes, either by geographical regions or subgroups of goods and services, until arriving at the general price index.

3. Classification of inflation according to its magnitude.

The bibliography on this subject usually classifies inflation into three types:

a) Moderate Inflation. It is that with which the Governments and society may live without greater inconveniences. People still trust cash, its power or the financial

system. It is said that it occurs when inflation does not reach two digits; that is, it is below 10%.

b) Galloping Inflation. Is when inflation begins to upset the economic agents. There is no longer trust in the circulating currency and especially the people try to get rid of the cash which is not strictly necessary and also to acquire goods and services that will not easily lose value or which may satisfy their vital needs within short term. Significant economic changes arise. Contracts and prices, among others, tend to be indexed according to indicators related to inflation or also to stronger or stabler currencies such as the Dollar, Euro or Yen. It is said that there is galloping inflation when it is greater than 10% but does not exceed 1.000% anually.

c) Hyperinflation. This is the term applied to that inflation of the greatest magnitude. It is synonymous of a severe economic crisis which normally occurs following important political conflicts or war episodes, or simply as a consequence of an excessive inorganic issuance of money by a government. In this case, people do not want to have money and in the economy there appears to be a resurgence of bartering. There is no precise definition of the rate of inflation required so that it may be considered hyperinflation, but a working definition is that a country experiences hyperinflation when its anual rate amounts to 1.000%. (When inflation is too high, it is not estimated by year, but by month. The power of the compound interest becomes evident. For example, the correspondence between a monthly inflation of 21.16% is equivalent to 1.000% of the anual rate)[8]. Some of the most critical cases of inflation in history are: Germany, 1922; Greece, 1944; Hungary, 1946; Yugoslavia 1994; and, Zimbabwe, 2008.

However, the International Financial Reporting Standards (IFRS) consider there is hyperinflation when, among other criteria[9], the cumulative growth is over 100% in the last three years. In view of the approach followed by this study, hyperinflation will be considered in accordance with the provisions of the accounting standards.

4. Effects of inflation on the economy.

It is said that in the economy, inflation is not always bad; that even depending on its level it may have positive effects. Hereunder we will undertake a quick review of the general effects that may occur and, in particular, the effects it may have on taxation:

[8] Dornbusch Rudiger, Fischer and Startz. Macroeconomía, p. 474.

[9] Paragraph 3, literal e) of IFRS 29.

a. Positive effects. There is no precise determination as to the level in which inflation may become a serious problem for the economy. However, there is a certain consensus in that inflations lower than 10% annually; that is, one-digit inflations may invigorate the economy.

   It is said that low inflation helps the labor market to quickly achieve a balance when nominal salaries have not been adjusted to the downward trend. It also affords the banks a maneuvering trend when there is a need to reduce the nominal interest rate; and it is even said that it further invigorates the productive sector, since the people perceive a high risk in the financial investments, except if they are of a speculative nature.

b. Negative effects. When inflation is higher than 10% annually, there is a greater probability that it may produce negative effects in the economy, mainly because it results in a high level of uncertainty and instability and even affords speculative players the possibility of taking advantage of their position to generate benefits to the detriment of other players. For example, even though the business sector may annually adjust the salaries, in most cases it will be impossible to recover the workers' purchasing power and even if it may occur, there will be a loss that began generating in the workers since the first day after the last increase, because inflation does not wait.

c. Effects on taxation. If tax systems do not include regulations that adjust the effect of inflation, payment obligations that would be contrary to the contributive capacity could be generated. For example, let us see what could happen in a capital investment and let us recall that the rate of interest paid by the banks, includes the loss in purchasing power.

Let us assume an economy where there is a 25% annual inflation and banks are paying 30% annual interest. When a taxpayer makes a $100 deposit, it shall be considered that at the end of the year he will receive 130, it being understood that at present, those 130 dollars would be equivalent to 105 dollars a year ago, since those 25 dollars would represent the loss in acquisition power. In sum, the taxpayer has generated a net benefit of 5 dollars. Nevertheless, when generating the income tax, the latter will take into consideration all of the revenue; that is, 30, and the tax will be applied thereon. Assuming a 25% income tax rate, if the effect of inflation is not considered, the assessed tax could be 7.5 dollars, thus being greater than the net benefit which was barely 5 dollars.

5. Accounting aspects related to inflation.

When the accounting practice responds to the principles of historical accounting, usually the assets and liabilities, revenues and expenses are shown in their original amounts without considering any adjustment for the fluctuations occurring at the general price level.

In this sense, as uniformly stated by the doctrine, omission of the loss in the currency's purchasing power seriously affects the homogeneity of the accounting statements, thus affecting the comparison of data within a same state, between the financial statements of an enterprise on a different date, or between financial statements of several enterprises[10].

With inflation, assets of a monetary nature generate losses, while monetary liabilities generate profits.

Therefore, in inflationary contexts, historical accounting[11]:

- Does not render comparable the figures of the accounting statements of an enterprise on different dates.
- Does not render comparable the figures within the same accounting statement, such as monetary and nonmonetary items.
- Certain balances lack validity per se, regardless of the comparisons, due to the inconsistency of the factors calculated in their assessment.
- Absolutely does not reflect the monetary losses and gains originating from maintaining monetary assets and liabilities, respectively.

The errors stated take away validity from the indexes or ratios which, as we shall see, are the main basis of the comparison used in the transfer pricing methodology, transactional net margin and gross margins (resale and cost-plus) methods. As stated by the quoted author: What could be the value of a profitability index calculated on the basis of an overestimated earning and an underestimated net worth? On exaggerating

[10] LAZZATI, S. Contabilidad e Inflación. Conceptos fundamentales (1992). Buenos Aires: Ediciones Macchi.
[11] Lazzati, s. Ob. cit.

the numerator and arbitrarily reducing the denominator which forms the quotient of the index, a false result is obtained.

Therefore, it is a priority and essential issue to adjust the accounting statements for inflation for the analysis in inflationary periods.

In said sense, the IFRS do not provide for regulations that directly consider or include the effect of inflation. Nevertheless, it is considered indirectly when using such methods as the current cost[12], the feasible value[13] or the present value,[14] when measuring the elements of the financial statements for their inclusion in the balance and in the statement of earnings. The current cost refers to the price that should be currently paid for acquiring the same or similar good, the feasible value deals with the price that could be charged in case the good is sold in market conditions and the present value takes into account the current value of a good.

The three methods mentioned have the *"current price"* as common denominator; that is, the one that has already been modified through the increase in the price level. The application of these methods leads us to a more precise result than the one we would obtain on directly taking inflation into account, since the latter only refers to the general increase of prices, while these criteria consider the particular increase in the level of prices that may correspond to each element of the financial statements.

Nevertheless, the way companies affected by a period of hyperinflation, is actually regulated. The International Financial Reporting Standard (IFRS) N° 29 (IFRS 29) *"Financial Information in Hyperinflationary Economies"* has been created to be applied to the financial statements, including the consolidated financial statements, of an entity whose functional currency is that corresponding to a hyperinflationary economy.[15]

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[12] *"Assets are registered in accounting terms according to the cash amount and other cash equivalent items that would have to be paid if the same asset or other equivalent would be acquired at present. Liabilities are registered in accounting terms according to the amount without discounting cash or other cash equivalent items that would be required to pay the obligation at present."*

[13] *"Assets are registered in accounting terms according to the cash amount and other cash equivalent items that could be obtained, at present, for their nonforced sale. Liabilities are registered at their liquidation value; that is, the amounts not discounted from cash or other cash equivalent items that are expected to be paid to cancel the liabilities during the normal course of the operation."*

[14] *"Assets are registered in accounting terms at the present value, discounting the future net cash receipts expected to be generated by the ítem during the normal course of the operation. Liabilities are registered at their present value, discounting the future net cash disbursements expected to be needed for paying the debts during the normal course of the operation."*

[15] This regulation does not provide an absolute rate to consider that, upon exceeding it, the state of hyperinflation arises. Much to the contrary, it is a matter of criterion to determine when it is necessary to re-state the financial statements according to the present Regulation. The state of hyperinflation results

What has additionally happened is that in many countries, especially those where inflation acquires or would acquire importance, local entities issuing accounting regulations have been concerned about issuing resolutions or internal rules regarding those accounting aspects dealing with the inflationary process in the financial statements. Such is the case, for example, of Mexico, where the Mexican Council of Financial Reporting Standards has issued regulation NIF B-10, providing for two economic environments where the entity could act at some given time. One is the *"Inflationary",* when the accumulated inflation is equal to or greater than 26% in the three previous anual periods. The other environment is the *"Non- inflationary";* that is, when the accumulated inflation has been less than the accumulated 26%.

It is important to mention that NIF B-10 states that when the economic environment is inflationary, the entity must indicate the effects of inflation in its financial statements through the application of the integral method. However, when the economic environment is non-inflationary, the entity must not provide any clarification in its financial statements in relation to the effects of inflation in the period in question.

Another interesting example worth noting is the case of Venezuela, one of the Latin American countries most affected by inflation in recent years. In this case, The Federation of Public Accountants Associations of Venezuela issued in 1992 a Declaration of Accounting Principles known as DPC10 which stated that in addition to the financial statements prepared on the *"historical cost"* basis, the enterprises had to prepare re-stated financial statements in order to recognize inflation, based on the *"monetary correction"* process. However, in 1996 the Federation determined that the only valid financial statements would be those that were re-stated.

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from the characteristics of the country's economic environment, which include the following, although they are not exhaustive:

[15](a) the population, in general, prefers to preserve its wealth in the form of nonmonetay assets, or else, in a relatively stable foreign currency. The amount of local currency is invested immediately to maintain its purchasing capacity;

[15](b) The population, in general, does not take into consideration the monetary amounts in terms of local currency, but rather considers them in terms of another relatively stable foreign currency and the prices may be established in said other currency;

[15](c) the credit sales and purchases take place at prices that compensate the expected loss of purchasing power during the deferment, even when the period is short;

[15](d) the rates of interest, salaries and prices are linked to the evolution of a price index; and

[15](e) the accumulated rate of inflation in three years is close to, or exceeds 100%.

The Federation clarified that such requirement had not been invented by them, but rather it originated from the International Financial Reporting Standards, in particular IAS 29. The latter states that hyperinflationary economies, defined as those where the accumulated rate of return in the past three years is close to, or exceeds 100%, should be re-stated in order to determine the inflationary effects. Nevertheless, when inflation in the country significantly decreased from the accumulated 100% in the last three years mentioned in the IFRS, then the Federation re-edited the rule in 2000, noting that the re-statement would continue to be obligatory if the year's inflation exceded.[16]

According to information published by the Economic Commission for Latin America and the Caribbean (ECLAC), since 2000, there has not been an annual inflation rate lower than 10% in Venezuela.[17]

To conclude this topic we may say that some countries have expressed to the International Accounting Standards Board (IASB) their nonconformity with the fact that only those cases of hyperinflation are regulated. For example, the Latin American Group of Issuers of Final Information Standards (GLENIF), in an inquiries process expressed to the IASB their objections to IAS 29 and according to their representative, Ricardo Lópes Cardoso, *"GLENIF's vision is that it is not enough to lower the 100% inflation level in three years. It is also necessary to improve the (correction) methodology. However, since each country worked out its own solution, perhaps each of them might think that their outcome is better than that of another"*.[18]

6. Relationship between inflation and risk perception in investments.

One element that is linked to the economies faced with inflationary problems is the uncertainty generated in the economy, for existing investments as well as for the individuals or enterprises that are analyzing the option of investing in said economy. As it is known, the greater the uncertainty, the greater the risk, and while the risk is greater, so is the profitability expected from the current or potential investors.

To conclude, and with respect to what will be discussed further on, it could be said that if an enterprise has investments in two different States and one of them is in an inflationary process, the multinational group must expect that in the State where said

[16] Fernando Catacora Carpio.

[17] http://websie.eclac.cl/Cuaderno_40/datos/23.VEN_Cuadro%20D.pdf

[18] http://glenif.org/es/index.php?option=com_content&view=article&id=73:latinos-quieren-corregir-balances&catid=36:noticias&Itemid=55

process exists the profit margins will be higher than in the State where there are no high inflation figures.

C. Incidence of inflationary effects on:

1. The Tax Administration's process for controlling abusive manipulation of transfer pricing.

Since the control of transfer pricing consists of the direct or indirect price comparison through the different methods available, the incidence of inflation and its effects on the control of abusive manipulation of transfer pricing could in certain cases be direct and even significant, depending on the accounting criteria used for the preparation of the financial information.

The incidence of inflation may appear at the beginning; that is, in the structuring of the transfer price of the good or service or, at the end, in the control, namely: the application of the methodologies and transfer pricing adjustments.

Incidence at the beginning: price structuring.

Inflation being defined as a percentage rate of change in the price levels, based on an average of all the prices in an economy, there are two causes that could mainly explain inflation: a radical change in the offer and excess in the demand. Actually, it is very probable that the combination of these two causes may give origin to inflation.

To understand inflation, the analysis of the behavior of the economic cycles is likewise important. When there is a decrease in demand due to the contraction of consumer expenditure, there may be a reduction or decrease in price growth. On the other hand, when salaries or purchasing power of the consumers increase at a lower rate than the offer, there may be increases in prices.

To understand the incidence of inflation in transfer pricing based on the structuring of prices, it is necessary to understand the transmission of the inflationary pressures. The latter are transferred through the economy in the following manner: from the prices of the inputs and the salaries to the prices of the producer, and from the prices of the consumers to the GDP deflator.

Likewise, it is of vital importance to complement the aforementioned analysis with the evaluation of prices and their variation in imports and exports. One important exercise would be to compare the indicators of price variation for exports with the national prices, (for the internal market). This will allow for determining whether the producers are transferring costs to foreign purchasers.

Incidence at the end: transfer pricing control (methods and adjustments).

On the other hand, inflation may affect the analysis of transfer pricing manipulation in different manners, according to the methodology chosen and the technical adjustments selected. The result or incidence may vary depending on the method; that is, it may range from one incidence in the direct analysis when comparing prices up to one indirect when comparing the margins of benefits of the linked transactions versus the independent ones.

Beginning with the comparable uncontrolled price method, for example, since it is a direct price comparison, inflation and its effects could have a very significant incidence in the analysis through this method. The differences in prices that may be identified in transactions between related companies versus independent ones may be explained by the incidence of inflation in the assessment or structure of those prices. As was previously stated, the prices of exported goods, compared with the indexes of local prices may give us an idea as to how producers are transferring the costs of production of the goods.

In the case of transactions between independent parties, this transfer could be made or not. In this latter case, it might not be made due to strategies and/or pressures for maintaining competitive advantages in international markets. Nevertheless, in the case of transactions between related enterprises, this transfer might not exist or have an inverse behavior. For example, between related parties, the maintenance of competitive advantages and, accordingly, the nontransfer of inflationary effects could not occur, since these advantages might not be a maintenance priority, to the extent their operations might be in a greater or lesser proportion carried out within the multinational group.

On the other hand, the transfer of inflationary costs, because of the increase of the price of inputs, might not take place due to the incidence or convenience analysis according to the tax rates that may arise between the systems that support the transactions between related enterprises. In other words, if inflationary effects are significant in a market wherein the tax rate is high, it is expected that there be less incentives for transferring earnings through the export prices to related foreign customers. In sum, when applying the comparable uncontrolled price method, one must consider and

examine carefully the inflationary effects of the markets where the analyzed and comparable transactions occur, in order to determine their incidence in the determination or structuring of the price of transactions.

The incidence of inflationary effects in transfer pricing manipulation may be present in the structuring of prices, as well as in the transfer pricing analysis. In the first case, the incidence must be analyzed to the extent the price indexes of the local producers are transferred to the export or import prices. Therefore, the foregoing will have an effect in the analysis of the transfer pricing methods; in particular, in the comparable uncontrolled price method. In the case of the other methods, the incidence of inflation is similar; however, its determination or evidence diminishes or is differentiated by the objetives pursued by each method in the analysis.

2. The enterprises' process for determining prices.

It had been thought that everything related to the determination of transfer pricing should be found in the guides developed jointly with its member countries and civil society by the international organizations that are experts on the subject. However, it would seem that an additional chapter is waiting to be developed by the international tax community and it is precisely the one dealing with the incidence of inflation in transfer pricing.

Likewise, when the international financial reporting standards are reviewed, there are only differentiated treatments in the case of hyperinflation. Could it be that inflation is no longer as important? The answer might probably be no, since inflation shall never cease to be a very important element when evaluating the economies, regardless of the purpose of said evaluation.

When trying to determine how inflation influences the enterprises at the time of setting the transfer prices, we become aware that there is no literature on the subject an so one must directly consult the price setting decisionmakers within the companies or their advisors that support them in risk coverage, especially when it is a matter of setting transfer prices.

It may be concluded that when enterprises set the prices, the "*inflation index"* has no direct influence in the decision, as it does occur in a government and even with the consumers themselves. In the enterprises, the *"inflation index"* acts in an indirect and focalized manner when they take into consideration the increase in costs, while maintaining the usual margin of profit and from said process there may arise special profits or losses.

Hereunder, we will briefly analyze some aspects related to the reasons why inflation is not considered by the enterprises or their advisors when determining the transfer prices:

a) Probably the most important aspect may be that inflation, based on a general index, does not necessarily have a direct relationship with the price of a specific good or service. An important role is played here by the elasticity of the demand of a good or service, which has a greater influence in the variation of prices than in inflation per se.

b) There would be different viewpoints, depending on whether the company's activity is linked to marketing or manufacturing.

c) There would likewise be different considerations, depending on whether the price determination takes place in a country with a low inflation index and if comparables of a country with high inflation indexes are used, or viceversa.

d) Even though the inflation factor were considered, it would not be technically adequate to discard a possible comparable, because of the simple fact that it may be in an inflationary economy.

e) The methodology used for applying the arm's length principle could also generate different connotations. For example, in the case of methods that use margins, one may apply or not the premise that the higher the inflation in an economy, the greater the percentage of earnings which the companies require from their investment.

f) It would seem that in some aspects, enterprises respond in reaction to the actions of the Tax Administration. If a tax administration has nothing to say regarding the way taxpayers should consider the inflationary effects on their established transfer prices, probably the message received by the entrepreneurs will be that there is nothing special to consider in this respect and they will set their prices without taking inflation into account.

g) If there is an advanced pricing agreement, it should be considered that if the economy would change from non-inflationary to inflationary or viceversa, the enterprise may request a modification so that the agreement may be adapted to

the new conditions, alleging that there has been a significant variation of the economic circumstances existing when the consultation was approved.

