WHO TOOK AWAY MY COMPARABLE? CONSIDERATIONS FOR AN ANALYSIS OF TRANSFER PRICING COMPARABILITY IN LATIN AMERICA

Fernando Becerra O´Phelan

SYNOPSIS

It is becoming more common to hear public outcry when media say that multinationals entities (MNEs) do not fully pay their taxes. Actions to mitigate this problem were published in 2015; however, they did not consider some specific actions that Latin American countries need to improve in order to tackle base erosion. The first installment of this article addresses topics such as the lack of data, adjustments and other items affecting the comparability of the transfer pricing analysis, as well as the challenges faced by tax authorities.

The Author: Bachelor Degree in Economics from Ricardo Palma University. Postgraduate courses in Valuation of Investment Instruments from Pacifico University and Corporate Finance and Taxation from ESAN University. International Taxation and Transfer Pricing Manager at the Peruvian Tax Administration (SUNAT). Delegate of Peru at the OECD in the Working Party No6 on the Taxation of Multinationals Enterprises.
After decades of international coexistence with the Arm’s Length Principle as a cornerstone on which transfer prices are structured, in recent years we have heard voices growing louder to change this approach. However, despite the insistence of academics and non-governmental organizations, alternatives to the current model failed to convince the countries to make the leap towards what, in theory, would be a fairer distribution of the benefits.

In effect, theoretical alternatives like “unitary taxation” or criticized as in the case of the “formulary apportionment”, used in the United States to distribute the profits achieved by MNEs among the states participating in an operation, were discarded, and instead, a global consensus was reached to fix the current system. Therefore, the challenge now is to provide technical tools and transparent information to support tax administrations to control international taxes, without discouraging private investment, generating double taxation or moving away from the predictability that every company expect from a modern authority.

In this regard, one of the reasons for criticizing the Arm’s Length Principle is the practical limitation to identify comparable companies or comparable transactions that allow met the market value at independent parties would agree to operate. This problem is accentuated in the case of developing countries, where the lack of public information obstructs the work of data collection and analysis.

In fact, the G-8 Group of Leaders, in their press release of June 2013 point out in item 29 that:

“The ability of tax administrations to compare relevant price information across jurisdictions is essential for the effective operation of transfer pricing rules, and a lack of data on comparable transactions is a significant issue for effective tax collection, particularly in developing countries. We ask the OECD to find ways to address the concerns expressed by developing countries on the quality and availability of the information on comparable transactions that is needed to administer transfer pricing effectively”.

Thus, this issue is considered by the Organization for Cooperation and Economic Development (OECD), which identifies risky situations of profit shifting faced by developing countries which are not included in the BEPS project (“Base Erosion and Profit Shifting”). A more extensive elaboration of this specific problem can be found in “Transfer Pricing Comparability Data and Developing Countries” (OECD, 214).

The topics addressed in the first part of this article are as follows: First, how the lack of companies used as comparable, and how a vague analysis of the transfer pricing comparability, can become one of the reasons why the taxable of Latin American countries is eroded. Second, the challenges faced by the tax administrations to mitigate them.

A second installment part of this article will analyze the impact generated by asymmetries of information (“moral hazard”) in Latin America, a product of the lack of comparable transactions, either in assessing the value of intangible; low value-added services; cross-border commodities transactions, following
recommendations on actions 8-10 of the BEPS project. Practical alternatives to this lack of comparable operations will be proposed, such as the implementation of simplified measures, safe harbors and the coherence and consistency of the so-called “sixth method”.

1. **LACK OF INFORMATION ON COMPARABLE COMPANIES**

As noted above, both taxpayers and tax administrations in Latin America face practical limitations to select companies that are truly comparable, in order to successfully apply the methods based on gross or operating margins¹.

a. **They are just “potentially”**

The first reflection we must ask by attempting to identify operations comparable to those made between related parties, is that these are unique, which makes impossible to find exactly the same. I.e., the synergies or fragmentation of the value chain within an MNEs have been planned with specific tasks towards a particular target, which makes them different from any other company coming into the market to compete independently.

