Considering Market Features in Latin America as Part of a Transfer Pricing Analysis

With a focus on comparing circumstances in OECD and Latin American countries, the authors consider the OECD Revised Discussion Draft on Transfer Pricing of Intangibles and “other market features” as part of a transfer pricing analysis.

1. Introduction

In the context of the various tax and transfer pricing discussions taking place currently internationally, the OECD recently issued a document titled “Revised Discussion Draft on Transfer Pricing Aspects of Intangibles.” This article will focus on the analysis of the proposed changes to chapters I-III of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines), specifically discussing the incidence of the “other market features” in a transfer pricing analysis for companies that operate in Latin America.

2. Comments on Revised Discussion Draft on Transfer Pricing Aspects of Intangibles: Proposed Amendments to Chapters I-III of the OECD Guidelines

In the section on “other local market features”, the OECD deepens the discussion (already present in the OECD Guidelines available to date) of how local market features can potentially affect the transfer pricing analysis through distortions in the comparability between intercompany transactions and transactions with independent parties. In this regard, elements to consider include the following:

- the size of the geographic market in which products are sold;
- the purchasing power and product preferences of households in that market;
- whether the market is expanding or contracting;
- the degree of competition in the market;
- the relative availability of the local country infrastructure;
- the relative availability of a pool of trained or educated workers; and
- proximity to profitable markets.

These factors, among others, can generate advantages or disadvantages to doing business in a particular market, which must be considered when performing a transfer pricing analysis. Therefore, the need to make adequate comparability adjustments based on the circumstances of the particular case is established in the Revised Discussion Draft.

In order to mitigate this significant technical problem, the OECD proposes that taxpayers use, first, comparable information from the local market under analysis, avoiding the need to perform comparability adjustments for these factors, as the comparables (companies, contracts or prices) used would have the same systemic characteristics as the tested party.

This first theoretical recommendation has serious application issues in Latin American countries. In these markets, available public information is still scarce. This necessarily implies that the number of potentially comparable companies in Latin America is less abundant than in other regions where the capital markets are more robust. In this regard, the Revised Discussion Draft states as follows:

The need for comparability adjustments related to features of the local market in cases where reasonably reliable local markets cannot be identified may arise in several different contexts. In some circumstances, market advantages or disadvantages may affect arm’s length prices of goods transferred or services provided between associated enterprises.

One of the main technical difficulties for transfer pricing practitioners, as well as taxpayers and tax authorities, concerns the lack of practical guidance regarding how transfer pricing comparability adjustments are to be applied. Considering that the differences in the application of these adjustments is a frequent cause of technical disputes between tax authorities and taxpayers, it seems imperative that the new OECD Guidelines include a detailed analysis of transfer pricing comparability adjustments that eventually could be performed even in situations where there are virtually no local comparable companies available.

3. Local Market Features in Latin America

As mentioned, there are many factors that can render two markets not comparable from a transfer pricing perspective. Specifically, Latin America has characteristics significantly different to the rest of the world’s regions. Some of these factors, which are considered below, are especially significant in light of the major impact that they have on Latin American firms.

3.1. Volatility and business cycles

The OECD Guidelines contain scarcely any references to the business cycle as one of the factors that affects compa-
rability in a transfer pricing analysis. Chapter I states that “[t]he existence of a cycle (economic, business or product cycle) is one of the economic circumstances that may affect comparability”.

Chapter III, paragraph 3.77, regarding the use of multiple year data where there are cycles, states that “[m]ultiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables”, and then adds that “[d]ifferences in business or product life cycles may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability”.

The study of the effect of the evolution of the business cycle on the comparability in transfer pricing analysis has not yet been dealt with in the specialized literature in full detail. Moreover, the way in which differences between business cycles in Latin America and those of developed countries affect the transfer pricing analysis of a Latin American firm has barely been considered. This section focuses on analysing the evolution of the economic cycle in LAC-7 countries versus the evolution of the economic cycle in developed economies of G7 countries and OECD member countries, and how these differences directly impact transfer pricing analysis when one compares the results of a Latin American company with those of entities that operate primarily in developed economies.