EFFECTS OF INFLATION IN THE TRANSFER PRICING METHODOLOGY.

The purpose of this section is to make some considerations regarding how the fact that the analyzed or tested company is immersed in an inflationary economy influences the transfer pricing methodology.

A. Comparability and adjustment for inflation.

As it is known, the application of the arm's length principle is generally based on the comparison of the conditions of a related transaction with the conditions of the transactions carried out between independent companies. In that sense, in order that the comparisons may be useful, the relevant economic characteristics of the situations being compared must be sufficiently comparable. *"Being comparable means that no difference (if any) between the situations being compared may significantly affect the conditions analyzed in the methodology (for example, the price or margin), or that sufficiently precise adjustments may be made as to eliminate the effects of such differences"*[19].

The OECD Guidelines state that adjustments to comparability should be considered *"if (and only if)"* it is expected that they improve the reliability of the results, it being necessary to consider *"the difference with respect to which the adjustment is being considered, its purpose and the reliability of the criterion used for making it"*[20].

In that sense, it turns out that the comparison of *"accepted or imposed conditions that differ from those that would be agreed by independent enterprises"*[21] cover more than the simple comparison of prices or margins.

Within the comparability adjustments, accounting adjustments stand out for purposes of the topic discussed in this document.

[19] Item 1.33. of the OECD Guidelines.

[20] Item 3.50 of the OECD Guidelines.

[21] Article 9, OECD DTA Model.

These accounting adjustments focus on the differences of accounting criteria that exist between countries and which may have permanent or temporary effects. Neverthless, it is worth clarifying that not all accounting differences may always be identified, especially because of the difficulties that may exist for accessing the pertinent information for such purposes.

Likewise, the difficulty described in the foregoing paragraph is influenced by the data bases that are used in the transfer pricing methodology which have certain limitations, such as the lack of standard information on the enterprises according to the country in which they operate. In addition, usually commmercial bases have scarce information on Latin American enterprises, thus rendering difficult the comparability with similar economic markets[22].

The foregoing statement leads to another important aspect linked to comparability, namely: that referring to the economic circumstances which include the importance of geographical markets.

Since usually Latin American multinational enterprises carry out comparability studies with enterprises from other markets; it is necessary that such markets be effectively comparable and, to this end, it will be aceptable that adjustments be made in some cases to consider certain specific aspects of the market, such as the inflation rates.

Going back to the accounting adjustments issue it is important to point out that there are different types of accounting differences to be considered: some deal with differences in classification (for example, a disbursement which in a country may be accounted for as a sales cost and in another, as administrative or commercial expense). In this respect, depending on the accounting criteria used, the difference in allocation of the item may imply the use of dissimilar criteria to recognize the effects of depreciation of the currency.

As in many cases, with the information available it will not be possible to identify all the differences of the accounting criteria. This circumstance must be carefully analyzed since, in inflationary contexts, it is necessary to determine which accounting entries are stated at current values and to what extent.

[22] In this respect, consult ANNEX II of the Study on the "Availability of public information of tax interest in the Latin American countries" ITC-GIZ-CIAT. April 2013.

[22] http://www.ciat.org/index.php/es/productos-y-servicios/publicaciones/documentos-de-trabajo.html

In addition, in the comparability analysis, one must determine the period to which the tranfer pricing analysis will be applied.

On the other hand, the OECD Guidelines state that, in practice, examination of data covering several years, turns out to be useful for the comparability analysis[23].

In this respect, when multiple years are used, the quantification of averages should anticipate the effects established in the reporting standards to recognize the effects of the currency's depreciation and thus avoid inconsistent analyses.

One last issue to consider in this section is the so-called "*country risk"* adjustment which is applied by taxpayers from several countries of the region.

The country risk adjustment is based on the idea that the risk of an investment is reflected in the return demanded from such investment by the investor and that, all other factors being constant, two similar investments although in regions with a different risk level, should show a difference in their rate of return called country risk Premium and represents the additional return to be required by investors for operating in a more risky market, as compared to a less risky one[24].

In that sense, given that the country risk premium takes into consideration some variables that may affect the investment (among them, the effect of inflation), it should be used carefully if it is to be combined with other comparability adjustments related to inflation, in order to avoid that the corrections of the economic phenomenon being analyzed may be overdimensioned.

By way of conclusion, it may be said that the incidence of inflation in the transfer pricing methodology may be considered as another economic circumstance to be evaluated within the comparability factors. It is in that context that the incidence of inflation in transfer pricing should be evaluated: as a circumstance that distorts the comparability of goods, services and/or profit obtained by the enterprises being analyzed and which may require an adjustment at the level of revenues, costs, disbursements or gross or net operational results, depending on the method being used. To assume such position implies admitting that the adjustment for inflation must be treated as an additional adjustment to comparability. That is, it shall be applied, if feasible, and if as a result thereof, a better comparison may be made.

[23] Item 3.75 OECD Guidelines.

[24] CASANOVAS, C., VAL LEMA, M. *Manual de Precios de Transferencia en Argentina*. Goldemberg C. (Directora) (2007). Buenos Aires: La Ley.

Therefore, when the analysis is performed in low inflation situations, the adjustments for adapting the comparison at the currencies' constant values might not be mandatory, which conclusion would have to be intuitively rejected in the case of highly inflationary processes.

In the coming sections attempts will be made to analyze how inflation affects certain aspects of application of the different transfer pricing methods.

B. Comparable Uncontrolled Price Method.

The comparable uncontrolled price method -CUP for its English acronym- consists of comparing the invoiced price of the goods or services transmitted or rendered in a related transaction with the invoiced price of the goods or services transmitted or rendered in a comparable unrelated transaction in likewise comparable circumstances.[25]

Any of the following conditions should exist in order that a nonrelated transaction may be comparable to a related transaction:

a) None of the differences (if any) between the two transactions being compared, or between the two enterprises that carry out those transactions significantly influences the normal market value; or

b) Sufficiently precise adjustments can be made so as to eliminate the significant effects caused by those differences[26].

In that sense, the comparability adjustments should not pose greater difficulties for recognizing the effect of inflation when applying this method. This is so, in those cases where it may be possible to show the price differences related to the loss of value of the currency in a time line and to homogeneously re-state those prices at the constant currency value.

[25] Item 2.13. OECD Guidelines.

[26] Item 2.14 OECD Guidelines.

However, this latter statement may only be consistent in those cases where the date (or at least the month) is known; that is, as to when the products or services under analysis and their comparables were commercialized, in order to make the aforementioned re-statement.

Likewise, the doctrine states that it is extremely difficult to make adjustments when the market conditions, the regulatory activity of the State and the size and presentation of the products are different, as regards the price to be tested and the comparables that could be obtained[27].

In this context, one must analyze the possible comparable transactions found in inflationary economies, with these having to be selected, given the nonexistence of other useful transactions for the comparison and provided that the necessary adjustments may be made.

With respect to the financial components, it is always important to evaluate the extent to which inflation is taken into account in the prices agreed in the term transactions. This situation must be considered at the time of making, for example, an adjustment to financing comparability.

With respect to financing transactions, it must be borne in mind that although the *"good"* involved is money, the "price" subjected to analysis is the rate of interest agreed in the transaction[28].

In this sense, one must take into account the implicit financial components that may be found in the price: the rates of interest (those explicitly agreed as well as those implicitly included in the invoiced prices) tend to be greater when inflation is very high. Accordingly, one must expect that, the greater the inflation rate and equality in the financing term, the greater the implicit rate of interest used in the price of an installment sale, set on the value of the good or service on the date of the transaction.

In sum, this method is based on the comparability of prices measured in homogeneous currency. For this reason, in inflationary economies the transfer pricing analyst must first adjust the values considered on the date on which the comparability analysis is made

[27] DISKENSTEIN, M. BLANCO, S. *Manual de Precios de Transferencia en Argentina*. GOLDEMBERG. C. (Directora). (2007) Buenos Aires: La Ley.

[28] MARTIN, Julián. *Manual de Precios de Transferencia en Argentina*. Goldenberg, C. (Directora) (2007) Buenos Aires: La Ley.

and, if appropriate, verify them after the corresponding currency conversions have been made at the rates of exchange in force at the time of making the analysis.

C. Resale Price and Cost-Plus Methods.

In this section we will deal with the effects of inflation at the time of applying two methods for evaluating transfer pricing: resale price and cost-plus.

The reason why these methods are discussed in the same section is because of the relation existing between both, considering that, for purposes of the analysis proposed in this document, the observations to be made to the cost-plus method are similar to those of the method of resale price between independent parties.

The resale price method seeks to indirectly evaluate the acquisition price of a good or service. The resale price agreed with an independent party *"is reduced to an appropriate Gross Margin…which represents the amount with which the reseller endeavors to cover its sales costs and operating expenses…"*[29].

The comparable profit margin is a percentajge of the gross profit obtained as a result of the relationship between the gross profit and net sales. Thus, the elements that comprise the selling price and the cost of the goods of the transaction being evaluated as well as those corresponding to the transactions classified as comparable must be equivalent in order to achieve the homogeneity required for the comparability. In this sense, it may be necessary to undertake accounting reclassifications in order to achieve consistency in the treatment of different items that comprise the resale margin[30].

Likewise, in inflationary contexts the homogenization of information may require that the respective sales and/or cost of goods or services items linked to the analyzed transactions be adjusted at constant values.

In that sense, it will always be necessary to express, in homogeneous currency, the items that make up the Gross Margin. On the other hand, revenues must be stated in homogeneous currency. When the sales item may have been adjusted according to the effect of inflation, it will not necessarily reflect the revenue obtained, thus becoming an

[29] Item 2.21. OECD Guidelines.

[30] GOLDEMBERG, C. *Manual de Precios de Transferencia en Argentina*. GOLDEMBERG. C. (Directora). (2007) Buenos Aires: La Ley.

estimated value that considers the inflationary effect and is useful for making financial comparisons.

If the transactions analyzed are carried out in an inflationary scenario, the effect of inflation must be considered for the application of the method. This is so, by virtue of the existence of costs added to the value of the good (or related ones) that could be affected by inflation, such as, for example, the national components added to the main product that has been imported from the country of the related enterprise. In this way, the resale price would be affected, for example if the value of the good acquired from the related party has been modified as a result of inflation. This appraisal would also be valid when applying the comparable uncontrolled price method between independent parties as well as the cost-plus method.

An example of the foregoing could be the acquisition of a good that must be labelled in the country where it is finally resold – such as a medicine, to which one must adhere a label with the country's health permits. This additional cost is part of the product's final price. Considering that there is significant inflation in the country where the resale takes place, the cost of said product would be affected.

In numerical terms, the situation would be the following: the local enterprise acquires the product from the related party at a cost of 10 dollars per unit. Its labelling, at the beginning of the year, has a 1 dollar per unit value. At the end of the year, after applying the effect of inflation, the labelling could be around 1.30 dollars. Thus, the cost of the labelled product would be 11.30 dollars. Although it could be concluded that the incidence of inflation is not significant; on adding the cost of the labelling process, to the extent more processes of this nature influence the cost of the good sold, the greater will be the proportional increase of the effect of inflation and, accordingly, the profit margin will be negatively affected.

Regardless of the fact that these methods may be used in individual or aggregated transactions and that, in addition, they admit the application of pluri-annual comparisons, this does not affect the fact that, in inflation contexts, what is important is to make comparisons with homogeneous information.

On its part, the cost-plus method is based on the costs incurred by the supplier of the goods (or services) in a related transaction for the goods transmitted or the services rendered to an associate buyer. This cost is increased by a margin that may allow it to obtain an appropriate benefit, bearing in mind the functions performed and the market conditions[31].

[31] Item 2.39 OECD Guidelines.

The application of this method implies determining an appropriate cost that will likewise be increased by an appropriate margin. Mainly with respect to the cost, it will be necessary to observe the homogeneity of the concepts integrating it, especially the criteria followed for allocating the different items as costs or expenses.

In that sense, the concepts stated regarding the adjustments to be made in the resale price method, in particular, with respect to the accounting adjustments, are totally valid for the correct application of the cost-plus method.

D. Transactional net margin method.

The transactional net margin method (TNM) and the results distribution method are methods based on the result of the transactions. *"The transactional net margin method analyzes the net benefit calculated on the basis of an appropriate magnitude (for example, the costs, the sales or the assets) which a taxpayer obtains from a related transaction (or a series of transactions …)*[32].

The aforementioned analysis will be based on the comparison of independent enterprises with similar activities and circumtances as those of the tested enterprise.

In cases were one of the related enterprises is in inflationary contexts, the decision as to which participant will be analyzed –when it is possible –is conditioned to the fact that the necessary adjustments may be made in the comparability analysis to neutralize eventual distortions caused by the phenomenon being analyzed.

Likewise, since the free competition range is calculated through profits that are compared on the basis of a profit level indicator or "PLI" (Return on Invested Capital, Operational Margin on Sales and Gross Margin on Operational Expenses, among others) taking into consideration the activity and the characteristics of the enterprises analyzed, in an inflationary context the transfer pricing analyst must evaluate the accounting components of the respective PLI, in order to identify those that are not stated in homogenous currency and determine how inflation affects the analysis.

For example, in the return on sales – Operational profit /Sales – one must determine whether sales are shown at current values. The same is applicable in the case of sales costs and operational expenses that lead to an operational profit. It is worth recalling

[32] Item 2.58. OECD Guidelines.

that the sales cost includes the inventory, where said item is not only evaluated for inflationary purposes, but one must also take into consideration the inventory valuation method.

It is important to pay particular attention to the selection of an indicator, such as, for example, the “return on assets”; where for purposes of its determination it is necessary to take into consideration items wherein inflation has a particular influence. In view of this conclusion, it will be necessary to observe which asset directly influences the generation of income and its restatement, and if its restatement, considering the effect of inflation, is the appropriate one. The acquisition date directly influences the restatement of the amount and accordingly, the indicator and consequently, the analysis.

On the other hand, with respect to the accounting adjustments, since this method only considers the accounting items that are related to the transactions being analyzed, it is generally necessary to segment certain accounting items, even in an extra-accounting manner. When including the effect of inflation in the process of segmentation of a financial statement, it is important to point out that a financial statement adjusted for inflation could complicate said process, thereby making the enterprise incur in greater costs (time allocated to the task, friendly systems that may serve to segment and adjust for inflation).

In this respect, in the process of segmentation, it is important to consider the criteria followed by the international and/or local reporting standards involved, and anticipate the effects that could affect the comparability in inflationary contexts. In particular, it is important to verify the effective application of standard reporting criteria in the classification of accounts as *“monetary”* or *“nonmonetary”* and in the methodology used for updating the values at a homogeneous currency.

Although it is considered that in the TNM the differences in the accounting criteria might not directly affect the quantification of the Operational Margin, this statement must be verified in relation to the different items that comprise the PLI selected for the analysis. In that sense, for example, it might be necessary to carefully observe the accounting items that comprise the expense, in particular, whether the administrative expenses are part of said structure. Under the administrative expenses one may observe local expenses eventually affected by the impact of inflation.

On the other hand, as stated in the section corresponding to the comparability analysis, the OECD Guidelines indicate the possibility of using multiple years to improve the analysis; for example, in situations where the productive cycle is extended through time. In that case, the quantification of averages must anticipate the effects established in the

reporting standards to recognize the effects of depreciation of the currency and thus avoid inconsistent analyses.

Likewise, one must bear in mind the effect of inflation on the items evaluated, since otherwise the impact would be extended on evaluating plurianual periods. The excessive extension of the periods analyzed in inflationary economies could be harmful, especially if the economy shows high inflation indexes. In addition, it is necessary to evaluate the impact of inflation in the specific sector analyzed, given that the market's elasticity with respect to the prices of the products or services could behave in a dissimilar manner vis-a-vis de effect of inflation.

The use of multiple years in the comparables, especially if the selected interval is broad, also implies evaluating whether rates of inflation that could have little significance from year to year, would not turn out to be so if they are accumulated.

E. The transactional profit split or division of profits method.

"The transactional profit split method seeks to eliminate the effect on profits of special conditions made or imposed in a controlled transaction (or in controlled transactions …), by determining the division of profits that independent enterprises would have expected to realise from engaging in the transaction or transactions"[33]. In that sense, through this method profits are split between related companies using internal or specific information on the basis of economically valid criteria, in order to approximate the division of profits that would have been anticipated and reflected in agreements made at arm's length.

It is worth noting that this method allows the variant known as *"residual profit split"*, whereby in the first stage an arm's length remuneration is allocated for the contributions that may be compared with similar ones through some other method and, then, the *"residual"* profit is distributed according to the methodology under study and the characteristics of the *"unique"* transactions involved[34].

According to experience, this method is not widely used in practice. The OECD guidelines indicate that the profit split method may be found to be the most appropriate where both parties to a transaction make unique and valuable contributions (for example, contribute unique intangibles) to the transaction[35].

[33] Item 2.108. OECD Guidelines.

[34] OECD Guidelines. Item 2.121.

[35] OECD Guidelines. Item 2.109.

In this sense, bearing in mind the increasing importance of intangibles in intragroup transactions and the abuses that may be incurred through them, it is to be expected that the tax administrations of the region begin to consider the frequent application of this methodology.

In sum, consolidated profits obtained in related transactions are allocated in the proportion they would have been allocated by independent parties.

It is for this reason that in the profit split method the effects of inflation must be carefully examined when quantifying the total amount of profits to be distributed –values must be expressed in homogenous currency- such as at the time of evaluating the uniformity of the criteria selected for prorating such income. When consolidating the financial information –in a homogenous currency- the effect of inflation will be recognized in this conversion process.

In this respect, when prorating said income it is important to consider which of the parties assumes the financial economic risks, since they are used to divide the income obtained. In relation to this aspect in particular, where only one of the parties would be assuming the risk caused by inflation, it would then be expected that the percentage allocated for the payment of income be proportional to the risk initially assumed.

For example, it is worthwhile to mention the case of transactions carried out by independent enterprises, where profits from an activity are distributed on the basis of costs and/or expenses incurred by each participant. In view of this situation, if a consistent result is expected, such items should be considered at constant values for the application of the method.

The reporting criteria adopted for recognizing the effects of depreciation of the currency play a decisive role when being considered in the comparability analysis, for which reason the transfer pricing analyst must ensure that his decisions be based on consistent accounting parameters.