Moreover, in practice, the entities selected as comparable are the headquarters (HQ) of those MNEs; i.e., is not the direct competitor or that entity that performs the entirety of their operations with independent parties. However, since the HQ is the one that consolidates the financial information, the effect of a potential overvaluation or sub-valuation produced with their related parties is mitigated and compensated.

Therefore, a first conclusion is that all the companies selected are “potentially” comparable; however, a diligent debugging process allows identifying those that approximate the behavior of a normal and robust market, reflecting what rational economic agents, under similar conditions, would agree.

b. **The twin limitations**

Dependence from extractive natural resources, low industrialization and tight market penetration (concentration of businesses in certain cities or regions) cause that many economic sectors in Latin America are conformed by natural oligopolies that concentrate the market subsidiaries of foreign multinationals, which limits the competition and identification of potential comparable².

Even though the above-mentioned may vary in intensity from a territory to another, it is a fact that the Latin American countries, with shallow equity markets, face the same twin limitations: too few players and many of them are not bound to display public information for the investors.

In the Peruvian case, an example of what could have been the start for trying to overcome this situation was the obligation to companies, not listed on the stock market and reaching a certain income level, to present annually their audited financial statements to the security market supervisory entity (“SMV”). However, this initiative was vetoed by the Constitutional Court in 2016, ruling the unconstitutionality of the law, recognizing the right to privacy of the companies that this standard, they say, violated. So this information was presented for the fiscal years 2013 and 2014 only.

1. The Resale Price and Cost Plus (Traditional Methods) suggest an evaluation at the level of gross margins; while the Transactional Net Margin and the Residual Profit Split (Profit Methods) analyzed returns at the operational level.
2. Just as an example to outline that situation in Peru, one MNE of the brewing industry reached a market share of 97% in 2014. In addition, in 2014, a cement MNE concentrated 51% of the local sales; and a telecom company obtained 71% of the market share.
Thus, in Peru only very little public financial information are published, mainly from mining companies\textsuperscript{3}, which are unrepresentative for a capital importing country, which should aiming to build performance benchmarks.

The following table attempts to measure the representativeness of the main players in the countries that compose the Pacific Alliance (Peru, Mexico, Chile and Colombia), trade bloc that aims to facilitate the economic integration, with respect to their GDP (2014):

**Table 1**

**Importance of the leading companies in the Pacific Alliance regarding their respective shares of GDPs**

<table>
<thead>
<tr>
<th>Country</th>
<th>Main Groups</th>
<th>Revenue (Billions of USD $)</th>
<th>% GDP</th>
<th>% GDP Accumulated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>America Movil</td>
<td>61.60</td>
<td>2.87</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Femsa</td>
<td>20.00</td>
<td>0.93</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Grupo Alfa</td>
<td>15.90</td>
<td>0.74</td>
<td>4.54</td>
</tr>
<tr>
<td>Colombia</td>
<td>Ecopetrol</td>
<td>37.70</td>
<td>5.91</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Grupo Aval</td>
<td>9.00</td>
<td>1.41</td>
<td>8.24</td>
</tr>
<tr>
<td></td>
<td>Bancolombia</td>
<td>5.90</td>
<td>0.92</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>Antar Chile</td>
<td>24.40</td>
<td>6.15</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Cencosud</td>
<td>20.70</td>
<td>5.22</td>
<td>14.70</td>
</tr>
<tr>
<td></td>
<td>Falabella</td>
<td>13.20</td>
<td>3.33</td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>Relapasa</td>
<td>4.11</td>
<td>1.11</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Banco de Crédito del Perú</td>
<td>3.28</td>
<td>0.88</td>
<td>2.87</td>
</tr>
<tr>
<td></td>
<td>Teléfonica del Perú</td>
<td>3.27</td>
<td>0.88</td>
<td></td>
</tr>
</tbody>
</table>


By: Author

Thus, we can observe that in Chile, the incomes of three conglomerates represented in 2014 approximately 14.7% of GDP and this suggests how concentrated the market is.

