Transfer Pricing Audits in Latin America

The author considers current transfer pricing audit trends in some Latin American countries. Topics are selected based on either their importance in the region or their novelty in the transfer pricing arena.

1. Introduction

Transfer pricing has been in the spotlight for many years in most countries. The OECD has estimated that at least – if not even more than – 60% of international trade happens within multinational enterprises. In addition, the OECD and G20 have also recognized that there seems to be trend amongst a number of taxpayers to erode the tax base and shift profits to low-tax jurisdictions. As a result, tax authorities have reacted in an attempt to defend their tax collection.

In the Latin American region, on the one hand, most countries have enacted transfer pricing provisions as a means of ensuring that local companies reflect the taxable profit that corresponds to the functions they conduct, the risks they bear and the assets they use or own. The author has seen how, in addition to Argentina, Colombia, Mexico and Venezuela (the initial countries to require local compliance with local transfer pricing regulations), now almost all Latin American countries have enacted transfer pricing provisions. Among the most recent countries to enact transfer pricing provisions are Costa Rica, Guatemala, Honduras and Uruguay. Even though Nicaragua has had transfer pricing provisions in place, those rules will be applicable only starting from 2017.

On the other hand, the author has seen a significant increase in transfer pricing audits in the region. This actually represents the enforcement of transfer pricing provisions by the tax authorities and helps to ensure taxpayer compliance with those requirements. This article will discuss the current transfer pricing audit trends in some Latin American countries. Topics will be selected based on either their importance in the region or their novelty in the transfer pricing arena.

2. Costa Rica

Audit history in Costa Rica is very quirky. Costa Rica drafted several laws starting in the early 2000s that were not officially approved until 2013 with Decree 37898-H. However, the transfer pricing experience in Costa Rica dates back to 2000-2002. It is recognized that the 2000-2002 fiscal years were the first to which some intercompany transactions were adjusted by the tax authorities. At that time, there were not specific transfer pricing rules in place, but there was an income tax provision which required that all transactions be conducted in accordance with market values. This tax provision was used by the Costa Rican tax authorities (Dirección General de Tributación, DGI) to adjust the price agreed mainly in cross-border transactions between members of a multinational group.

In 2003, the DGI released Decree 20-03, which served as the basis for the assessment of several transfer pricing adjustments by relying on the substance-over-form rule contained in the Tax Code. Therefore, from 2006 to 2012, there were many transfer pricing adjustments to transactions conducted by taxpayers resident in Costa Rica with foreign related parties and mainly involving tangible goods. There were many discussions regarding the applicability of Decree 20-03, given that it was not a law, but rather a decree released by the tax authorities that many taxpayers asserted should not be applied unless it was actually enacted a tax law. In any case, in 2012, the Decree was ratified by the Constitutional Court and by the Supreme Court of Justice in verdicts concerning assessments for fiscal years 2015 and 2016 in which a simple rule of three was applied by the tax authorities instead of proper transfer pricing methodology. Those rulings clarified that the Decree was legal and, in addition to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010), was considered to be technical guidance that should be followed by taxpayers (even though not enacted officially in the country). As a result of these court decisions, there were several transfer pricing adjustments ratified by the Tax Courts even before Decree 37898-H, which establishes transfer pricing rules in Costa Rica, was enacted in September 2013.

Historically, these audits have questioned the transfer pricing of transactions involving tangible goods in different industries, mainly when internal comparables were available. The tax authorities had to wait until 2014 to obtain access to a financial information database in order to be able to apply a profit-based analysis as the transactional net margin method. However, the author has not noticed that transfer pricing audits have targeted specific industries or products (i.e. commodities) or services, but rather have targeted the largest taxpayers carrying out cross-border intercompany transactions. Currently, the author expects that more transfer pricing audits and transfer pricing adjustments will end up in litigation and disputes, as the pressure to increase tax collection has caused the tax authorities to significantly increase the number of tax examinations. Furthermore, as has been seen in other countries in the region, it is expected that the DGI will issue massive requests for transfer pricing documentation, starting with the documentation for fiscal year 2013 (the first year when it was compulsory for taxpayers to prepare such documentation and the statute of limitations of which

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will expire in December 2017). So far, transfer pricing documentation has been requested only from certain companies that are classified as large taxpayers, and in almost all such cases a tax examination took place thereafter.

3. Panama

Transfer pricing audit activity initially was focused on companies located in the Colon free trade zone – mainly pharmaceutical and electronic companies. These audits focused on companies the main activity of which was the purchase of finished products from foreign related parties for subsequent resale to foreign related parties or third parties. The current second wave of transfer pricing audits in Panama is focused on large taxpayers that market and sell commodities. As part of these audits, with regard to technical issues, the tax authorities are questioning the use of the transactional net margin method instead of the resale price method with internal comparables defined by the tax authorities, as well as the comparable companies used in the analysis of the arm’s length nature of the intercompany transactions.