Any time this method is evaluated under the effects of inflation, it will be necessary to verify how the profit or loss to be distributed has been structured and recorded. Likewise, it is important to observe how the economic risk is distributed according to the comparability analysis and whether the inflationary effects have been taken into consideration in the same proportion. It is important to determine whether, in order to consolidate the financial statements, the reconversion to another currency has been necessary, with the effect of inflation being implicitly recognized.

F. Other Methods: The so-called sixth method.

An alternative to the application of the comparable uncontrolled price method has been developed in the Latin American sphere in order to assign value to the exports of products from the land and natural resources, based on an experience from Argentina.

In that country, the first transfer pricing examinations were mainly focused on the cereal sector and based on those experiences, the development of the so-called *"sixth method"* was promoted in reference to the five transfer pricing assessment methods recognized by the OECD.

It should be noted that this way of determining transfer pricing for *"commodities"* has been very favorably accepted in the region: to date, Uruguay, Ecuador, Peru and Guatemala have included in their legislation rules inspired in those developed in Argentina.

In sum, it was provided that –unless the taxpayer proves that the international intermediary who intervened fulfills certain requisites set by law- in the case of export transactions with related parties involving cereals, oils, and other products from the land, hydrocarbons and their by-products and, in general, goods with quotation known in transparent markets, with the intervention of an international intermediary who is not the actual addressee of the goods, the quotation value of the good in the transparent market on the day of loading the goods –regardless of the means of transportation- and without considering the price at which it would have been agreed with the international intermediary, shall be considered the best method to determine the export income from Argentine source.

In the so-called *"sixth method"* (in the Argentine version) the price conditions agreed between the parties shall not be considered since, the transparent price of the goods on the day of shipment is considered in its application.

In sum, if the transaction fits in the method, the value mentioned in the foregoing paragraph should be considered, without the need for any additional analysis.

That is why it would seem there would be no difficulties in stating that the so-called *"sixth method"* would actually seem closer to an anti-abuse measure and when it is strictly applied, the methodology affords an objective valuation guideline of the good which, as said, does not allow for any adjustment. On this basis, it is reasonable to state that inflation has no effect on the application of the anti-elusive measure stated herein.

III. ANALYSIS MODEL OF THE IMPACT OF INFLATION ON TRANSFER PRICING ADJUSTMENTS.

The study of the impact of inflation on transfer pricing requires a numerical analysis that may allow for observing the behavior of the adjustments –among them, those of capital – vis-a-vis the inclusion of the inflation factor.

This model endeavors, within the framework of a simplified scenario, to present the previously proposed numerical analysis. In other words, the purpose is to provide the reader a mathematical analysis of how inflation influences the determination of the adjusted financial indicators and the subsequent calculation of the transfer pricing adjustment.

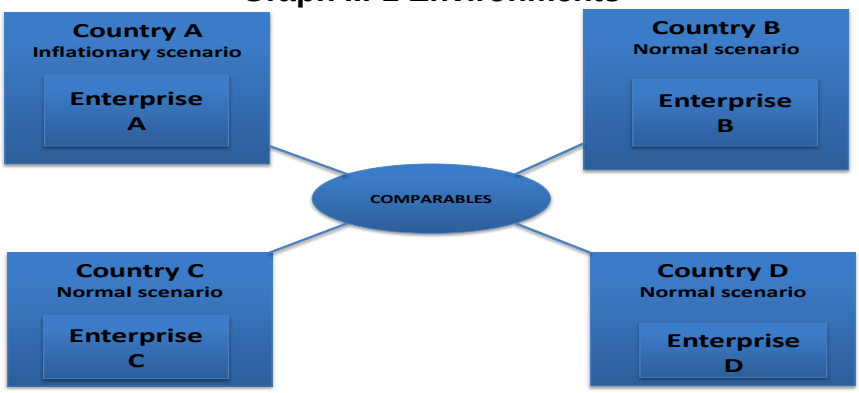
A. Assumptions of the model

The following are the assumptions which this model takes into consideration for its development:

Four comparable enterprises with identical structures among themselves and similar to those of the enterprise being analyzed are considered. In turn, these enterprises are located in countries with minimally controlled inflation. This scenario has been posed for the purpose of clearly visualizing the effect of inflation on the model.

The enterprise which is under the influence of an inflationary scenario is only the enterprise being analyzed.

Graph III-1 Environments



Prepared by the authors of the study.

The items affected by inflation and which require a restatement of their value are the following:

Table III-1 Items and restatement

Item	Monetary	Non Monetary	Observations
Accounts receivable	X		Are not restated because of their nature.
Inventories		X	Are restated, unless they have been recorded at their net realizable value or reasonable value at the end of the year.
Accounts payable	X		Not restated because of their nature.
Properties, Plants and Equipment		X	It is necessary to make the restatement.
Sales		X	See notes.
Cost of Goods		X	Not restated provided their sub-accounts are maintained at current costs.
Purchases		X	Not restated provided their sub-accounts are maintained at current costs.
Operational expenses		X	It is necessary to make the restatement.

Prepared by the authors of the study.

The items defined as monetary will not be restated in the following model, in accordance with that provided in IFRS 29[36].

Sales are recorded at current values and the values are updated for effects of inflation at the time of each sale; therefore, the values of this account will not be affected by a restatement in the model.

For purposes of the model the following parameters are defined in order to consider or not an inflationary scenario:

a) Normal or non-inflationary environment: a scenario with these characteristics shall be considered when the inflation is between zero and eight per cent (0%-

[36] IFRS 29: the monetary items will not be restated since they have been expressed at the current valuation unit on the date of the balance..

8%) in average for three years; and additionally, when future inflation projections do not anticipate an increase that may exceed these values.

b) Inflationary environment: an inflationary environment will be considered to exist when the values of this variable are above eight per cent (8%) and less than thirty three per cent (33%) in average during the last three years.

c) Hyper-inflationary environment: this type of scenario or environment is considered to exist when the values of inflation exceed thirty three per cent (33%) as annual average during the past three years.

The rate of interest applied to capital adjustments of the comparable enterprises is the average PRIME[37] rate of the last three years (2010, 2011 and 2012).

Under a zero inflation scenario or, if it is not taken into consideration because of its null effect on the financial information, the analyzed enterprise would not require a transfer pricing adjustment vis-a-vis the comparable enterprises established for the model.

B. Methodology applied to the model (simulation).

The model analysis of the impact of inflation on capital adjustments and the calculation of the transfer pricing adjustments was carried out as follows:

Variables were established for inflation and for the transfer pricing adjustments (results variable) according to each financial indicator calculated.

The following accounts were identified and the capital adjustments were applied:

- Accounts receivable,
- Acounts payable,
- Inventories, and
- Sales

The formulas applied to the aforementioned accounts for calculating capital adjustments were the following:

[37] PRIME Rate: Is the interest rate which U.S. Banks provide to their best corporate customers ("*prime*") for short term credit. http://financial dictionary.thefreedictionary.com/Rate+of+prime y http://economics.about.com/cs/economicsglossary/g/prime_rate.htm

Adjusted accounts receivable:

$$AR_{adj} = \left[\left(\frac{AR}{Sales}\right)_{Comparable} - \left(\frac{AR}{Sales}\right)_{Analyzed}\right] \times Sales_{Comparables} \times \left(\frac{i}{(1+i)}\right)$$

Adjusted accounts payable:

$$AP_{adj} = \left[\left(\frac{AP}{Sales}\right)_{Comparable} - \left(\frac{AP}{Sales}\right)_{Analyzed}\right] \times Sales_{Comparables} \times \left(\frac{i}{(1+i)}\right)$$

Adjusted inventories:

$$Inventory_{adj} = \left[\left(\frac{Inventory}{Sales_{adjusted}}\right)_{Compomarable} - \left(\frac{AP}{Sales}\right)_{Analyzed}\right] \times Sales_{Comparables} \times (i)$$

Adjusted sales:

$$Sales_{adj} = Sales_{Comparables} - AR_{Adjusted}$$

Four financial indicators were used:

- Gross Margin,
- Operational Margin,
- Net Added Cost, and
- Berry Coefficient.

The aforementioned financial indicators were used according to their original formulas; as well as according to the calculation formulas for adjusted results after calculating and applying the capital adjustments to the accounts receivable, accounts payable, inventories and sales.

Gross Margin:

$$GM = \frac{GP - AR_{adjusted} + AP_{adjusted} - Inventories_{adjusted}}{Sales_{adjusted}}$$

Where;

GP: Gross Profit

Operational Margin

$$OM = \frac{OP - AR_{adjusted} + AP_{adjusted} - Inventories_{adjusted}}{Sales_{adjusted}}$$

Where;

OP: Operational Profit

Net Added Cost

$$NAC = \frac{OP - AR_{adjusted} + AP_{adjusted} - Inventories_{adjusted}}{(Costs + Expenses)adj.}$$

Berry Coefficient

$$BC = \frac{GP - AR_{adjusted} + AP_{adjusted} - Inventories_{adjusted}}{Expenses_{adjusted}}$$

Ten thousand calculations were made for every inflationary scenario. That is, the inflation variable adopted ten thousand values among the percentages established for each of the previously described scenarios (normal, inflationary, hyper-inflationary).

Ten thousand results were obtained for each of the previously mentioned financial indicators and for each of them an analysis was made of three inflationary scenarios for

the purpose of determining how each of them affected the financial indicator and its potential transfer pricing adjustment.

Variations of the values adopted by the inflation variable and the result variable were calculated: transfer pricing adjustment for each one of the financial indicators selected.

The results, the variations adopted and obtained, as appropriate, of the variables were compared in graphs in order to visualize the behavior and impact of inflation in the calculation of a potential transfer pricing adjustment.

C. Data used in the model.

The details of the data used in the model appear in Annex I. Below are the data and explanation relative to the main variables that determined the results obtained and which will be described further on.

1. Inflation variable.

Normal or noninflationary scenario:

Minimum value: 0%
Maximum value: 8%
Expected value: 5% (value that may most probably occur
Normal data distribution

Inflationary scenario:

Minimum value: 9%
Maximum value: 33%
Expected value: 15% (value that may most probably occur)
Normal data distribution

Hyper-inflationary scenario:

Minimum value: 34%
Maximum value: 100%
Expected value: 40% (value that may most probably occur)
Normal data distribution

2. Other variable

PRIME interest rate: 3.25%

D. Results Obtained.

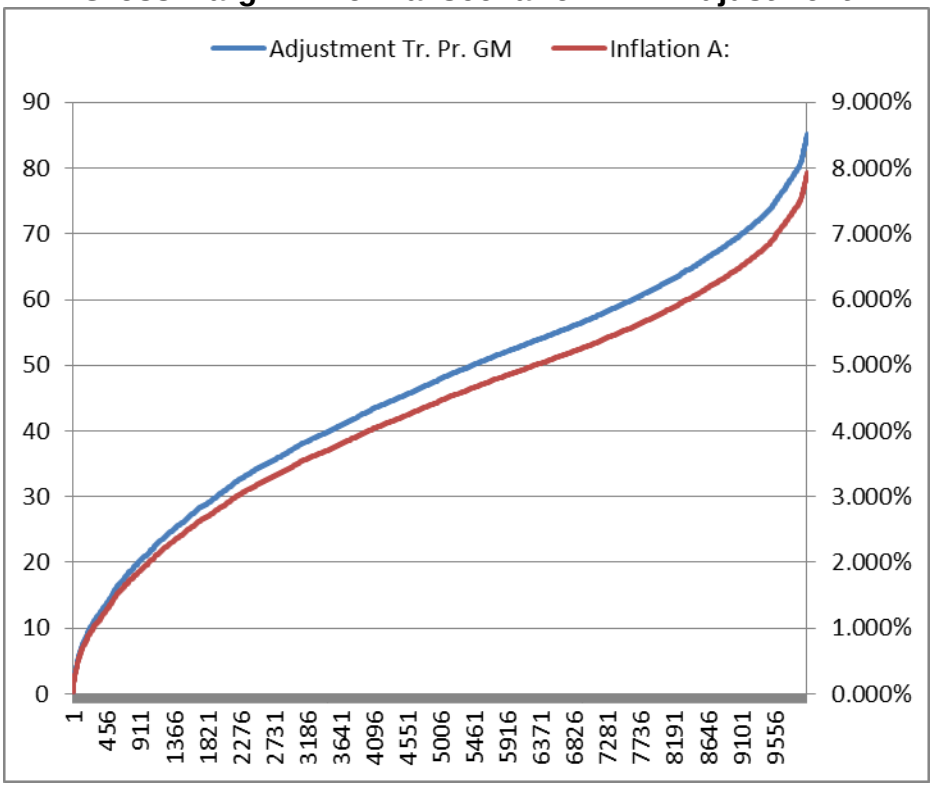
Shown below are the results obtained from the calculations applied to each of the scenarios. Ten thousand calculations were applied to each of the scenarios in each of the selected financial indicators (four). In sum, the results of the study consist of one hundred twenty thousand data (calculations) obtained from the calculations applied to the inflation variable and its impact on the selected financial indicators which, in turn, determined the existence of a transfer pricing adjustment.

1. Gross Margin Indicator

Normal scenario.

The evolution of the data; those which the inflation variable adopted as well as those obtained from the calculation of the transfer pricing adjustment was as follows:

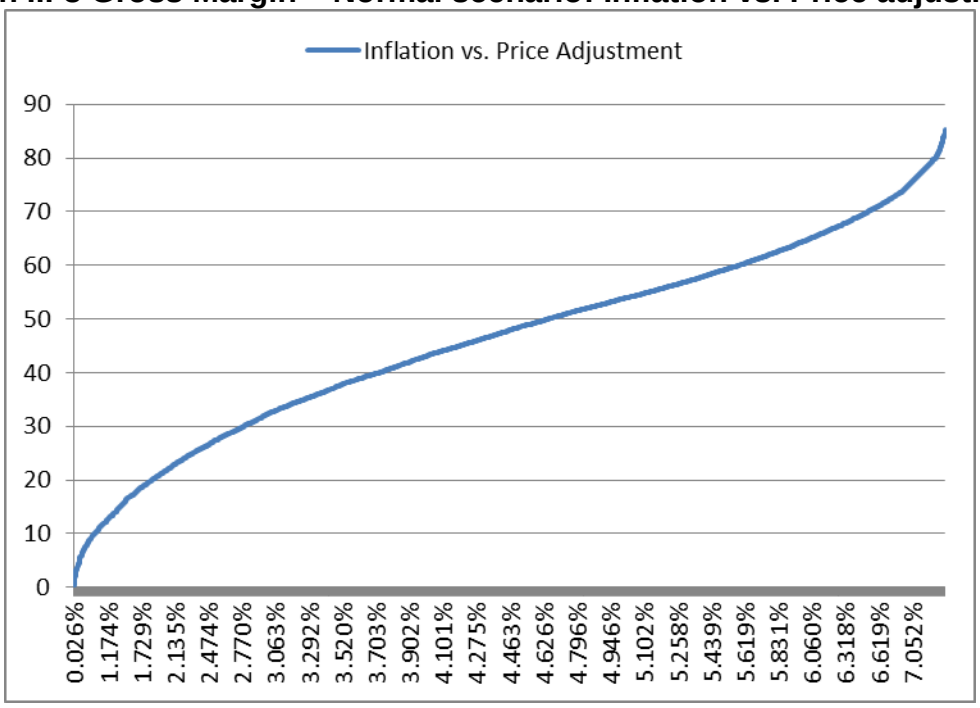
Graph III-2 Gross Margin – Normal scenario: Tr Pr Adjustment – Inflation.



Prepared by the authors of the study.

As may be observed in the previous III-2 graph, the behavior of the data adopted by the inflation variable in a Normal scenario is very similar to the behavior of the transfer pricing adjustment data calculated for this indicator.

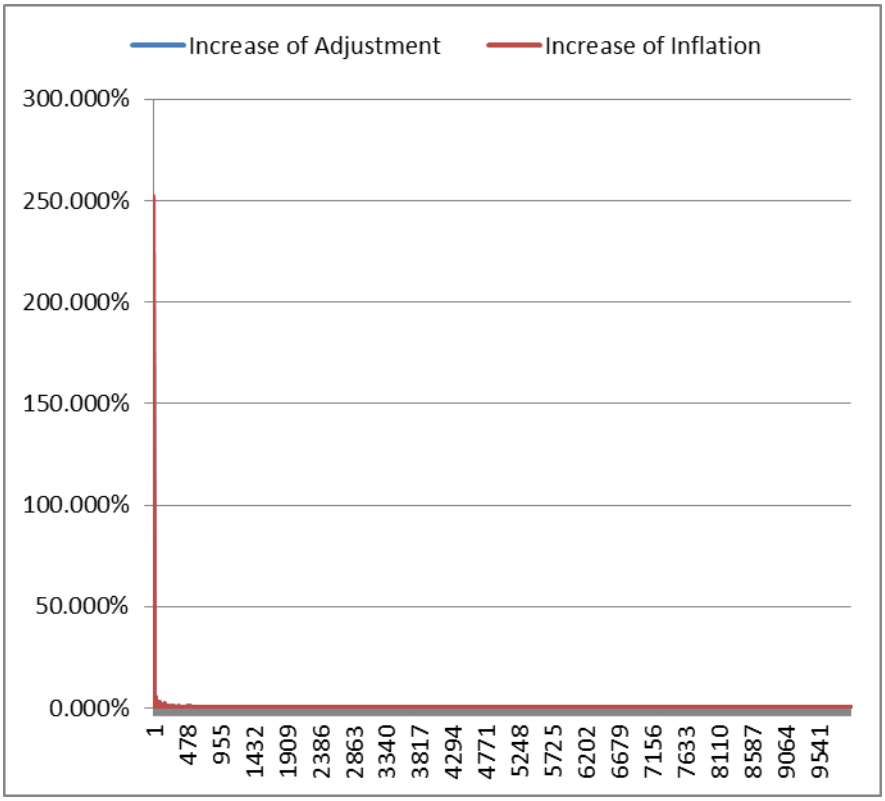
Graph III-3 Gross Margin – Normal scenario: Inflation vs. Price adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time or when consolidating both variables, one may observe that there is an increasing trend in behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase experienced due to the adjustment, shows stages of accelerated or de-accelerated growth, at the beginning and end of the Graph. However, the variation of values of this indicator in the pertinent scenario is low, as may be observed in Graph III- 4 below.