By contrast, it seems that in Peru the market is diversified; however, the effect produced by the informal sector in the economy distorts the obtainable conclusions\textsuperscript{4}.

In Mexico, the inbounds of one single MNE are almost 3% of the national GDP; without taking into consideration the Pemex State Company, the largest oil producer of Latin America.

Therefore, a way of celebrating the first five-year term (2011-2016) of the Pacific Alliance could be to make accessible the financial data of its main companies. This can be done, while respecting

\textsuperscript{3} In 2016, twenty mining companies listed on the stock market of Lima published their financial information.

\textsuperscript{4} "Them features structural of the informality labor in the Peru not have changed significantly during the last decade, of this mode, the rate of informality labor urban average between the 2004 and the 2014 is between 53% and 75% according to the definition of informality" (Cespedes, 2015).
the tax secrecy, building a representative regional database that would enable sharing information between the tax administrations, as well as providing the private sector with efficiency ratios by sectors. There is no doubt that this would encourage competition.

Therefore, if the countries of the Pacific Alliance have promoted the creation of the Integrated Latin American market, regional market for trading equity securities, and are currently discussing the implementation of a platform allowing the exchange of information on migration, the proposal made here corresponds to the objectives that this block has stated.

Therefore, the constrain would not be the lack of potentially comparable companies to build benchmarks, but to implement mechanisms improving the information flow; procedure that can follow the high standards proposed by OECD for the exchange of automatic information, ensuring thus reliability, traceability and transparency in its use. This proceeding is no different for any of the countries that seek to comply with FATCA and CRS international regulations.

Thus, it would be convenient to establish a workgroup composed of technicians from the four countries, to assess and propose solutions of tax convergence with a view to reduce the international tax gaps and harmonize its treatment.

C. The use of Secret Comparables

The hidden or secret comparables are information accessible only to the Tax Administration and in respect of which there is a duty of confidentiality in compliance with the tax normative. Given this obligation, the following questions would arise:

Can this information be used for transfer pricing issues? If the answer is yes, which are the conditions that enable their use?

In this regard, the OECD guidelines of transfer pricing applicable to multinational enterprises and tax administrations (IEF, 2010) in paragraph 3.36 point out:

“Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts”.

Regarding the above mention, the use of secret comparable information would be possible if two conditions are met: i) to provide the taxpayer with the necessary and sufficient information so that he can defend its position; and (ii) comply with the tax rules on confidentiality. However, in practice, is it possible to meet these two conditions at the same time?

Tax rules on confidentiality protect the taxpayers’ right to confidentiality, which is not absolute, as all constitutional rights, and may therefore be validly limited in order to protect other rights or the common good, such as the tax collections of a country. Therefore, the cornerstone is to determine the core of the right to confidentiality of taxpayers that cannot be limited without emptying the other content.

According to one interpretation, the core is the information that identifies the hidden comparable, to be understood as the name or company name, tax identification number, brands, industrial or commercial secrets among other distinctive signs. Thus, Latin American tax administrations, without transgressing the duty to maintain confidentiality, could reveal
various items. For example: i) outlook of the business; (ii) entity size; (iii) market level where operates; (iv) amount of sales; (v) gross profitability; and (vi) operating profit, without this implying having infringed their rights and/or the tax reserve. However, the question still arises if this information is sufficient for the taxpayer to exercise conveniently his right of defense for transfer pricing purposes and, in particular, when applying operating margins methods (non-traditional), comparing companies’ returns.

In this regard, if the company selected as secret comparable owns valuable brands and other specific intangible, this information should not be disclosed. Nor would be shared the extraordinary facts that could affect, positively or negatively, the profitability of the comparable; i.e. financial elements that affect and determine the gross and operating profitability of the company. Moreover, not disclosure the name of the taxpayer could not demonstrated that whether is or not part of an MNE, main condition where the arm’s length principle is based.

Therefore, with the limited financial information to which taxpayers would have access, they could not exercise properly the right of defense to validate the accuracy of comparability with other companies, when profit margin methods are applied.