The dynamic in the economy of the region consisting of the LAC-7 countries is characterized by recurrent oscillations...
tions of economic activity, measured by the annual growth rate of the gross domestic product (GDP), as compared to G7 and OECD economies. See Figure 1.

At the same time, as seen in Figure 2, the growth rates of GDP for LAC-7 countries are highly volatile. The average volatility in the growth rates of GDP, measured by the standard deviation, is almost the double of that in developed countries.

According to the UN Economic Commission for Latin America and the Caribbean (CEPAL) (2009-2010):

The level of macroeconomic volatility is associated with various elements which differ according to the specificities of each country, but which commonly include issues such as the level of participation in the world trade, the productive structure, economic policy, vulnerability to natural disasters and the institutional framework, among others. 10

All these elements have an impact on the business cycle of emergent economies and therefore affect the comparability level when performing a transfer pricing analysis.

3.2. Human capital

Related to business cycle volatility, one consequence of the frequent oscillations in emerging economies (relative to developed economies) is the negative impact of lower economic growth on the welfare level of the population. In turn, this lower performance in emerging markets limits the possibilities of appropriate economic development and affects the progress of human capital – the most important productive factor.

Figure 3 shows the human development index (HDI) from 1980 to 2013 of LAC-7 economies vs. developed economies of G7 and OECD countries. The human development index is a compound measure concerning health, education and income in each country. This graph indicates that in LAC-7 countries, where economic growth rates are highly volatile, the human development index is remarkably lower than the human development index shown for G7 and OECD countries. It is expected that this relatively poor progress in human capital will affect the productivity of Latin American companies, especially those that are labour intensive, as will be discussed below.

3.3. Productivity

Another significant difference to be considered is the labour productivity in Latin America countries vis-à-vis OECD countries. To verify the differences between LAC-7 countries and OECD countries, the analysis here considers the GDP per person employed (1990=100). Data are used from 1980 to 2012 for OECD member countries and LAC-7 countries.

The average of growth rate is 1.58% in OECD countries and 0.70% in LAC-7 countries; which implies that the productivity growth rate in Latin America is less than half of the productivity growth rate of an OECD country. Obviously, this has huge implications from a corporate profitability perspective.

Figure 4 shows the growth in the labour productivity for a range of years, distinguishing between the average in OECD countries and LAC-7 countries.

3.4. Ease of doing business

A notable aspect of the advantage or disadvantage of performing activities in a particular market concerns the ease of doing business. Relevant variables are revised and ranked in the document: “Doing Business”, released annually by the World Bank.

The afore-mentioned ranking takes into account factors such as: ease of starting a business, ease of dealing with construction permits, ease of obtaining electricity, ease of registering property, ease of obtaining credit, investor protection, ease of paying taxes, ease of cross-border trading, ease of enforcing contracts and ease of resolving insolvency.

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According to the data studied, it is clear that LAC-7 countries present more difficulties to doing business than OECD countries, with a tendency to even increase the gap between these two groups of countries.

Table 1 indicates that even among Latin American countries there is a heterogeneous situation, with countries of the Pacific Alliance (Chile, Colombia, Mexico and Peru) being in a better relative position in the World Bank ranking.

Table 1: Ranking ease of doing business

<table>
<thead>
<tr>
<th>Economy</th>
<th>Year</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>116</td>
<td>124</td>
<td></td>
</tr>
<tr>
<td>Brazil</td>
<td>128</td>
<td>130</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>33</td>
<td>37</td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>44</td>
<td>45</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>53</td>
<td>48</td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>43</td>
<td>43</td>
<td></td>
</tr>
<tr>
<td>Venezuela, RB</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Germany</td>
<td>18</td>
<td>20</td>
<td></td>
</tr>
<tr>
<td>Canada</td>
<td>15</td>
<td>17</td>
<td></td>
</tr>
<tr>
<td>United States</td>
<td>4</td>
<td>4</td>
<td></td>
</tr>
<tr>
<td>France</td>
<td>32</td>
<td>34</td>
<td></td>
</tr>
<tr>
<td>Italy</td>
<td>75</td>
<td>73</td>
<td></td>
</tr>
<tr>
<td>Japan</td>
<td>20</td>
<td>24</td>
<td></td>
</tr>
<tr>
<td>United Kingdom</td>
<td>6</td>
<td>7</td>
<td></td>
</tr>
</tbody>
</table>