Graph III-4[38] Gross Margin – Normal scenario: Increase of adjustment and inflation.



Prepared by the authors of the study.

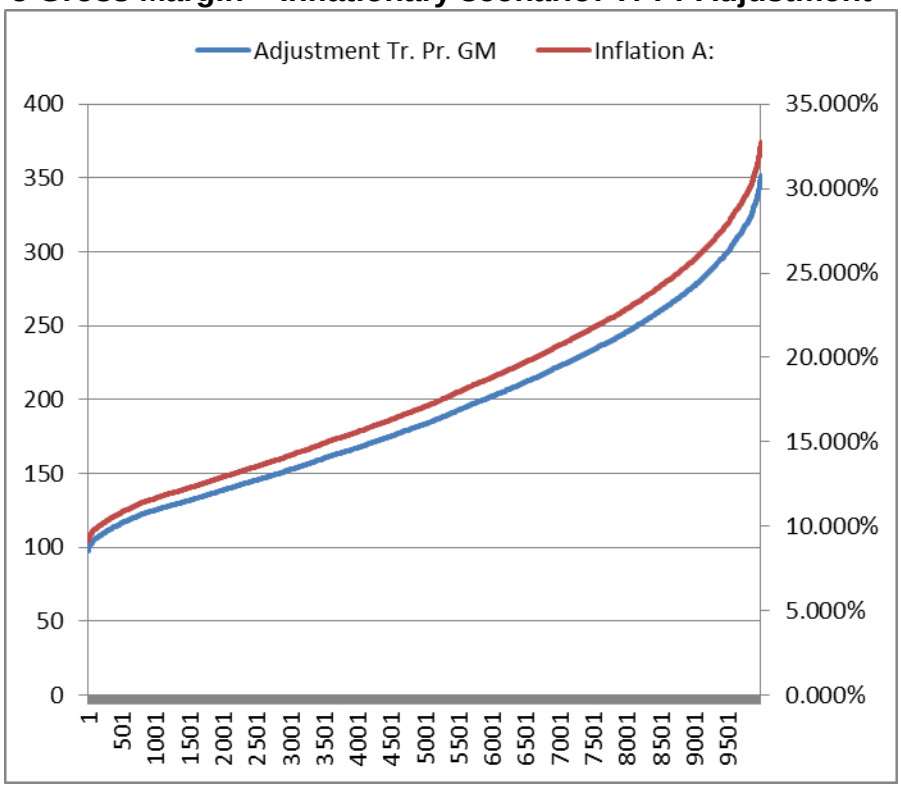
Therefore, depending on the level of inflation, there may be a greater or lesser increase in the adjustment due to a simple variation thereof; without this variation being significant in most of the cases observed.

[38] Due to the results obtained in the simulation, the line of the adjustment increase as well as that of inflation, follow a very similar behavior, for which reason, one does not practically allow for observing the other in the graph.

Inflationary scenario.

The evolution of the data; that is, those which the inflation variable adopted as well as those obtained from the calculation of the transfer pricing adjustment is as follows:

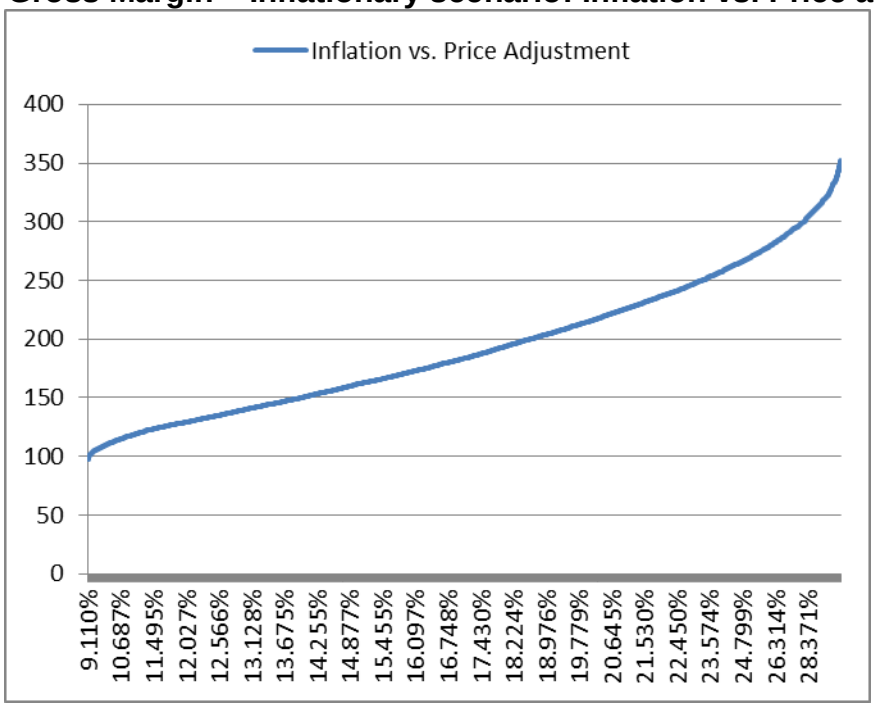
Graph III-5 Gross Margin – Inflationary scenario: Tr Pr Adjustment – Inflation



Prepared by the authors of the study.

As may be observed in the above graph III-5, the behavior of the data adopted by the inflation variable in an inflationary scenario is very similar to the behavior of the transfer pricing adjustment data calculated by this indicator.

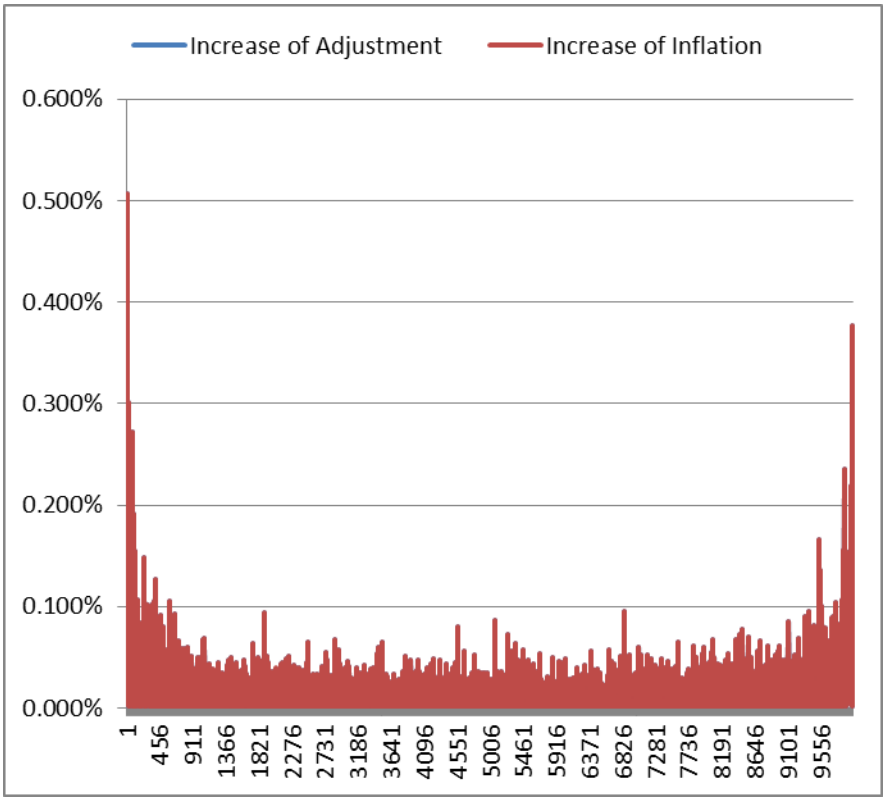
Graph III-6 Gross Margin – Inflationary scenario: Inflation vs. Price adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time, one may observe an increasing trend in behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase experienced by the graph shows stages of accelerated or de-accelerated growth, at the end of the graph. However, the variation of the values of this indicator in the pertinent scenario is irregular, as may be observed in Graph III-7 below.

Graph III-7[39] Gross Margin – Inflationary scenario: Increase of adjustment and inflation.



Prepared by the authors of the study.

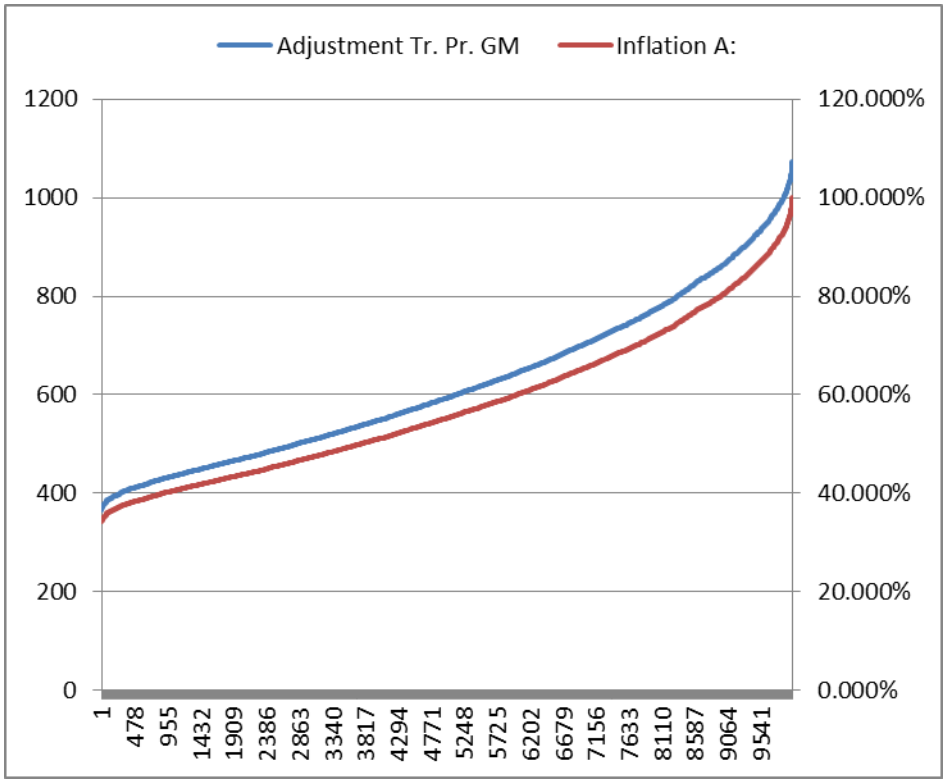
Therefore, depending on the level of inflation, the adjustment may experience a moderate or low increase by a simple variation thereof; without this variation being significant in most of the cases observed.

[39] Due to the results obtained in the simulation, the line of the adjustment increase as well as that of inflation, follow a very similar behavior, for which reason, one does not practically allow for observing the other in the graph.

Hyper-inflationary scenario

The evolution of the data, those which the inflation variable adopted as well as those obtained from the transfer pricing adjustment calculation is as follows:

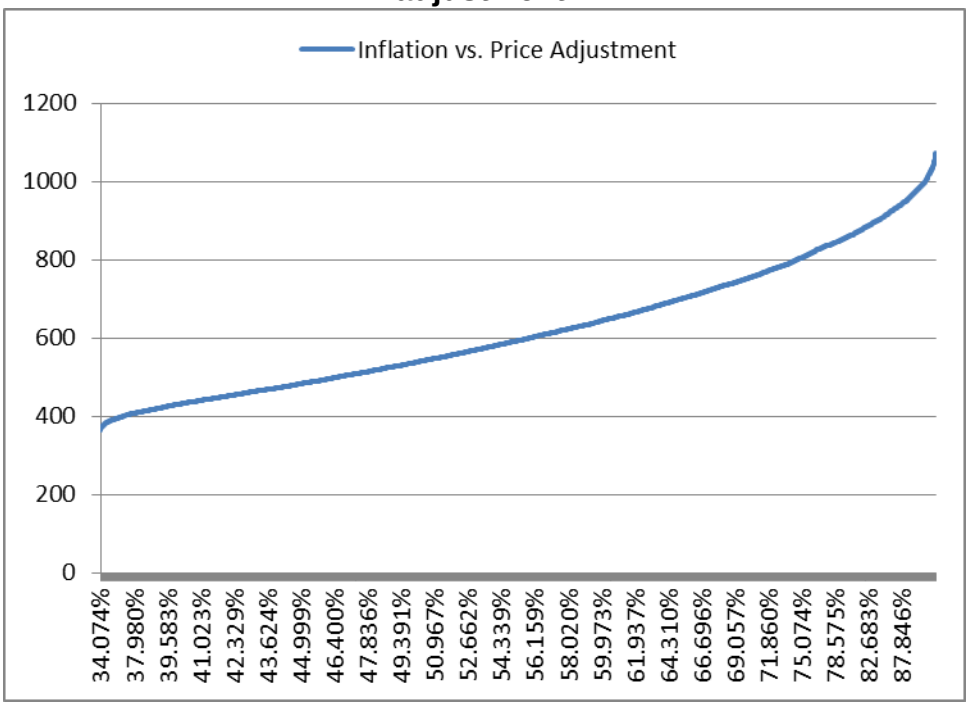
Graph III-8 Gross Margin – Hyper-inflationary scenario: Tr Pr Adjustment – Inflation



Prepared by the authors of the study.

As may be observed in the above graph III-8, the behavior of the data of the inflation variable in a hyper-inflationary scenario is very similar to the behavior of the transfer pricing adjustment data calculated for this indicator.

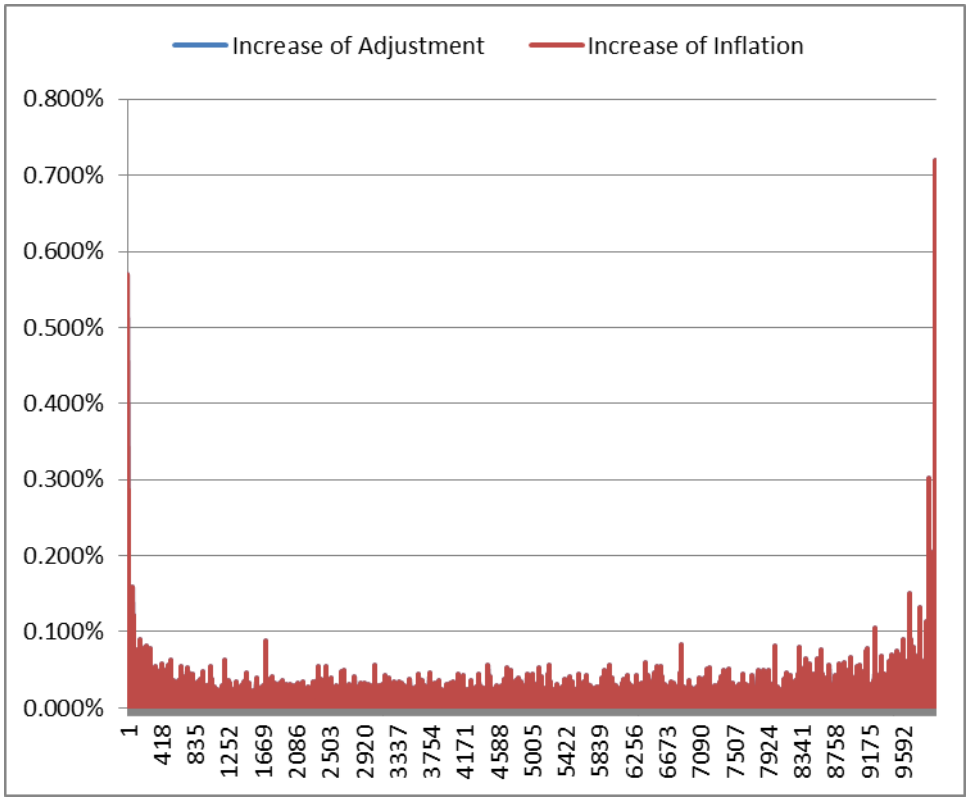
Graph III-9 Gross Margin – Hyper-inflationary scenario: Inflation vs. Price adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time, it may be observed that there is an increasing trend in the behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase resulting from the adjustment shows stages of accelerated or de-accelerated growth, at the end of the graph. Nevertheless, the variation of the values of this indicator in the pertinent scenario is irregular, as may be observed in Graph III-10 below.

Graph III-10[40] Gross Margin – Hyper-inflationary scenario: Increase of adjustment and inflation.



Prepared by the authors of the study.

Therefore, depending on the level of inflation, the adjustment may experience a moderate or low increase due to a simple variation thereof, without this variation being significant in most of the cases observed.

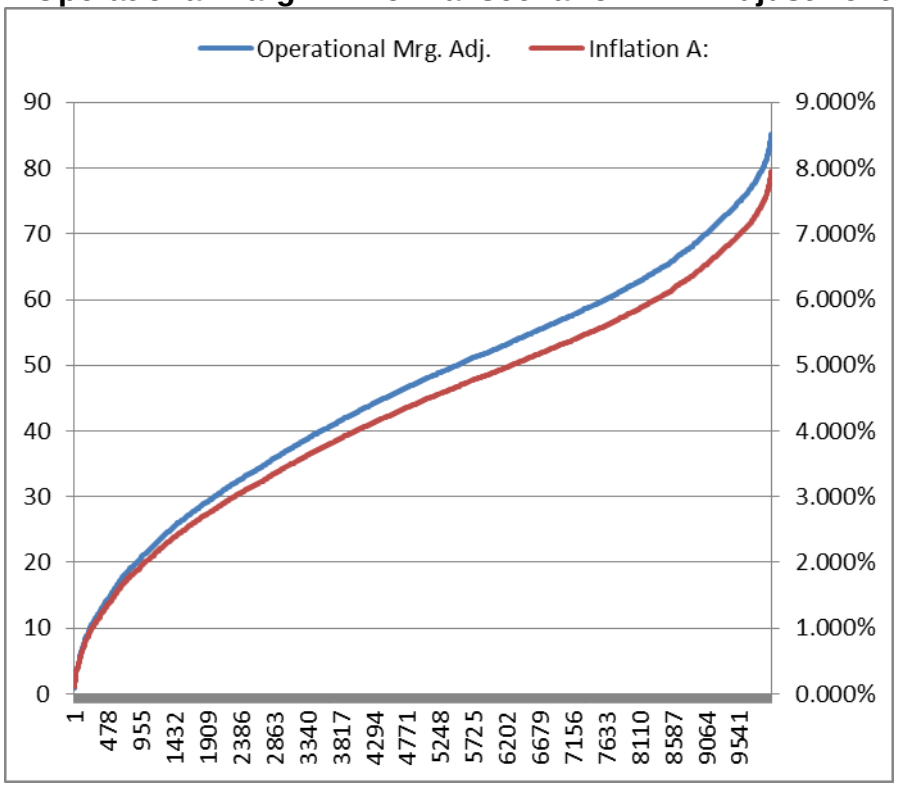
[40] Due to the results obtained in the simulation, the line of the adjustment increase as well as that of inflation, follow a very similar behavior, for which reason, one does not practically allow for observing the other in the graph.