However, it is important to highlight that this situation is quite different from comparing market conditions or contractual terms through traditional methods (Comparable Uncontrolled Price), where the trend or market behavior is what we try to identify. Thus, contracts between third parties are reviewed and the conditions in which a particular sector agrees on business with third parties are studied, without violating the confidentiality or the taxpayer’s right of defense. It is important to note that Action 10 of the BEPS project, with regard to cross-border commodities transactions, suggests that tax administrations identify trends and market conditions at the time of determining a presumptive quotation period; and an option to achieve it is building an internal database of contracts. Further details of this procedure will be addressed in the second part of this article.

Therefore, we confirm the need to promote broad and transparent information to markets, which serve as a sector reference parameter to taxpayers, and provide toolkits to Latin American tax administrations to demand fair payment of taxes.

d. External information

The lack of local comparable companies imposes that both taxpayers and tax administrations opt to select companies that operate in similar industries, even though they are not in the same geographic market. Thus, in theory, their results should converge, regardless of the territory where they are produced. This approach leads, in general, to less precise searches but broadens the framework of analysis. Companies with public information from abroad are an alternative that, potentially, approach to the sector that will be compare. The comparability adjustments that allow eliminating the distortions between different countries is another challenge that remains.

In this regard, the OECD notes in its Guidelines that:

1.36“(…) In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm’s length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm’s length transactions. Attributes or “comparability factors” that may be important when determining comparability include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.
3.35. “Taxpayers do not always perform searches for comparables on a country-by-country basis, e.g. in cases where there are insufficient data available at the domestic level (...).” Non-domestic comparables should not be automatically rejected just because they are not domestic. A determination of whether nondomestic comparables are reliable has to be made on a case-by-case basis and by reference to the extent to which they satisfy the five comparability factors. (...).

The United Nations, in their Practical Manual on Transfer Pricing for Developing Countries (2012) mention that:

5.3.4.13 “With regard to geographic location and product/service market, independent companies operating in the same market(s) as the tested party, where available, will generally be preferred. However, in many countries, especially developing countries, the availability of independent comparables, or of public information on independent comparables, is limited. Use of foreign comparables may therefore be needed, although this can also be difficult for many developing countries without access to relevant databases and with limited resources to analyze and adjust the foreign comparables”.

Meanwhile, in Peru, section d) article 32-A of the Income Tax Law points out that:

“When for purposes of determining the comparable transactions, available local information is not available; the taxpayers can use information from foreign companies, and must make the necessary adjustments to reflect the differences in the markets”.

However, comparability will be increased if the market conditions where these companies operate are similar to those of the tested party, both in size and in the particular regulation (i.e.: NAFTA, CAN, Mercosur or Pacific Alliance economic clusters). Certainly, there are more similarities in the way and risks of doing business between Latin American and resources-rich countries, than among developed countries. Hence, it is important to promote the construction of regional samples; for example, the use of pan-European comparables are recurrent and accepted in Europe. However, OECD in its guidelines 3.35 indicates:

“Whether or not one regional search for comparables can be reliably used for several subsidiaries of an MNE group operating in a given region of the world depends on the particular circumstances in which each of those subsidiaries operates”.

Therefore, it can be concluded that, for purposes of applying methods based on gross or operating margins, it is possible to use of non-domestic comparable companies, preferably from regional or similar markets, if they satisfy the five comparability factors and the delineation approach suggest in the BEPS Project (Actions 8-10).

e. The databases

Commercial databases (DB) are used as sources of information, both financial and functional, for the identification of external comparables. They collect public data, essentially accounting, of the memoirs and reports for investors, who then adapt to perform searches in accordance with certain parameters. Although this is a widespread practice, there is a certain distrust because of the limitations of these databases for the comparability analysis (Rubio, 2010):

1. Not all countries provide reliable information that feed the DB;
2. Even when they have it, they do not always have the same information available or with the same accounting standards;
3. Many DB are not intended to be used for performing transfer pricing documentation;
4. Analyses of comparability with DB often give more importance to the number of comparables than to their quality.
5. The cost of these DB may be important for small and medium-sized enterprises.