By the same token, from a transaction perspective, transfer pricing audits are also focused on the intra-group nature of intercompany services. The tax authorities seek not only support for the arm’s length nature of intercompany service fees, but also information that supports the fact that the services were actually rendered and were not duplicative or the result of shareholder or stewardship activities. This is similar to the focus of some other tax authorities in Latin America, such as Mexico and Peru.

4. Honduras

Honduras is another country that is worth mentioning, not necessarily because of its tradition in observing transfer pricing rules, but for what does seem to be a new trend in the region. Even though transfer pricing documentation requirements were published in 2011, the first year that these rules were enforced (i.e. the first year for which taxpayers must comply and prepare transfer pricing documentation) was 2014. In Honduras, the deadline for complying with the 2014 transfer pricing documentation requirements and submitting the information return on cross-border intercompany transactions was extended to March 2016, while the deadline for complying with such requirements for 2015 was April 2016. However, right after this deadline, the tax authorities requested that certain taxpayers submit their transfer pricing documentation report to the tax authorities.

In addition, some penalties have also been imposed on specific taxpayers that failed to submit the transfer pricing information return on intercompany transactions, even though they were required to do so. Presently, this penalty amounts to USD 10,000.

At this point in time, there is not much information regarding what will be the specific focus or concern of the Honduran tax authorities with regard to transfer pricing.

5. Guatemala

Guatemala is another country with a very peculiar experience in and enforcement of transfer pricing rules. Even though the relevant provisions were enforced for fiscal year 2013, in 2014 these requirements were not applicable. Again in 2015, taxpayers were required to comply with transfer pricing documentation requirements. With regard to fiscal year 2013, there are only a few transfer pricing audits that are focused on commodity transactions and companies in the agriculture sector. With regard to 2015, as happened in Honduras and now might be seen as a trend in the region, the Guatemalan tax authorities requested from some taxpayers the electronic version of their transfer pricing documentation reports, as well as financial information on the comparable companies. However, no specific outcome from the 2015 audits is yet available.

Transfer pricing audits conducted for fiscal year 2013 have resulted in transfer pricing adjustment that are currently being communicated to the audited taxpayers. These adjustments mainly focus on specific questioning of the transfer pricing methodology used (including the proper application of the so-called sixth method).

Tax authorities have mentioned that their intention is to audit intercompany transactions conducted during fiscal year 2015, and it is expected that these transfer pricing audits will be focused on (i) taxpayers that did not file the transfer pricing information return (the tax authorities might be able to find out based on other information that needs to be filed for compliance purposes) and (ii) taxpayers that conducted transactions with taxpayers in low-tax jurisdictions (i.e. tax havens). By the same token, other risk factors that might increase the probability of a transfer pricing audit include recurring losses, an increase in intercompany transactions and a high debt-to-equity ratio.

6. Mexico

From a transfer pricing audit perspective, Mexico reflects changes in the approach to transfer pricing audits. One of the main unique aspects is that the Mexican tax authorities (Servicio de Administración Tributaria, SAT) sent an “invitation letter” to certain taxpayers to provide information to the tax authorities.

As part of this new procedure, the SAT sends an invitation letter to the targeted taxpayer. It is up to the taxpayer to provide the requested information to the tax authorities. Under the invitation letter procedure, the SAT will send two specific requests (i.e. invitation letters to provide information) to the targeted taxpayers to gather appropriate information that would enable the SAT to reach a conclusion as to whether the taxpayer’s intercompany transactions have been carried out at arm’s length.

6.1. Taxpayer provides information to the SAT

If the taxpayer provides the requested information to the SAT, the SAT will analyse whether the taxpayer is complying with the arm’s length principle or whether a transfer pricing adjustment is required so that all intercompany transactions will be able to be regarded as at arm’s length. If an adjust-
ment is required, it is up to the taxpayer to pay the tax due or wait until an actual transfer pricing audit starts following the procedures provided under the Federal Tax Code.

Unfortunately, there is presently no certainty that no further audit will be conducted by the SAT, given that such invitation letters do not constitute a true audit. The SAT is working to craft a set of rules that will provide complete certainty that an audit has been conducted and an agreement reached between the SAT and the taxpayer if the taxpayer agrees to any adjustment as part of an invitation letter procedure. In such case, the SAT will conclude that an adjustment is required. If the taxpayers do not concur with that adjustment, the tax authorities will have up to two months to decide on whether a transfer pricing audit should be initiated.