2. Operational Margin Indicator

Normal scenario

The data; that is, those which the inflation variable adopted as obtained from the calculation of the transfer pricing adjustment evolved as follows:

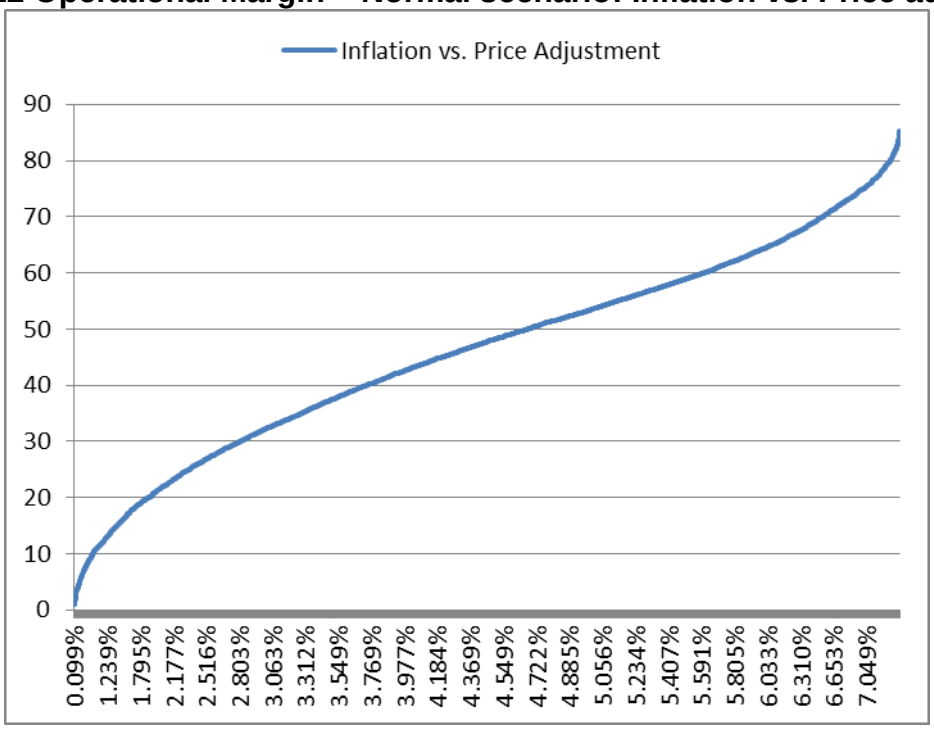
Graph III-11 Operational Margin – Normal scenario: Tr Pr Adjustment – Inflation



Prepared by the authors of the study.

As may be observed in the above graph III-11, the behavior of the data adopted from the inflation variable in a normal scenario is very similar to the behavior of the transfer pricing adjustment data calculated for this indicator.

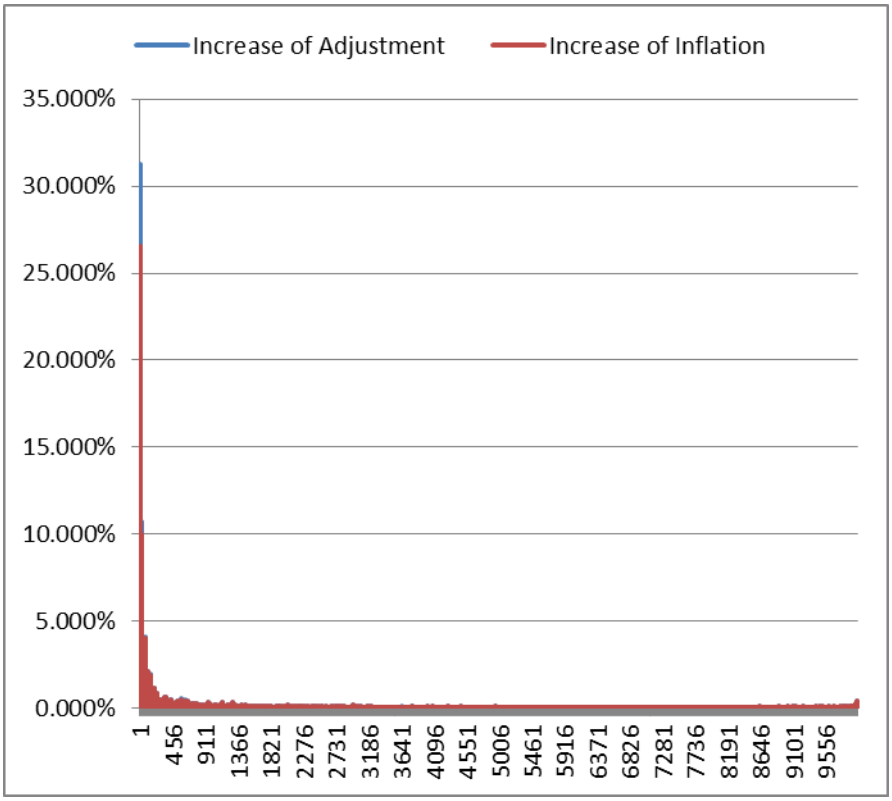
Graph III-12 Operational Margin – Normal scenario: Inflation vs. Price adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time, one may observe that there is an increasing trend in the behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase experienced by the adjustment shows stages of accelerated or de-accelerated growth, at the beginning and end of the graph. However, the variation of values of this indicator in the pertinent scenario is low, as may be observed in Graph III-13 below.

Graph III-13[41] Operational Margin – Normal scenario: Increase of adjustment and inflation.



Prepared by the authors of the study.

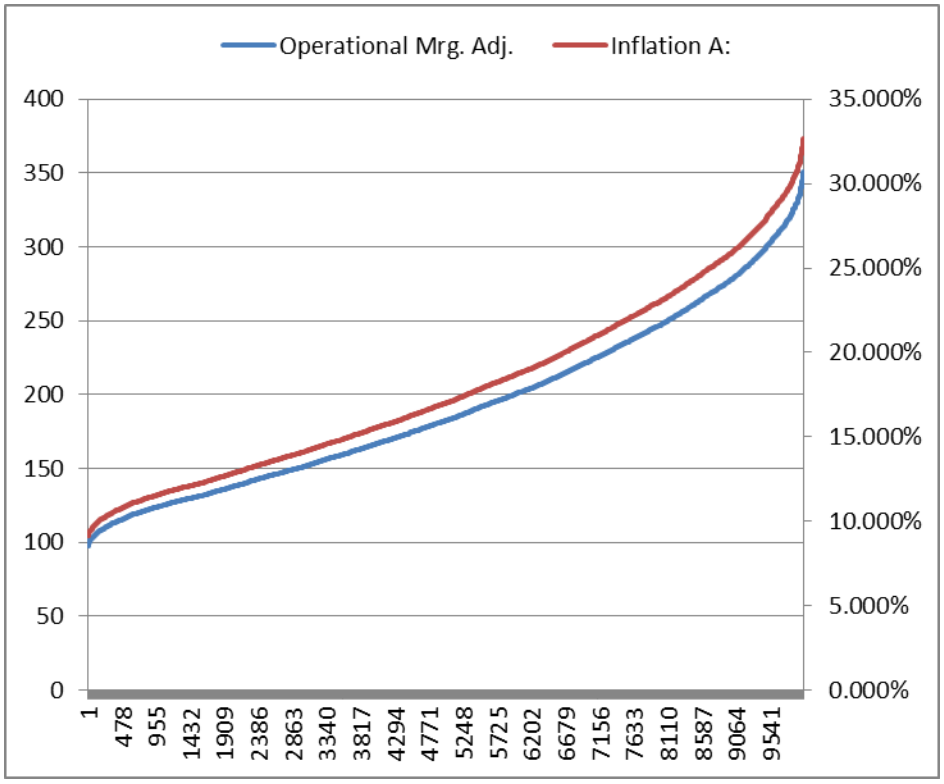
Therefore, depending on the level of inflation, the adjustment may experience a greater or lower increase due to a simple variation thereof, without this variation being significant in most of the cases observed.

[41] Due to the results obtained in the simulation, the line of the adjustment increase as well as that of inflation, follow a very similar behavior, for which reason, one does not practically allow for observing the other in the graph.

Inflationary scenario

The data; that is, those which the inflation variable adopted as obtained from the calculation of the transfer pricing adjustment evolved as follows:

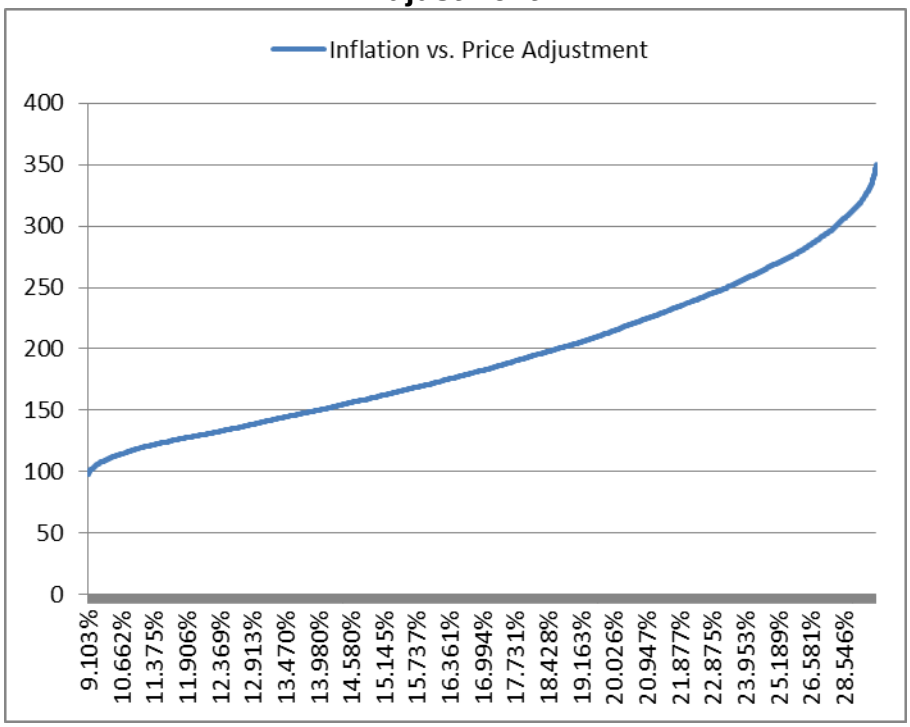
Graph III-14 Operational Margin – Inflationary scenario: Tr Pr Adjustment – Inflation



Prepared by the authors of the study.

As may be observed in the above graph III-14, the behavior of the data adopted from the inflation variable in an inflationary scenario is very similar to the behavior of the transfer pricing adjustment data calculated for this indicator.

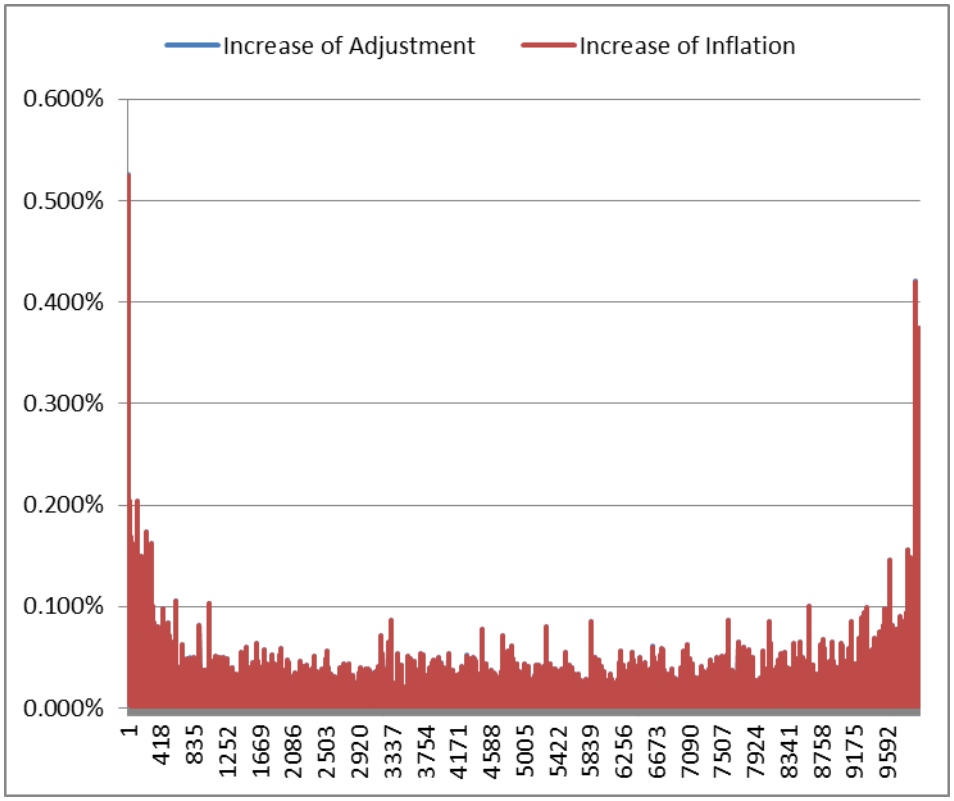
Graph III-15 Operational Margin – Inflationary scenario: Inflation vs. Price Adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time, one may observe that there is an increasing trend in the behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase experienced by the adjustment shows stages of accelerated or de-accelerated growth, at the end of the graph. However, the variation of values of this indicator in the pertinent scenario is irregular, as may be observed in Graph III-16 below.

Graph III-16[42] Operational Margin – Inflationary scenario: Increase of adjustment and inflation.



Prepared by the authors of the study.

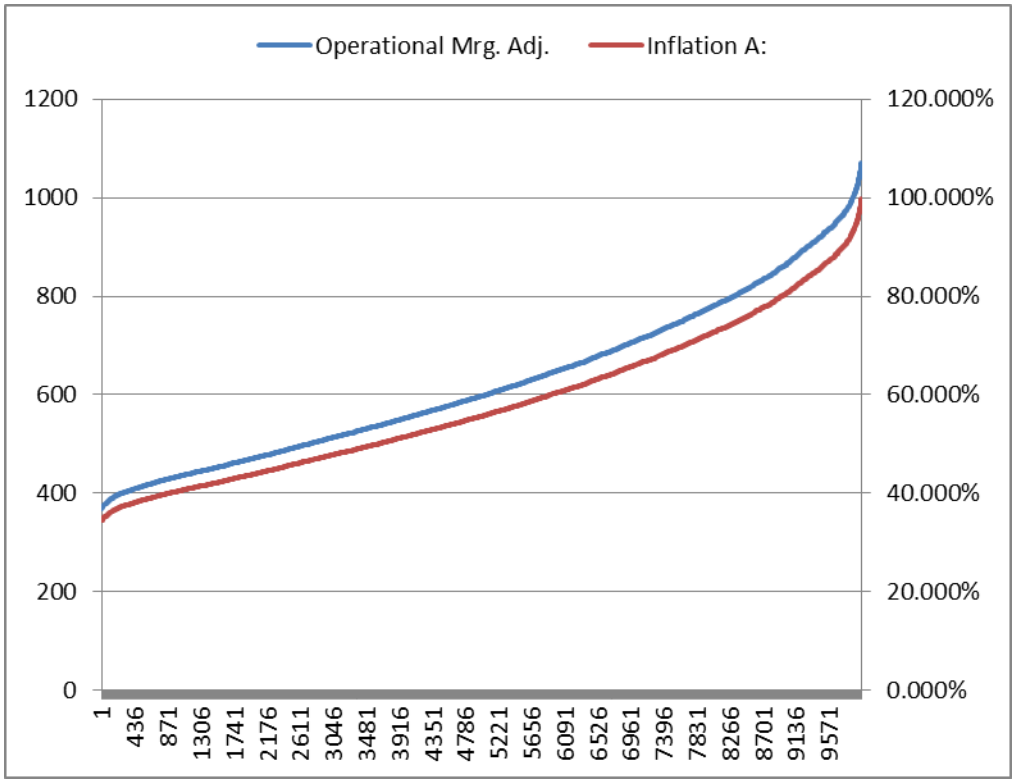
Therefore, depending on the level of inflation, the adjustment may experience a moderate or low increase due to a simple variation thereof, without this variation being significant in most of the cases observed.

[42] Due to the results obtained in the simulation, the line of the adjustment increase as well as that of inflation, follow a very similar behavior, for which reason, one does not practically allow for observing the other in the graph.

Hyper-inflationary scenario

The data; that is, those which the inflation variable adopted as obtained from the calculation of the transfer pricing adjustment evolved as follows:

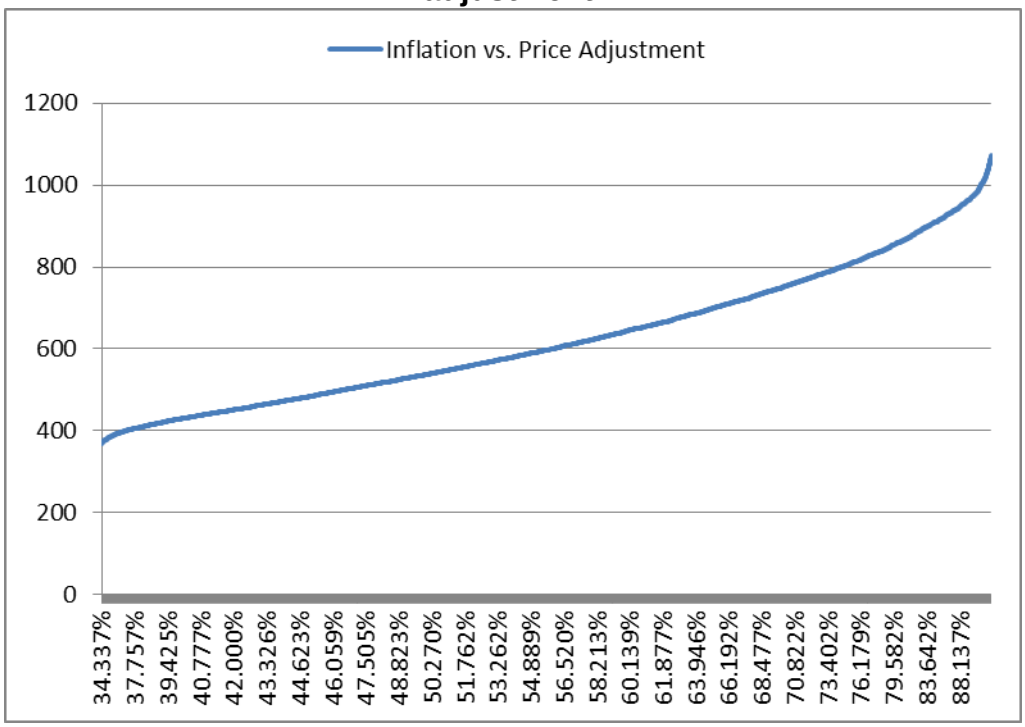
Graph III-17 Operational Margin – Hyper-inflationary scenario: Tr Pr Adjustment – Inflation



Prepared by the authors of the study.