Thus, the selection of comparables must go beyond what the DB present. It is necessary to filter and complement the results with other reliable sources of information. In addition, often, the comparables companies present their information in a language other than the one used in the country where the assessment is performed; therefore, the readability of the evidence is an issue.

On the other hand, it must be mentioned that, from a survey carried out by CIAT in 2013 to a group of tax administrations of Latin America and the Caribbean, six of them relied on the DB of the private provider Osiris; three had contracted with Compustat; and four noted that they had not even acquired one.

The survey also identified the following as the main advantages of using DB:

- Access to world information;
- Support for risk analysis;
- Verification of data that companies provide in their transfer pricing documentation; Homogeneous data access;
- Access to simple search engines that extract information quickly and timely;
- Access to comparables for control processes;
- These databases are the most used by taxpayers, so a same parameter of comparison for the validation of data is generated; and
- Ranges of benefits by sectors can be built.

As disadvantages, tax administrations indicated the following:

- They do not have enough information about the companies in Latin America and the Caribbean;
- In many legal systems, this information cannot be considered as evidence in the courts, for being “non-public” information;
- They are not available in the official languages of the countries, which may create translation barriers in the inspections; and
- They represent a high cost for various tax administrations.

Finally, they point out that the process of selection of comparable companies should be transparent, systematic and objective. The burden of proof rests on who proposes them, usually taxpayers; hence that it is mandatory to have documentation that supports the qualitative and quantitative filters used, even more when an audit case is in progress.

2. COMPARABILITY ADJUSTMENT FOR LATIN AMERICAN COUNTRIES

As is mentioned above, for the purposes of increasing or improving the comparability between the tested party and the companies selected, different adjustments should be carried out. However, two types of comparability adjustments are carried out: the business-related and the capital-related.

The first one seek to approximate functional similarities between the parties. Issues such as the terms of payment; negotiated amounts; costs of intermediation; accounting reclassifications; capacity installed and used; packaging, freight and insurance; among others, should be verified. The consistency of functional analysis is challenging; for that reason, the object and the basis by which these adjustments are proposed must be supported by the taxpayers, who bear the burden of proof.
In this regard, CIAT’s working paper states:

“All time an adjustment does not reflect or express reasonability and accuracy, it is likely to be rejected by the competent authority, and ultimately it is the first element that the tax authority must evaluate before an adjustment to improve the comparability. If the two abovementioned elements are properly proven and documented, it is more probable that a fiscal authority will accept the adjustment.”

Comparability adjustments are necessary as long as they meet their purpose of improving the analysis, and if they are properly used; conditions that often are not met. The CIAT, in its survey among the tax administrations of the region, list the main reasons of rejection:

- They do not improve the comparability.
- Irrelevant idle capacity.
- Excessive or faulty intermediation costs.
- They have no economic justification and/or the adjustment does not correspond with reality.
- The reasoning on the adjustment is faulty.
- The adjustment is not properly documented.
- Arithmetical and substantial errors in the formulas.
- Implied interest rates of the capital adjustment are incorrect.

On the other hand, the second type of adjustment are those that aim to “soften” the impact on the capital produced by the financial leveraging used by foreign companies. I.e., if the companies with access to more developed financial markets are used as comparable, it is presumed that the cost of borrowed or leased capital will be lesser than the one that entities in Latin America would get; therefore it is economically reasonable to take into account these differences before comparing the profit margins achieved by the parties.

Thus, in order to eliminate or minimize the effects that distort comparability, emerging countries should quantify and isolate the risk associated with the capital that companies based in developed countries implicitly incorporate in their financial statements. However, no consensual procedure currently allows put in place this.

Indeed, while adjusting the working capital is the usual practice to mitigate these differences, such as accounts receivable, payment and inventory; this measure may be necessary but is not sufficient.

I.e., it might not be enough to bring to zero the implicit interest to which the non-domestic companies sell or buy at credit, simulating this way that they have not benefited financially from lower interest rates or bringing these financial accounts to the level of the Latin American country. In fact, a risk premium should be included by sector risk and country risk, attempting to approximate transversely the systemic risk at the location where the revenue occurs.