6.2. Taxpayer does not provide information to the SAT

In this case, after the SAT has sent two information requests to the targeted taxpayer without receiving any response in the ensuing two-month period, the SAT will also need to decide whether an actual transfer pricing audit should be initiated. This will actually depend on the justification of the SAT that the intercompany transactions are not arm’s length and, therefore, the SAT concludes there is a some sort of erosion of the tax base of the Mexican taxpayer or profit shifting to another tax jurisdiction.

With regard to regular transfer pricing audits, the SAT is focusing on two main topics that are explained below.

Marketing expenses versus licence to use trademarks/trade names received. Currently, the SAT will question the marketing expenses incurred by a Mexican taxpayer if the taxpayer received a licence to use trademarks/trade names and paid a royalty therefor. The licence fee is not necessarily being questioned. Specifically, the Mexican tax authorities claim that the marketing expenses for positioning the trademark/trade name in the Mexican market should be borne by the foreign related party (i.e. the licensor involved in the controlled transaction). In this case, the issue that gives raise to double taxation refers to a local expense, such that the Mexican tax authorities might deny the deductibility of such expenses from an income tax perspective for those marketing expenses incurred to position products the use of which was licensed by the licensor. Therefore, there is not necessarily an option to initiate a mutual agreement procedure, given that this is a local deductibility issue.

Deductibility of prorated expenses. The Mexican tax authorities are auditing fees for inbound services charged out to Mexican taxpayers by foreign related parties. The issue being discussed is that the service fee corresponds to prorated (i.e. allocated) expenses and comes from a foreign entity. Thus, such expenses would be non-deductible from an income tax perspective. The argument of the Mexican tax authorities is article 32-XVIII of the Income Tax Law for 2013 and previous years and article 28-XVIII for 2014 and onwards, indicates that any prorated expense paid to a foreign entity will not be considered to be a deductible expense from an income tax perspective.

On 16 October 2014, Miscellaneous Rule 1.3.3.1.41. was issued with regard to prorated expenses paid to foreign taxpayers. Under this rule, the non-deductibility from an income tax perspective of prorated expenses paid to foreign taxpayers will not apply if all of the following requirements are met:

- the expenses are strictly required for the business activity of the Mexican taxpayer;
- the prorated expenses are paid to a taxpayer resident in a country with which Mexico has an agreement to exchange information as required by Miscellaneous Rule 1.2.1.1.1;
- there is supporting information of the fact that the expense corresponds to a service actually rendered. If the expense corresponds to a controlled transaction (i.e. between related parties), it will be considered, unless proven otherwise, that the service was not actually rendered if any of the following conditions are met:
  - under the same conditions, a third party would not have hired a third party to render the services or would not have those services rendered in-house;
  - the services are considered to be stewardship or refer to shareholder activities;
  - the services are considered to be duplicative of services rendered by another related party or by a third party to the Mexican taxpayer;
  - the services are duplicative or charged out to the Mexican taxpayer with other costs, expenses or investments conducted by the Mexican taxpayer as a result of commissions, royalties, technical assistance, advertising or interest;
- if the expense corresponds to a controlled transaction, the arm’s length nature of the service fee is supported;
- there is a reasonable relationship between the expense incurred and the benefit received or expected to be received by the Mexican taxpayer. In order to support this, the Mexican taxpayer must have entered into an arrangement or agreement that supports the prorated expense. Such agreement or arrangement must comply with at least the following requirements:
  - each participant in the agreement or arrangement has full access (1) to the transactions that will take place as a result of the agreement or arrangement, (2) to the projections or forecasts that will be the basis for the prorated expense and based on which the expected benefits will be analysed, as well as (3) to the prorated expenses actually paid and the benefits actually received with regard to the transactions supported by the agreement or arrangement;
  - the participants in the agreement or arrangement are only companies that could benefit from the whole agreement or arrangement;
  - the agreement or arrangement specifies the nature and scope of the global and individual benefits obtained by the group with regard to the expense incurred and which was allocated among the remaining members of the group;
the agreement or arrangement allows the allocated expense to be appropriately allocated using an allocation key that reflects the benefit received; and

- the agreement or arrangement details the scope of the specific transactions covered by the agreement or arrangement, and the term of the transactions and the agreement or arrangement; and

- the following information and documentation are maintained with regard to each of the transactions the compensation of which is computed on a prorated basis:
  - name, country of incorporation, tax residence, country of main administration of the business, address of place of effective management, tax identification number of each of the related parties involved in the allocation of expenses or that will use the results of the global expenditure;
  - type of transaction conducted, as well as the contractual terms;
  - functions or activities conducted with regard to the transaction subject to analysis for each of the related parties involved in such transaction, as well as the assets used and risks borne;
  - documentation that supports the actual expense incurred. Specifically, the Mexican taxpayer must have all documentation that supports that the expense it was allocated was actually incurred by the foreign taxpayer;
  - details of the payment method used to pay the expense allocated to the Mexican taxpayer, along with supporting documentation of the payment;
  - the transfer pricing method used to support the arm’s length nature of the transaction;
  - information used to support that the transactions or companies are comparable for each transaction; and
  - supporting information for the transactions that will be conducted, of the projections or forecasts based on which the expenses will be allocated and the expected benefits will be determined, as well as the allocated expenses actually paid and the actual benefit received.