As may be observed in the above graph III-17, the behavior of the data adopted from the inflation variable in a hyper-inflationary scenario is very similar to the behavior of the transfer pricing adjustment data calculated for this indicator.

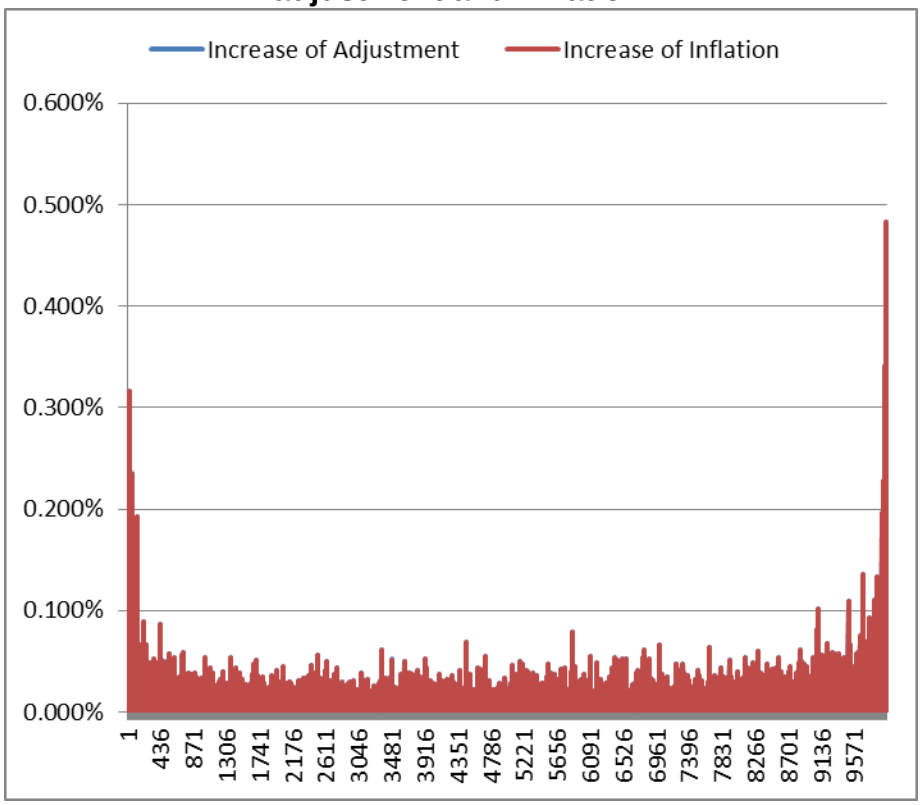
Graph III-18 Operational Margin – Hyper-inflationary scenario: Inflation vs. Price adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time, one may observe that there is an increasing trend in the behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase experienced by the adjustment shows stages of accelerated or de-accelerated growth, at the end of the graph. However, the variation of values of this indicator in the pertinent scenario is irregular, as may be observed in Graph III-19 below.

Graph III-19[43] Operational Margin – Hyper-inflationary scenario: Increase of adjustment and inflation.



Prepared by the authors of the study.

Therefore, depending on the level of inflation, the adjustment may experience a moderate or low increase due to a simple variation thereof, without this variation being significant in most of the cases observed.

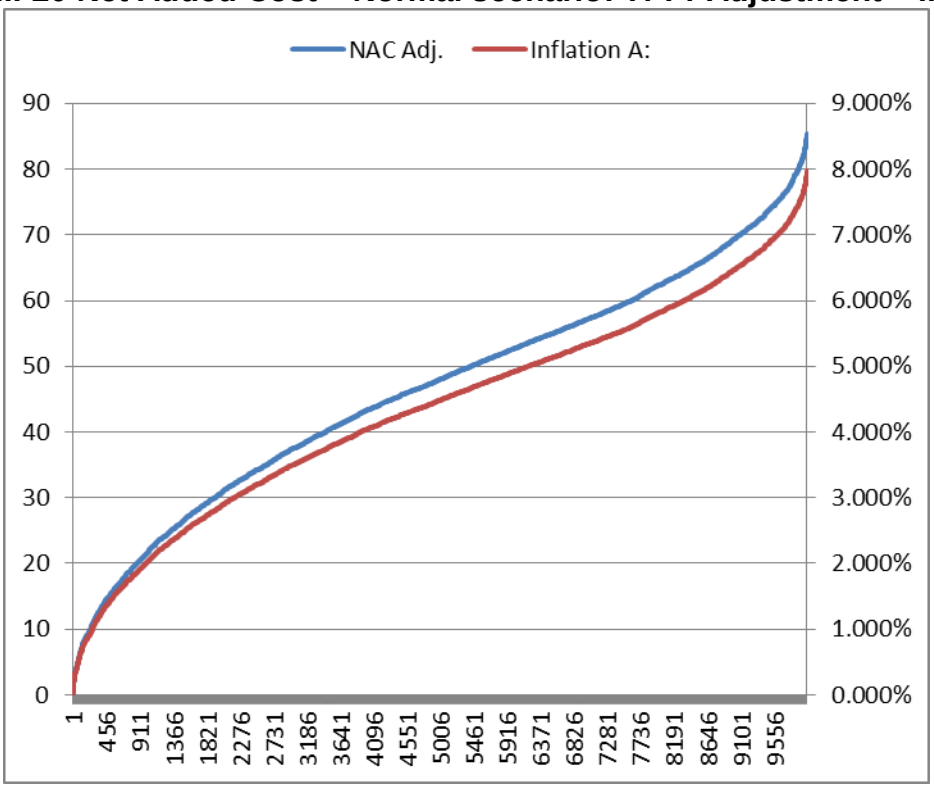
[43] Due to the results obtained in the simulation, the line of the adjustment increase as well as that of inflation, follow a very similar behavior, for which reason, one does not practically allow for observing the other in the graph.

3. Net Added Cost Indicator.

Normal scenario

The data; that is, those which the inflation variable adopted as obtained from the calculation of the transfer pricing adjustment evolved as follows:

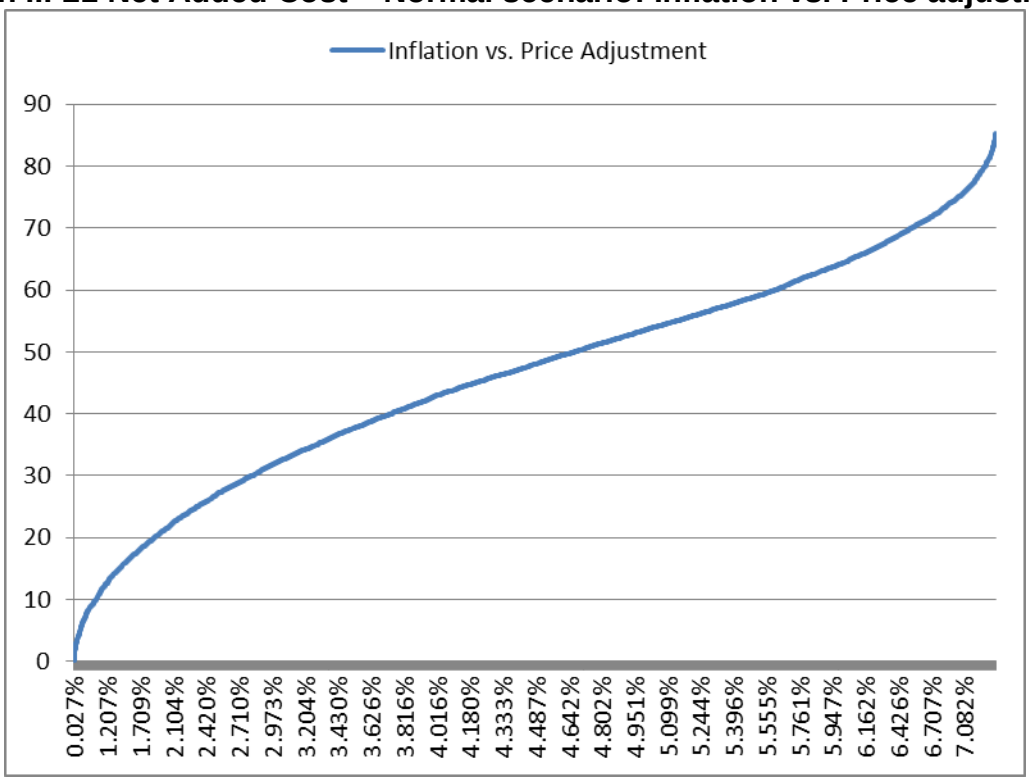
Graph III-20 Net Added Cost – Normal scenario: Tr Pr Adjustment – Inflation



Prepared by the authors of the study.

As may be observed in the above graph III-20, the behavior of the data adopted from the inflation variable in a normal scenario is very similar to the behavior of the transfer pricing adjustment data calculated for this indicator.

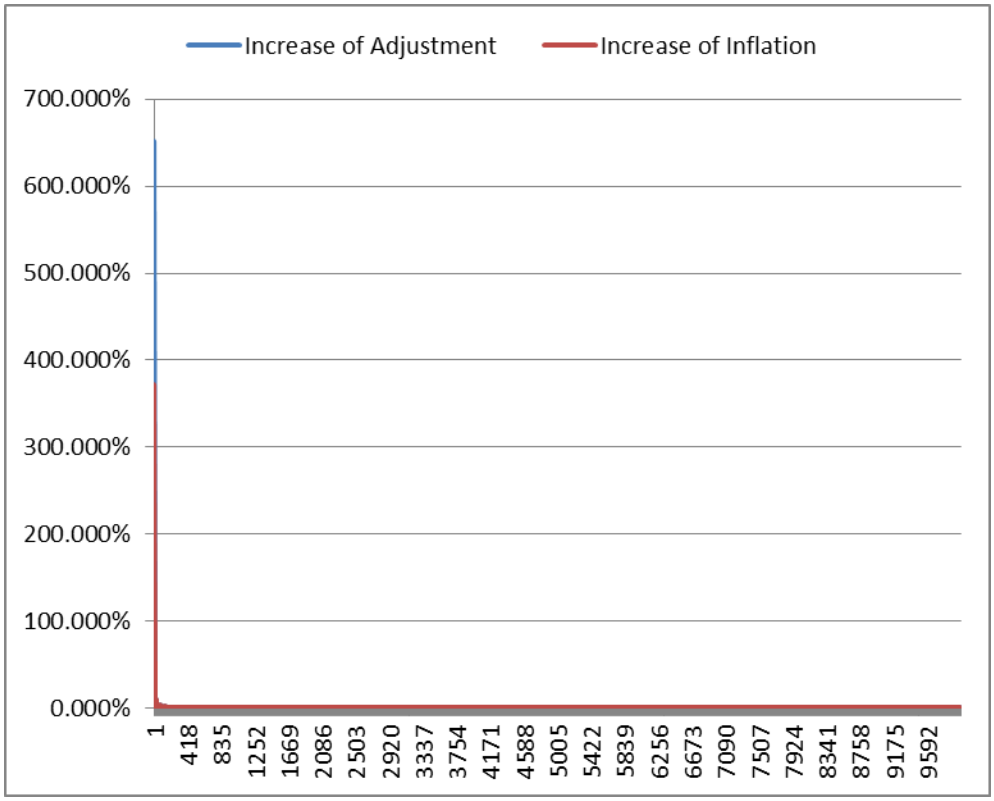
Graph III-21 Net Added Cost – Normal scenario: Inflation vs. Price adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time, one may observe that there is an increasing trend in the behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase experienced by the adjustment shows stages of accelerated or de-accelerated growth, at the beginning and end of the Graph. However, the variation of values of this indicator in the pertinent scenario is low, as may be observed in Graph III-22 below.

Graph III-22 Net Added Cost – Normal scenario: Increase of adjustment and inflation.



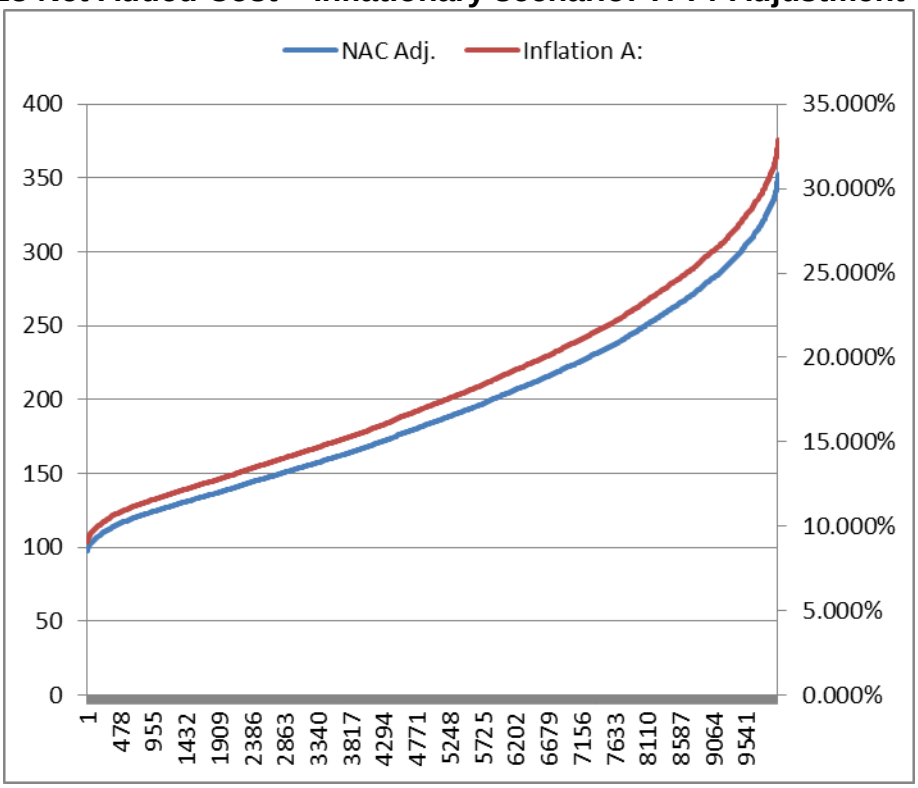
Prepared by the authors of the study.

Therefore, depending on the level of inflation, the adjustment may experience a greater or lower increase due to a simple variation thereof, without this variation being significant in most of the cases observed.

Inflationary scenario

The data, that is, those which the inflation variable adopted as obtained from the calculation of the transfer pricing adjustment evolved as follows:

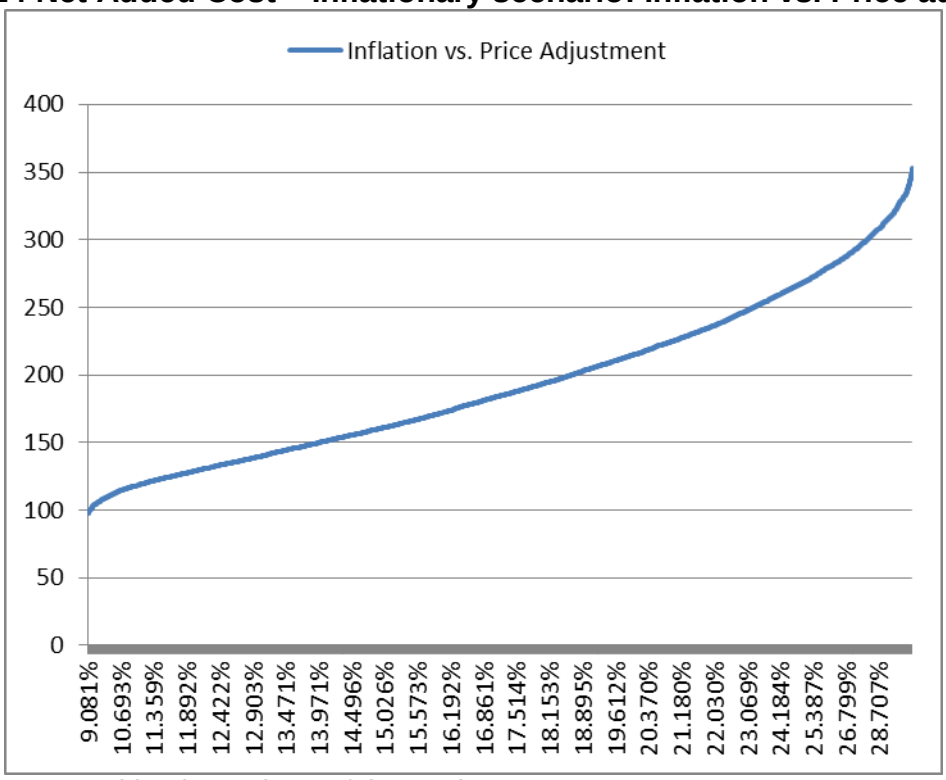
Graph III-23 Net Added Cost – Inflationary scenario: Tr Pr Adjustment – Inflation



Prepared by the authors of the study.

As may be observed in the above graph III-23, the behavior of the data adopted from the inflation variable in a normal scenario is very similar to the behavior of the transfer pricing adjustment data calculated for this indicator.