It would be naive to believe that it is enough to verify the effect of three financial accounts so that the profitability achieved by a European or North American country becomes comparable to the a Latin American or African.

What independent third party, acting as a rational economic agent, investing in a developing country (facing increased risks due to lack of political stability, legal security, and limited infrastructure, among others) would want to get a return on his investment equal to those achieved in a developed country?

If the portfolio model relies on the fact that greater risk is rewarded with greater profitability, and if all investments in financial assets are valued using discount rates, why not adding adjustments by sector risk? Why could we not add the systemic local risk to the foreign company margin as part of the transfer pricing comparability analysis?

Now, despite the fact that all statistical models have their limitations, the financial theory
shows these tendency, in the long term, to adjust the market. Thus, Gonnet, Starkov and Maitra (2013) proposed an adjustment to the capital cost that attempt to include this effect. In this regard, they isolate the financial component of the above-mentioned financial accounts; leading to zero the Return Over Capital Equity (ROCE), to then calculate the Weighted Average Cost of Capital (“WACC”), both for the tested party in the emerging country and for the comparable companies in the developed world. Finally, the differential of the WACC is calculated and the result is added to the ROCE of the comparables, in order to include the premium demanded by investors, which is associated with the various risks in the WACC (country, sector, market share, access to credit, interest rates, among others).

Therefore, it is possible to conclude that the adjustments to increase the business or functional comparability and those of financial or capital comparability are fundamental. That is why the G20 has charged the OECD and the World Bank to develop and propose toolkits for the mitigation of these asymmetries. It is expected that a document with the relevant recommendations will be issued in October 2016. In the particular case of accuracy adjustments related to the line of business, the correct delineation of functions, assets and risks will be put into practice (Action 8-10 BEPS); documentary evidence supporting will be the key. On the other hand, the methodological alternative to capital adjustments that was presented above should be evaluated by Latin American countries; however, other formulas can be discussed. The reality is that the actual approach (adjustments to accounts receivable, payment and inventories) has to be improved in order to include the underlying risk of investing in a risky region. The Pacific Alliance, with the technical support of CIAT, can be the platform that, in a coordinated manner, promote the measures proposed by OECD/WB and/or others that are adapted to our economies. Unfortunately, there is no simple solution.

3. OTHER ELEMENTS THAT AFFECT THE COMPARISON

a. Recurring losses

Every company is formed with the aim of generating profit; however, there are situations that may prevent this goal. The OECD guidelines in its paragraph 3.65 state the practical application in these situations:

“Generally speaking, a loss-making uncontrolled transaction should trigger further investigation in order to establish whether or not it can be a comparable. Circumstances in which loss-making transactions/enterprises should be excluded from the list of comparables include cases where losses do not reflect normal business conditions, and where the losses incurred by third parties reflect a level of risks that is not comparable to the one assumed by the taxpayer in its controlled transactions. Loss-making comparables that satisfy the comparability analysis should not however be rejected on the sole basis that they suffer losses”.

The inclusion of comparable companies with recurring losses over a period of years should be evaluated case-by-case, passing through the five steps of the analysis of comparability, showing evidence that the losses reflect lower conditions in the market of these transactions. It would not be an economic sense, for example, to use unprofitable entities when the tested party is characterized as a low-risk supplier or a contract manufacturer.

5. See paragraph 1.70 to 1.72 of the OECD guidelines (2010).
Strictly speaking, a company selected as comparable must be robust and represent a sector whose objective is to generate profits. The whimsical and little argued inclusion of loss-making entities generates disputes. Ecuador faced a similar situation that led by 2015 to publish measures to standardize the analysis of Transfer Pricing; point 2, paragraph VII, D, referred to “Selected Comparables” notes that:

“Not presenting operating losses (both before and after the application of comparability adjustments) in the year under analysis. Unless the taxable person justified objectively and in detail that such losses are a feature of the business, by circumstances of market, industry or other criteria of comparability and clearly establish that the conditions that have led to loss are not consequence of characteristics affecting comparability.”