2. Economies are ranked on the ease they provide for doing business, from 1-189. A high ranking on the ease-of-doing-business index means the regulatory environment is more conducive to the starting and operation of a local firm.
3. RB is the Spanish-language acronym for Bolivarian Republic.

Another relevant aspect is cross-border trading, which takes into account factors such as the number of documents required for export and import; time to export and import; and cost of export and import.

Table 2 reveals the differences between OECD and LAC-7 countries. It is clear that LAC-7 countries in general present inefficiencies that make cross-border trade more difficult in the region, thereby generating significant additional expenses for a company that operates in Latin America. The simple fact that the export cost per container is 4.7 times higher in LAC-7 countries than in OECD countries, and that the import cost per container is 6 times higher in LAC-7 countries, clearly shows the enormous economic differences that should be considered in a transfer pricing analysis, where one is comparing companies that operate in “different worlds”.

Table 2*

<table>
<thead>
<tr>
<th>Economy</th>
<th>OECD</th>
<th>LAC-7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade Across Borders</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Documents required to export (number)</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Time to export (days)</td>
<td>10</td>
<td>18</td>
</tr>
<tr>
<td>Cost to export (USD per container)</td>
<td>369</td>
<td>1719</td>
</tr>
<tr>
<td>Documents required to import (number)</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Time to import (days)</td>
<td>10</td>
<td>25</td>
</tr>
<tr>
<td>Cost to import (USD per container)</td>
<td>328</td>
<td>1980</td>
</tr>
</tbody>
</table>


In this regard, the OECD, in its Latin American Economic Outlook 2014,11 places special emphasis on the above-mentioned disparities, specifically the high logistics costs in Latin America, which lead to inefficiencies and therefore render these countries less competitive than countries in other regions. The logistics performance index (LPI) is mentioned, which takes into account factors such as:

- efficiency of the clearance process (i.e. speed, simplicity and predictability of formalities) by border control agencies, including customs;
- quality of trade- and transport-related infrastructure (e.g. ports, railroads, roads, information technology):

- ease of arranging competitively priced shipments;
- competence and quality of logistics services (e.g. transport operators, customs brokers);
- ability to track and trace consignments; and
- timeliness of shipments in reaching their destination within the scheduled or expected delivery time.

This index reveals that the average LPI Score is 2.96 for LAC-7 countries, while the average in OECD countries is 3.63. A country that improves its LPI grade by a single point will see a positive impact on the average labour productivity of 35%. This indicates the importance of not discounting the impact of logistic costs when one compares enterprises in a Latin American country with enterprises that operate outside the region, as logistic costs directly affect development issues, competitiveness and productivity.

4. Final Considerations

This article has considered some of the systemic principal differences that can affect any company that operates in Latin America. A sound and in-depth understanding of these differences is necessary when seeking to make comparability adjustments where a Latin American enterprise is compared with a firm that operates in a G7 country.

In the authors’ opinion, the OECD Discussion Draft’s consideration of the economic advantages and disadvantages of operating in different countries is very valuable. The OECD Discussion Draft adds significant elements to comparability analysis issues. However, it is indispensable to delve deeper into the discussion. The authors recommend that the next OECD Guidelines include practical suggestions of the different kinds of comparability adjustments to be performed in a transfer pricing analysis (with an emphasis on emerging markets).

As the application of comparability adjustments is a point of major transfer pricing dispute between tax authorities and taxpayers, broader guidance on this matter will provide benefits to the major tax actors, reducing costs of tax audits and the transfer pricing litigation process.

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