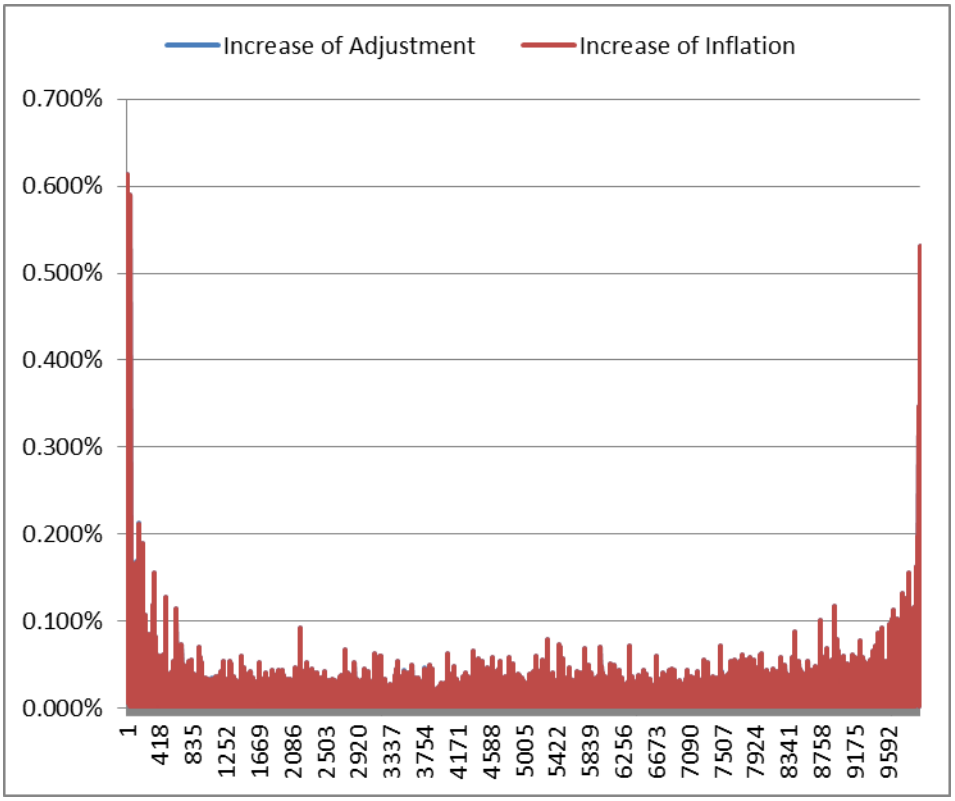
Graph III-24 Net Added Cost – Inflationary scenario: Inflation vs. Price adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time, one may observe that there is an increasing trend in the behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase experienced by the adjustment shows stages of accelerated or de-accelerated growth, at the end of the Graph. However, the variation of values of this indicator in the pertinent scenario is irregular, as may be observed in Graph III-25 below.

Graph III-25[44] Net Added Cost – Inflationary scenario: Increase of adjustment and inflation.



Prepared by the authors of the study.

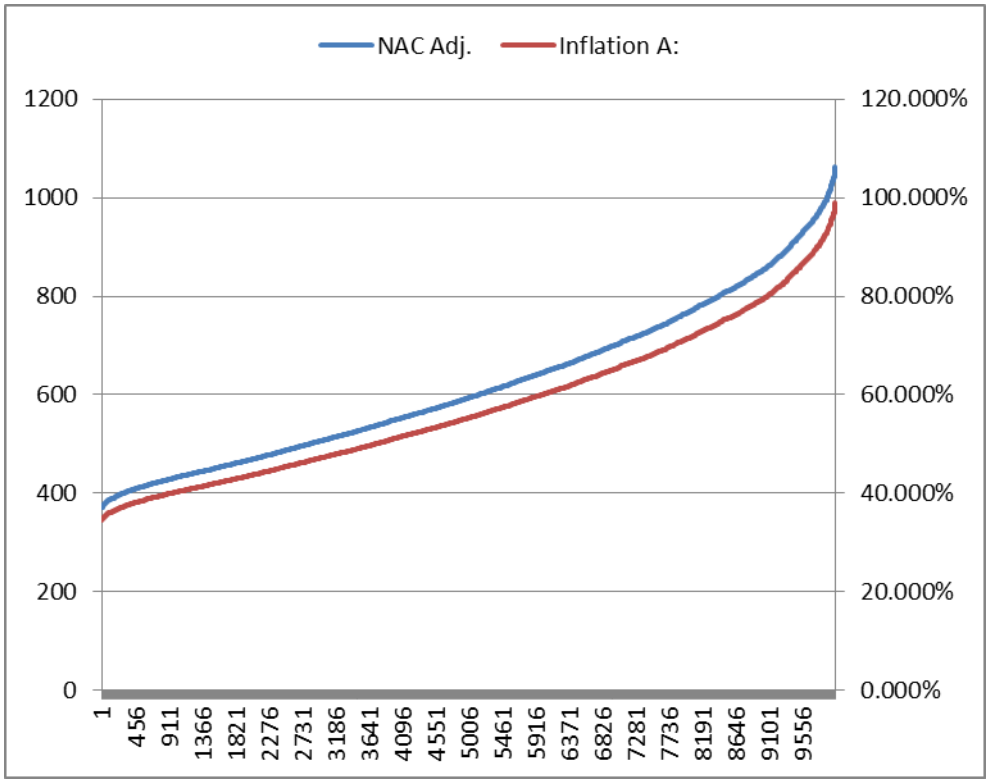
Therefore, depending on the level of inflation, the adjustment may experience a moderate or low increase due to a simple variation thereof, without this variation being significant in most of the cases observed.

[44] Due to the results obtained in the simulation, the line of the adjustment increase as well as that of inflation, follow a very similar behavior, for which reason, one does not practically allow for observing the other in the graph.

Hyper-inflationary scenario.

The data, that is, those which the inflation variable adopted as obtained from the calculation of the transfer pricing adjustment evolved as follows:

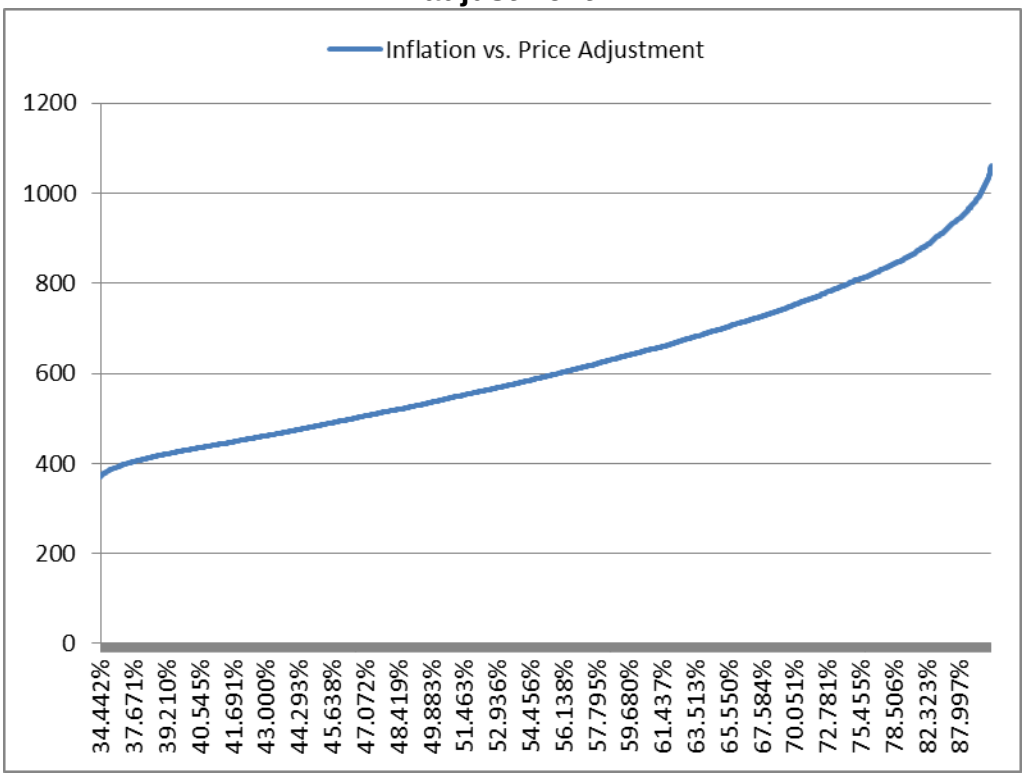
Graph III-26 Net Added Cost – Hyper-inflationary scenario: Tr Pr Adjustment – Inflation



Prepared by the authors of the study.

As may be observed in the above graph III-26, the behavior of the data adopted from the inflation variable in a hyper-inflationary scenario is very similar to the behavior of the transfer pricing adjustment data calculated for this indicator.

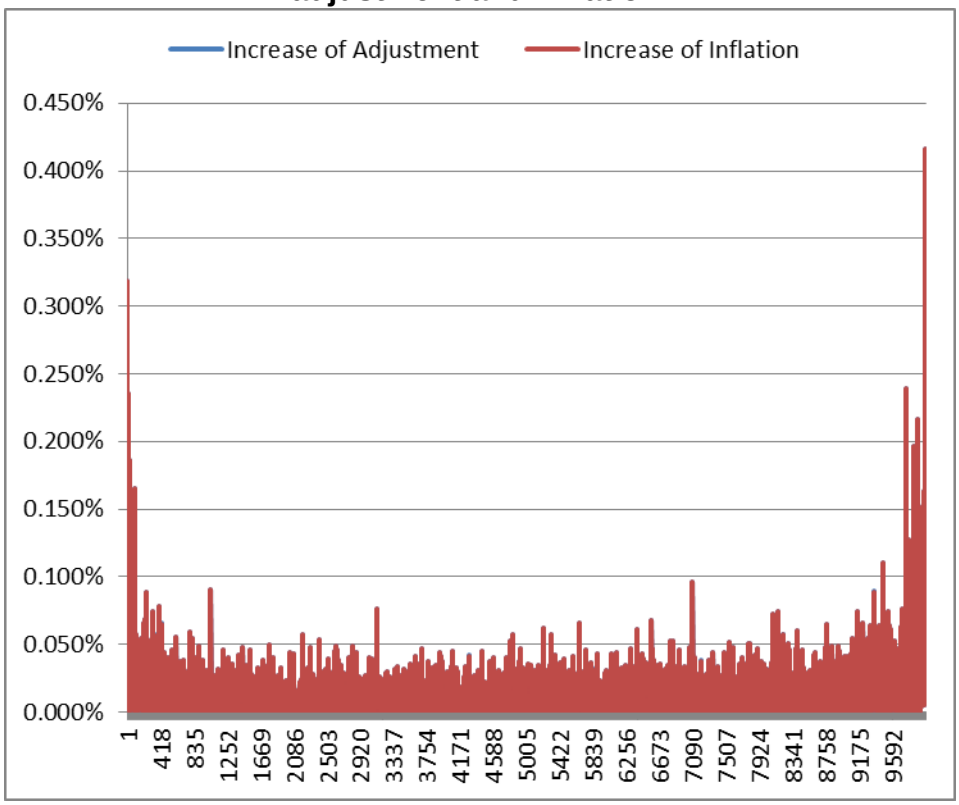
Graph III-27 Net Added Cost – Hyper-inflationary scenario: Inflation vs. Price adjustment.



Prepared by the authors of the study.

When preparing the graph of the two variables (inflation and transfer pricing adjustment) at the same time, one may observe that there is an increasing trend in the behavior; that is, as inflation increases, the transfer pricing adjustment also increases. It is also important to observe that the increase experienced by the adjustment shows stages of accelerated or de-accelerated growth, at the end of the Graph. However, the variation of values of this indicator in the pertinent scenario is irregular, as may be observed in Graph III-28 below.

Graph III-28[45] Net Added Cost – Hyper-inflationary scenario: Increase of adjustment and inflation.



Prepared by the authors of the study.

Therefore, depending on the level of inflation, the adjustment may experience a moderate or low increase due to a simple variation thereof, without this variation being significant in most of the cases observed.

4. Berry Coefficient Indicator

In the case of this coefficient, in all the scenarios the result of the transfer pricing adjustment variable was zero. To conclude, the inflation variable, regardless of the value it could adopt, the result in the transfer pricing adjustment is zero.

[45] Due to the results obtained in the simulation, the line of the adjustment increase as well as that of inflation, follow a very similar behavior, for which reason, one does not practically allow for observing the other in the graph.

D. Conclusion of the model

As a result of the data observed following the application of the assumptions to the previously proposed model and the calculations determined for the inflation variable as well as its impact on the transfer pricing adjustment, it could be concluded that:

- The impact of inflation in any of its scenarios, with the calculation of the transfer pricing adjustment is directly proportional to said inflation.

- The increase that may result in the transfer pricing adjustment due to the increase in inflation may depend on the level of existing inflation. See graphs in this section.

- Inflation as single variable in the transfer pricing adjustment has a direct incidence in its result. For example, in a *"ceteris paribus"* scenario, because of inflation, a taxpayer acting within arm's length and complying with the respective principle must make an adjustment that will imply a taxation thereon to the detriment of his economic reality.

- According to the model, in order to proceed with the comparability analysis, it is necessary that when evaluating transfer pricing, the effect of inflation be reviewed when the analyzed party is in an inflationary or hyper-inflationary scenario

IV. CONCLUSIONS.

1. Transfer pricing control represents a challenge for the tax administrations and its main problem is the availability of information for undertaking an analysis of compliance with the arm's length principle. In this sense, the incidence of inflation in the transfer pricing methodology must be considered an economic circumstance to be evaluated within the factors of comparability.

2. The nonexistence of a specific and standard methodology regarding the restatement of the financial statements in inflationary contexts may render difficult the comparability analysis, either in the comparison of entities from different countries –for example- for lack of application of homogeneous international standards- and even between entities of the same country if, among other assumptions, the election of the most representative inflationary impact index is in the hands of the administrators of the entity.

3. Undoubtedly, working with standard accounting criteria may afford greater accuracy in the comparability analysis and allow the transfer pricing analyst greater possibility for correcting or adjusting differences originating from other circumstances among them, inflation.

4. On the other hand, a potentially comparable company, immersed in an inflationary context, must be carefully analyzed in order to evaluate its comparability. To correct the effects of inflation without having available all the financial information may distort the comparability analysis and, accordingly, its reliability.

5. As will be evidenced in the following section –where consideration will be given to the methods based on the net margin and gross margin-, inflation *is an issue to be considered* in the transfer pricing analysis, since its incidence is different, depending on the accounting criteria applied and the method chosen.

6. Likewise, for the comparable uncontrolled price method, the prices must be compared in homogeneous currency, it being necessary, for such purpose, to evaluate the effects of inflation between the different dates analyzed.

7. In that sense, the transfer pricing specialists could evaluate the effects caused by the depreciation of the currency –even in low inflation contexts - and, eventually, undertake the corresponding adjustments when there are distortions that justify it.

8. The task mentioned in the previous paragraph would be facilitated if there were applicable guidelines and parameters for making adjustments to comparability given the inflationary contexts. The purpose of this study is to precisely point out the fact that there is no technical development in relation to this problem and thus encourage the international community to initiate the corresponding studies and discussions.

V. ANNEXES.

A. Annex I: Data and Variables of the Model.

Model 1 OF THE ANALYSIS OF THE COMPARABILITY EFFECT IN THE ADJUSTMENT OF CAPITAL USING FOREIGN COMPARABLES

DATA AND VARIABLES FOR THE MODEL (ENTERPRISE ANALYZED AND COMPARABLE ENTERPRISES)

	Local Enterprise		Comparable 1		Comparable 2		Comparable 3		Comparable 4	
Balance accounts	**Inflation**	**No Inflation**	**No Inflation**	**Inflation**	**No Inflation**	**Inflation**	**No Inflation**	**Inflation**	**No Inflation**	**Inflation**
Accounts Receivable	300	300	400	400	400	400	400	400	400	400
Accounts Payable	200	200	200	200	200	200	200	200	200	200
Inventory	150	150	50	50	50	50	50	50	50	50
State of Results										
Sales	1,074	1,074	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500
CGS*	890	890	3,750	3,750	3,750	3,750	3,750	3,750	3,750	3,750
Gross Profit	**184**	**184**	**750**	**750**	**750**	**750**	**750**	**750**	**750**	**750**
Operational Expenses	71	71	300	300	300	300	300	300	300	300
Operational Profit	**113**	**113**	**450**	**450**	**450**	**450**	**450**	**450**	**450**	**450**
Interest Rate A:		**19.47%**	**Interest Rate C1:**	**3.25%**	**Interest Rate C2:**	**3.25%**	**Interest Rate C3:**	**3.25%**	**Interest Rate C4:**	**3.25%**
Inflation A:		**0.00%**	**Inflation C1:**	**0.00%**	**Inflation C2:**	**0.00%**	**Inflation C3:**	**0.00%**	**Inflation C4:**	**0.00%**
min:		34%	min:	1%	min:	1%	min:	1%	min:	1%
max:		100%	max:	4%	max:	4%	max:	4%	max:	4%
probable:		40.00%	probable:	1.14%	probable:	1.14%	probable:	1.14%	probable:	1.14%

FINANCIAL INDICATORS

	Local Enterprise		Comp. 1	Comp. 2	Comp. 3	Comp. 3
	No Inflation	**Inflation**				
Gross Margin	17.13%	17.13%	16.67%	16.67%	16.67%	16.67%
Operational Margin	10.52%	10.52%	10.00%	10.00%	10.00%	10.00%
NAC	11.76%	11.76%	11.11%	11.11%	11.11%	11.11%
Berry	259.15%	259.15%	250.00%	250.00%	250.00%	250.00%

ADJUSTED CAPITAL ACCOUNTS

	Comp. 1	Comp. 2	Comp. 3	Comp. 3
Accounts Receivable Adjustment:	(26.98)	(26.98)	(26.98)	(26.98)
Accounts Payable Adjustment:	(20.08)	(20.08)	(20.08)	(20.08)
Inventory Adjustment:	(18.80)	(18.80)	(18.80)	(18.80)
Sales Adjustment:	4,526.98	4,526.98	4,526.98	4,526.98

ADJUSTED CAPITAL ACCOUNTS

	Comp. 1		Comp. 2		Comp. 3		Comp. 3
Gross Margin adj1.:	*17.1349%*	*Gross Margin adj2.:*	*17.1349%*	*Gross Margin adj3.:*	*17.1349%*	*Gross Margin aj3.:*	*17.1349%*
Operational Margin adj1.:	*10.51%*	*Operat. Margin adj2.:*	*10.51%*	*Operat. Margin adj3.:*	*10.51%*	*Operat. Margin aj3.:*	*10.51%*
NAC adj1.:	*11.75%*	*NAC adj2.:*	*11.75%*	*NAC adj3.:*	*11.75%*	*NAC aj3.:*	*11.75%*
Berry adj1.:	*258.56%*	*Berry adj2.:*	*258.56%*	*Berry adj3.:*	*258.56%*	*Berry aj3.:*	*258.56%*

Arms' Lenght Range Data:	*Comp. 1*	*Comp. 2*	*Comp. 3*	*Comp. 4*
Gross Margin adj1.:	*17.13%*	*17.13%*	*17.13%*	*17.13%*
Operational Margin adj1.:	*10.51%*	*10.51%*	*10.51%*	*10.51%*
CAN aj1.:	*11.75%*	*11.75%*	*11.75%*	*11.75%*
Berry aj1.:	*258.56%*	*258.56%*	*258.56%*	*258.56%*

ARMS' LENGHT RANGE

	Gross Margin adj.	Operational Margin. adj.	NAC adj.	Berry adj.
Quartile 1:	**17.13%**	**10.51%**	**11.75%**	**258.56%**
Median:	**17.13%**	**10.51%**	**11.75%**	**258.56%**
Quartile 2:	**17.13%**	**10.51%**	**11.75%**	**258.56%**
Spread of range:	0.00%	0.00%	0.00%	0.00%

TRANSFER PRICING ADJUSTMENT (Adjustment towards the median)

Local Enterprise (analized)			In terms of:	Gross Marg. Adj.	Operational Marg. adj.	NAC adj.	Berry adj.
	No Inflation	Inflation	*Tr. Pr. Adjustment*	*0*	*0*	*0*	*0*
Gross Margin	17.13%	17.13%	Sales	1,074	1,074	1,074	1,074
Operational Margin	10.52%	10.52%	CGS*	890	890	890	890
NAC	11.76%	11.76%	**Gross Profit**	**184**	**184**	**184**	**184**
Berry	259.15%	259.15%	Operational Expenses	71	71	71	71
			Operational Profit	**113**	**113**	**113**	**113**
			Adjusted Indicator:	**17.13%**	**10.52%**	**11.76%**	**259.15%**
			Difference with the range's median:	0.00%	0.01%	0.01%	0.59%

CONSIDERATIONS OF MODEL 1

1. U.S. comparable businesses
2. Comparable businesses only carry out transactions in markets with low inflation (e.g. U.S.A.)
3. All the businesses have similar values and proportions according to the simplicity of the model and to be able to see the effect of inflation, in case there may probably be a transfer pricing adjustment due to inflation
4. The business in an inflationary scenario is the business being analyzed (local); which will only be subject to adjustments for inflation
5. Difference between monetary and non-monetary items --> this determines which accounts should be adjusted for inflation and which not.