As can be noted, to avoid arbitrariness, the Ecuadorian tax administration clearly circumscribes the use of comparable companies with losses to certain extraordinary situations that the taxpayer must support with documentary evidence; this creates predictability and avoids disputes. The other Latin American tax authorities should imitate this normative approach.

b. Multi-year data

Using data from multiple years may be useful to check the facts that may have influenced the price, as well as to obtain information from the business cycles that influence its formation; however, these concepts are often interpreted incorrectly.

In this regard, the OECD guidelines indicate that:

3.75 “In practice, examining multiple year data is often useful in a comparability analysis, but it is not a systematic requirement. Multiple year data should be used where they add value to the transfer pricing analysis. (...)

3.77 “ Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables (...) “ may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability (...)

3.78 “Multiple year data can also improve the process of selecting third party comparables e.g. by identifying results that may indicate a significant variance from the underlying comparability characteristics of the controlled transaction being reviewed (...)

3.79 “ The use of multiple year data does not necessarily imply the use of multiple year averages (...)

These extracts show a line of ideas regarding the use of multiple-years information, which should not confuse their contribution to the analysis of comparability with the statistical purposes for the determination of the market range. Multi-year data should be used to measure the impact of products cycles and/or the economic situation on profits, as well as to understand the business context of the operation to compare. They do not imply that such information is necessarily part of the mathematical determination to obtain the range of prices or profit margins, or the consequent tax adjustment it is the case.

Mexican and Canadian tax authorities recognize this approach normatively to improve comparability. Thus, the article 179, fifth paragraph, of the Mexican income tax law mentions:

“When the cycles of business or commercial acceptance of a product of the taxpayer cover more than one year, comparable operations of two or more exercises, anterior or posterior, may be considered.”
This way, the approach of the tax authorities regarding the use of multiple years as element for comparison is confirmed, when it contributes value to the Transfer Pricing analysis. Determination, if there is a doubt, must be applied to the tax exercise of the tested party and, in the case of the companies selected as comparable, both Canada as Ecuador require using it on the same year, while Mexico suggests it, but does not limit it, subjecting this to more evidence on the part of the taxpayer.

Therefore, in order to mitigate potential disputes, it is necessary that Latin American tax administrations specify in their normative the particular circumstances where it is useful to implement of multiple years of comparable companies for the statistical purposes of the determination. This approach, case-by-case, would seek to “soften” the trend of one-year profits when they face extraordinary situations, such as projects of more than one exercise (i.e. construction of roads or plants; mining or oil exploration), structural facts or circumstances that have influenced the price (climatic events such as droughts, closures or pest; financial, technological or political crisis), cycles of business, among others. It even be evaluated to make it extensive to the tested party; however, it is clear that since the income tax is of annual periodicity, the determinations or adjustments are applicable only for the financial year under analysis.

c. Does size matter?

Another situation that could distort the analysis of comparability is the materiality of the selected companies. Although there is no limit of use and, in case of returns much above the market rate, the interquartile range filters them, it is motive of concern. In this regard, the following graphics attempt to explain this concern and estimate the size and relevance of the multinational companies in our countries:

For its part, the CRA’s Canada in its communiqué TPM-16 (2015) says:

15. “(...) It is important to note that in the Guidelines, the OECD discusses the use of multiple years of data in the form of information relevant to a comparability analysis. The OECD does not promote averaging multiple years of numerical data to establish comparability (...).”

29. “While multiple years of data may be useful to select, reject, or determine the degree of comparability of potentially comparable transactions, transfer prices for a given year should be determined based on the results of a single year of data from each of the comparable transactions. Therefore, taxpayers should not average results over multiple years for the purpose of substantiating their transfer prices in an audit context. The CRA will look at the results for comparable data and apply them on a year-by-year basis (...).”