Item	Monetary	Non- Monetary	
Accounts receivable	X		
Inventories		X	They are restated, unless they may have been registered at their net realizable or reasonable value at the end of the year.
Accounts payable	X		
Property, Plant & Equipment		X	
Sales		X	
Cost of Goods		X	Are not restated, provided that their sub-accounts are maintained at current costs
Purchases		X	Are not restated, provided that their sub-accounts are maintained at current costs
Operational Expenses		X	

Monetary items: are those stated in nominal monetary units, without any relationship to future prices of specific goods or services; ***their nominal value does not change as a result of the effects of inflation***, for which reason there is a change in their purchasing power. Monetary items, are money, the rights to be received in money and the obligations to be paid in money.

Monetary items: NIC 29; shall not be restated inasmuch as they are stated in the current value unit as of the date of the balance.

Non-monetary items: are those whose nominal value varies according to the behavior of inflation, for which reason, if derived from said inflation, ***there is no deterioration in their value***; these may be assets, liabilities, accounting capital or net worth.

Inflationary environment: when the levels of inflation cause the significant depreciation of the local currency for paying economic transactions occurring in the past; in addition, the impact of said inflation affects within short term, such economic indicators as rate of exchange, rates of interest, salaries and prices. For purposes of this regulation, the environment is considered inflationary when ***the cumulative inflation of the three previous annual periods is equivalent to, or exceeds 26%*** (8% annual average), and in addition, according to economic forecasts of the official entities, a similar trend is expected.

Source: International Financial Reporting Standards

Hyper-inflationary environment: The environment is deemed to be hyper-inflationary when ***the accumulated inflation of the previous three annual periods is equal to or exceeds 100%.***

6. The U.S. rate of interest is the prime rate which, in average, has not changed in the past three years and is, therefore, discarded as variable and assumes a fixed value

B. Annex II: Comparative experience of the incidence of inflation in the transfer pricing determination and adjustment process.

The information for preparing this Annex was obtained between the months of February and April 2013 by the Executive Secretariat of the Inter-American Center of Tax Administrations (CIAT), thanks to the collaboration of a group of tax administrations of its member countries.

Official answers were received from seven (7) tax administrations that represent approximately 59% of the tax administrations surveyed. These are mentioned hereinafter: Internal Revenue Service of Chile (SII), State Agency of Tax Administration of Spain (AEAT), Tax Administration Service of Mexico (SAT), National Superintendency of Customs and Tax Administration of Peru (SUNAT), General Directorate of Internal Taxes of the Dominican Republic (DGII), South African Revenue Service (SARS), General Directorate of Taxation of Uruguay (DGI).

The aforementioned information was provided according to the following scheme:

Countries	Tax Administration	Date of response
Chile	SII	April 2, 2013
Spain	AEAT	February 13, 2013
Mexico	SAT	February 7, 2013
Peru	SUNAT	March 26, 2013
DomiIASan Republic	DGII	March 28, 2013
South Africa	SARS	April 11, 2013
Uruguay	DGI	March 20, 2013

A template consisting of seventeen (17) fields has been developed in order to standardize, compare, classify and analyze the information.

The template mainly shows closed or multiple choice questions in order to simplify the presentation of the data and their analysis.

For purposes of compilation of the information,countries have been selected according to their level of development in the sphere of transfer pricing control, considering such variables as their economic and financial context, legislation and practice.

1. Comparative analysis.

Throughout the development of this study we have seen how inflation influences the process of transfer pricing determination and adjustment. However, regardless of the analysis of the effects of inflation, many could ask the following question: What is the experience in this respect for the different countries? For the purpose of attempting to respond to said question, the information provided by the tax administrations has been processed in such a way as to allow for comparing the situation of the different countries.

The first step was to determine which countries of the sample consider the effect of inflation when applying the controls for avoiding abusive transfer pricing manipulation. Secondly, an analysis was made of the different aspects related to the regulations in force, the way taxpayers apply the regulation and the controls carried out by the tax administrations.

Table VI-1 shows which countries consider the effect of inflation for calculating transfer prices:

Table V-1 Consideration of the effect of inflation for calculating transfer prices.

Countries	DO consider the effect	DO NOT consider the effect
Chile		X
Spain		X
Mexico	X	
Peru		X
Dominican Republic		X
South Africa		X
Uruguay	X	
Total (%)	**29%**	**71%**

Prepared by the authors of the study.

To date, only a few countries recognize the effect of inflation. Only 29% have in their regulations some mechanism for recognizing such effect, in order to avoid transfer pricing manipulation.

Regulations in force for correcting the incidence of inflation in transfer pricing

According to table V-1, Uruguay and Mexico are the two countries that have determined the possibility of considering the effect of inflation in transfer pricing calculation. Table V-2 shows the regulations in force in the countries that regulate this aspect, as well as the links thereto:

Table V-2 Legal regulations in force.

Countries	Regulation
Mexico	Article 215, paragraph three and 216, last paragraph of the Income Tax Act. (Web Page: http://www.diputados.gob.mx/LeyesBiblio/pdf/82.pdf)
Uruguay	Article 38 of Title 4 of the 1996 TO, in accordance with article 3, Act 18,083 of 27/12/ 2006. As well Articles 6 and 7 of Decree 56/009. Web Page: http://www.dgi.gub.uy/wdgi/page?2,principal,DGInormativa,O,es,0

Prepared by the authors of the study.

Uruguay, in article 7 of decree 56/009, refers to the elimination of specific differences, in particular, those originating on the dates when the transactions are carried out. Likewise, the Uruguayan regulation, for purposes of determining the transfer prices, provides for the use of the *"Price Index for the Producer of National Products"*.

On its part, Mexico provides a more explicit explanation of the necessary provisions for considering the effect of inflation in the transfer pricing determination and adjustment process. The Mexican regulation states that in an inflationary economic environment, *"values adjusted for inflation"* will be used, while in a non-inflationary environment use will be made of the *"historical values"*. In this respect, it is worth noting that since the last reform of the Financial Reporting Regulation "*B-10"* –in force as of the 2008 fiscal year-, it is considered that an inflationary environment exists when the addition of the accumulated inflation of three periods is equal to or exceeds 26% with an 8% annual average.

However, since 2008, cumulative inflation has not amounted to 26%. Likewise, the analysis of the economic circumstances of the company domiciled in Mexico can also be applied to the economic situations of the comparable companies that will be part of the market values.

In Mexico, corrections resulting from the effect of inflation will be applied within the framework of the functional analysis, while in Uruguay, the adjustment will be applied to any of the parts, depending on the type of transaction and the methodology used.

2. Taxpayer practices.

With respect to the practices adopted by the taxpayers, it is deemed timely to know which figures are mostly used by the taxpayers when making a transfer pricing assessment that may allow for improving the comparability analysis and determine the effects of inflation.

Within the framework of said assessment, one could consider the following situations:

1. Adoption of figures that have been corrected as a result of inflation.

2. Recognition of the effect of inflation as an adjustment for improving comparability, using as basis the historical figures; and

3. Acceptance of the adjustment which improves comparability by the tax administration.

Table V-3 Figures mostly used by the taxpayers.

Countries	Analysis with figures corrected as a result of inflation	Adjustment due to incidence of inflation	Acceptance of adjustment by the Tax Administration
Chile	No	No	Yes
Spain	No	No	No
Mexico	Yes	Yes	Yes
Peru	No	No	No
Dominican Republic	No	Yes	No
South Africa	No	No	No
Uruguay	Yes	Yes	Yes

Prepared by the authors of the study.

An analysis with corrected figures is only carried out in those countries whose regulations provide for recognizing the effect of inflation, this being consistent with the need for recognizing an additional adjustment. An adjustment that recognizes the incidence of inflation could only be made in the Dominican Republic, although the analysis may not have been carried out with figures corrected as a result of inflation.

In keeping with what has been provided in the regulations, the Tax Administrations accept the adjustments resulting from inflation. Even the Internal Revenue Service of Chile would accept an adjustment resulting from the effects of inflation.

3. Controls by the Tax Administration.

When carrying out a tax review, the tax administrations must evaluate the figures voluntarily declared by the taxpayers. In said sense, it has been considered relevant to know which are the figures considered by the tax administrations in order to audit the

income tax - table V-4 (in cases not involving abusive manipulation of transfer pricing), versus those considered when specifically controlling the transfer prices, within the framework of an income tax audit - table V-5.

On observing in each of the countries the figures used for carrying out the audits, one will be determining which figures show the less risk of transfer pricing manipulation for the respective administration. Even on observing them separately, it is determined that there are Tax Administrations that consider more than one figure (between two and three). It is important that taxpayers be consistent with respect to the figures registered and those declared, as well as those taken into consideration for the analyses –in particular, those dealing with transfer pricing. Any difference may be objected by the Administration.

Table V-4 Figures considered in an income tax audit which do not involve transfer pricing manipulation risks

Countries	Adjusted for inflation	Accounting – Historical	Sworn in the return	Financial statements	Others
Chile			X		
Spain			X	X	
Mexico	X	X	X		
Peru		X	X	X	
Dominican Republic		X	X	X	
South Africa			X	X	
Uruguay			X		1

Prepared by the authors of the study.

1/Uruguay: The Tax Administration additionally considers the figures integrally adjusted for inflation for fiscal purposes and the adjusted figures of the revaluation of use goods.

Table V-4 shows that all Tax Administrations use as basis for their audit, the figures declared for assessing the income tax. However, when transfer prices are to be analyzed, it may be observed that accounting-historical figures, those obtained from the income tax sworn returns and the ones reported in the transfer pricing return are used almost at the same level.

Table V-5 Figures considered in a transfer pricing analysis

Countries	Adjusted for inflation	Acounting – Historical	Sworn in the income tax return	Those reported in the TP return	Others
Chile		X	X	X	1
Spain			X		2
Mexico	X	X	X		
Peru		X	X	X	
Dominican Republic		X	X	X	3
South Africa		X	X	X	4
Uruguay	X	X		X	5

Prepared by the authors of the study.

1/Chile: Income Statement segmented by line of product, activity or type of customer. It is possible to make comparability adjustments on the basis of this segmented financial statement.
2/Spain: The Tax Administration additionally considers the figures declared which recognize the inflationary effect provided in the Income Tax Law.
3/Dominican Republic: The Tax Administration additionally considers the figures declared which recognize the inflationary effect provided in the Income Tax Law and the figures presented in the Financial Statements.
4/South Africa: Figures presented in the taxpayer's Financial Statements.
5/Uruguay: The Tax Administration additionally considers the figures presented in the Financial Statements.

Within the framework of a transfer pricing examination process a tax administration could consider different financial infomation from the audited taxpayer. In practice, one could find different obstacles when attempting to closely observe these figures to be audited, but undoubtedly the greatest problem to be faced will be when applying a primary or corresponding adjustment, since the figures taken into consideration might not coincide for one or the other contracting State in order to avoid double taxation, given the difference in quantification originating from the use of the figures.

In this sense, it is important to determine which figures, according to the regulations, should be included in the returns. In particular, the income tax sworn return and the transfer pricing information return.

Table V-6 Returns and values used

Countries	Income tax	Transfer prices
Chile	Financial Statements (1)	Historical Values (2)
Spain	Financial Statements (3)	n/d
Mexico	Historical Values	Historical Values
Peru	Historical Values	Historical Values
Dominican Republic	Historical Values	Historical Values
South Africa	Financial Statements	Not specified (4)
Uruguay	Accounting Statements	Accounting Statements

Prepared by the authors of the study

1/ Chile: These statements consider the monetary corrections.
2/ Chile: Depending on the type of transaction, it would be viable or not to consider the effect of inflation.
3/ Spain: This information has been subject to specific fiscal adjustments on the accounting results.
4/ South Africa: The legislation does not indicate the criteria under which the figures should be presented. In practice, those of the income return are used.
N/d: No data available.

As observed in the above table, the returns filed before the treasury are usually at historical values. If there is an adjustment that may correct the effect of inflation, it should be provided in the regulations and should be exclusive of the transfer pricing analysis. The adjustment correcting the effects of inflation is applied for the purpose of determining the fiscal result in order to tax the income but not to improve the comparability in the light of a transfer pricing analysis.

It could occur that a tax administration, within the framework of the review and analysis of the transfer prices, decides to incorporate the effect of inflation in instruments related to transfer pricing, such as, for example: advanced pricing arrangements, simplified transfer pricing measures or within the framework of agreements to avoid double taxation. The table below shows the procedure in which Mexico as well as Uruguay, recognize the effect caused by inflation. As was seen in table V-1, these countries are the only ones in the sample that recognize the inflationary effect in transfer prices.

Table V-7 Procedures wherein the inflation is recognized

Countries	Anticipated Agreements	Simplified measures	Double taxation conventions
Mexico	X	X	X
Uruguay	X		

Prepared by the authors of the study.

By taking inflation into consideration in these procedures, the tax administrations face several difficulties, for which they must determine criteria in their respective previous analyses. One example is to project the effects of inflation for an advance pricing arrangement. This may be estimated but there will be difficulties to make it precise. Another example is to agree with another administration what will be the inflation index to be used in an agreement to avoid double taxation, inasmuch as there are differences in the quantification originating from the different indicators.

Finally, one should highlight the importance of standardizing the regulations for preparing and submitting the financial information, especially for purposes of performing a reasonable comparability analysis, which appears to be more feasible when international reporting standards are recognized. Eighty five per cent of the countries of the sample take into consideration the International Financial Reporting Standards (IFRS) for purposes of the transfer prices. Most probably this is so given the importance of the standardization of regulations for preparing and submitting the financial information, which ensures reasonable comparability analysis.

As countries continue to acquire experience on the subject, they may be able to determine the impact of the effect of inflation for purposes of determining, setting and adjusting transfer prices.

C. Entities in charge of measuring in different States

Generally, government institutions in charge of census and administering the economic statistics of the States are responsable for measuring the level of prices of goods and services and, accordingly, monitoring inflation.

In this respect, we have identified the following organizations:

Alemania:	FSO, Federal Statistical Office.[46]
Argentina:	INDEC, National Statistics and Census Institute.
Brasil:	IBGE, Brazilian Geography and Statistics Institute.
Ecuador:	INEC, National Statistics and Census Institute.
U.S.A.:	BLS, Bureau of Labor Statistics.[47]
Spain:	INE, National Statistics Institute.
Mexico:	INEGI, National Statistics and Geography Institute.
Peru:	INEI, National Statistics and Information Technology Institute.
Venezuela:	INE, National Statistics Institute.

Regardless of the fact that these institutions are responsible for calculating inflation, on occasions other institutions are in charge of its dissemination, as happens with some Central Banks.

[46] Federal Statistical Office.

[47] BLS, Bureau of Labor Statistics.

VI. Glossary

APA	Advance pricing arrangement.
CP	Cost Plus Method
DTAs	Double Taxation agreements.
IFRSIC	IFRS Interpretation Committee.
CUP	*Comparable Uncontrolled Price Method.*
Deflator	Index which disaggregates the series into two components of prices and quantities.
GLENIF	Latin American Group of Financial Reporting Standards Issuers.
CPI	Consumer Price Index.
PSM	Profit Split Method.
TNM	Transactional Net Margin Method.
IFRS	International Financial Reporting Standards.
IAS	International Accounting Standards.

GDP	Gross Domestic Product.
MAPs	Mutual Agreement Procedures.
Arm´s Length Principle	Prices agreed at market value and which a third independent party would have accepted to set for a commercial transaction.
RPM	Resale Price Method.
SMEs	Small and Medium Enterprises.
SEC	U.S Securities and Exchange Commission.
OECD	Organization for Economic Cooperation and Development.

international tax compact

initiative to strengthen international cooperation with developing countries to fight tax evasion and tax avoidance