The above shows that, in the Mexican case, the financial information from the comparable could be used for more than one year, if the stated hypothesis can be demonstrated. Furthermore, the CRA limited the use of the multiple years only to comparability analysis, leaving the statistical determination of the adjustment to a single year. This situation is similar to the proposal by Ecuador at point 2, paragraph VII, clause (C), referred to “The profitability indicator selection” where indicates that:

“The profitability indicator, for operations, segments or analyzed companies as well as operations, segments, or comparable companies, must be calculated only with the financial information of the year under analysis. If operations, companies or comparable business segments have been identified, for which there is no financial information of the year under analysis, the year immediately prior to the analyzed year could be used, if it is proven that the relevant conditions were similar in both periods.”
Graphic 1

Income of World’s largest companies

Graphic 2

GDP of the countries comprising the Pacific Alliance


By: Author
As we can see, in 2014 two MNEs obtained incomes exceeding the GDP reached by Peru and Chile. I.e., if they were countries, they would be among the biggest players of the Pacific Alliance. Wallmart (USA) alone has revenues approximately 25 times higher than Cencosud (Chile) and 350 times greater than Supermercados Peruanos (Peru). In a hypothetical case, would they be comparable? Situations like these call our attention, including the influence power that corporations of this magnitude have; however, this is not decisive per se.

Statz (2009) mentions that by use historical data and/or multiples data from companies that are much larger or smaller than the tested entity can lead to incorrect results on the value of the business. He also points out that (...) “Any market data used to estimate the value of a company should be limited to an appropriate size range”.

Therefore, any effort to build a regional database, by individual companies or grouped by economic sectors of reference, will ensure accuracy in the transfer pricing comparability analysis.

4. CONCLUSIONS

Throughout this article, we have shared practical considerations, both for taxpayers and tax administrations, regarding certain limitations that prevent from performing an accurate analysis in the context of Transfer Pricing, when selecting comparable companies for the application of the margins methods.

First, it was conceptualized that companies are just “potentially” comparable, this since it is virtually impossible to identify independent entities with functions, assets and equal risk on which the involved parties would agree. Despite adjustments to increase the comparability, differences remain. However, a sample representative of the sector would come closer to the results that third parties expect to obtain when making similar activities.

It was also noted that Latin American countries face the same twin limitations: there are few players and many of them are not obligated to disclose public information, which complicates the identification of potentially comparable companies. In this respect, we propose the building of a regional database, with access to the financial data of the main companies included, in order to share the information between tax administrations. This initiative can be promoted within the Pacific Alliance, which, as a block, can encourage best practices for Transfer Pricing.

Regarding adjustments to improve comparability, it was concluded that the correct delineation of the parties through functional analysis is essential to identify companies similar to the tested party (Action 8-10 BEPS Project) and, if applicable, to perform the corresponding business or functional adjustments. The methodological approach of financial or capital adjustments is also questioned (accounts receivable, payment and inventories) to the point that an independent third party would not be willing to get a return on his investment in countries such as Latin Americans equal to the one reached in a developed country. In conclusion, it is not sufficient to adjust the effect of these accounts for obtaining approximate returns and we subscribe to an alternative methodology that aims to add a premium covering the country and sector risk; however, other formulas can be discussed.

Finally, we identified other elements that directly affect the comparison; thus, we concluded that the inclusion of companies with recurring losses should be evaluated case-by-case, passing through the comparability analysis filter, showing evidence that the losses reflect the market conditions. Similarly, to avoid litigation, Latin American tax administrations should explain normatively the specific circumstances where the application of multiple years of the comparable companies is useful for the statistical purposes of the determination.
5. BIBLIOGRAPHY


OECD (2010) applicable OECD guidelines on multinational enterprises and tax administrations Transfer Pricing. IEF.


CRS (2015) Role of Multiple Year Data in Transfer Pricing Analyses. Canada Revenue Services TPM-16.

Electronic references

Definitions for: https://en.wikipedia.org/wiki/Formulary_apportionment


Definitions for: http://www.oecd.org/ctp/beps.htm

Frequently asked questions about presentation of audited financial entities to which refers article 5 of the law 29720 and resolution SMV N° 011-2012-SMV/01: http://www.smv.gob.pe/Uploads/PREGUNTASFRECUENTES.pdf

Definitions for: http://www.mercadomila.com/home/resena

Definitions for: https://www.oecd.org/tax/automatic-exchange/