In any case, taxpayers must have information that supports that the prorating of the expense was done using objective accounting and tax elements, and must justify that there is a valid and defendable business reason.

These transfer pricing audits of prorated expenses and non-strictly indispensable marketing expenses are not necessarily targeting a specific industry, but rather many companies in various industry sectors (e.g., financial institutions, consumer products, food and beverage industries).

7. Brazil

In Brazil, given the characteristics of its transfer pricing regulations that are based on formulas and margins established in the applicable law, current court cases with regard to transfer pricing audits are more focused on the appropriate application of these formulas and margins fixed by law. There is also a trend with regard to the focus of the industry sector that such transfer pricing audits are targeting, namely the commodity sector. This is a result of changes in the law applicable from 2012 and onwards which requires the adoption of public quotations as a reference price in related-party transactions, as well as in service transactions. In the latter case, the focus of the audits is not only on the arm’s length nature, but also on the applicable withholding tax for example. Finally, based on the last report on audit trends released by the Brazilian tax authorities, tax audits focus on corporate tax subjects while being silent on transfer pricing. Specifically, during the last year, these audits focused on the following issues and industries:

- tax planning that drives the creation of amortizable assets;
- tax planning involving private equity funds;
- the taxation of foreign taxable profits; and
- cigarette, beverage and fuel sectors.

Due to the current economic situation, the tax authorities are constantly searching for sources of tax revenue by expanding the list of transactions, companies and industry sectors to be audited.

8. Chile

Since the incorporation of a specialized, and exclusively dedicated, transfer pricing team within the Chilean tax authorities (Servicios de Impuestos Internos, SII), the audits conducted by the tax authorities have changed. Initially, the tax authorities developed an audit programme that taxpayers regarded as fishing expeditions and that consisted in identifying and auditing taxpayers that might have transfer pricing contingencies. With the information that the SII was able to gather starting in 2013 with regard to intercompany transactions conducted in fiscal year 2012, and mainly as a result of the transfer pricing information return (i.e. Form 1907), the most recent transfer pricing audit procedures have been more focused on those industries in which the tax authorities perceive that intercompany transactions might not necessarily be conducted at arm’s length, such as the metallic and non-metallic mining industries, and on those taxpayers that the tax authorities perceive as having “reduced profitability”.

In past years, Chile became the country of residence of executives of multinational companies with regional responsibilities (mainly covering some or all of Argentina, Colombia and Peru) given that Chile had the economy with the highest growth in this area and the best quality of life. However, the costs associated with these executives and professionals are incurred in Chile, given that the expats are typically employed by a Chilean entity and very rarely does that entity invoice the appropriate service fee to entities in other countries. The SII identified this situation and considered it to be a red flag during audits by the SII.

In Chile, the transfer pricing provisions included in the Income Tax Law focus on cross-border intercompany transactions. However, article 64 of the Tax Code clarifies the power of the tax authorities to “assess” transactions the
agreed terms of which are less than those agreed locally. Thus, the SII has used this authority under the Tax Code to effect transfer pricing adjustments as a result of domestic controlled transactions that did not seem to have been conducted at arm’s length.

9. Argentina

Regarding audits and transfer pricing scrutiny in Argentina, there is an increasing tendency of the tax authorities (Administración Federal de Ingresos Públicos, AFIP) to challenge transfer prices of those taxpayers that record systematic losses beyond a specific fiscal year, mainly among resellers.

There are no particular types of transactions under scrutiny and the AFIP has initiated audits in various industries (as opposed to initial targets in the automotive, pharmaceutical and agribusiness sectors).

The AFIP does pay special attention to the criteria followed in the analysis to test the arm’s length nature of transactions in the different fiscal years, mainly with regard to the use of multi-year periods for the tested party. The AFIP is also requiring that financial information used in the analysis of comparables be that obtained directly from the relevant data sources (i.e. 10-K forms submitted with the US Securities and Exchange Commission) instead of information that might be obtained from specific databases that could be different to that of the source of reference. A lack of supporting information may cause the rejection of a comparable company from the set used by the AFIP for testing purposes.

If the tax authorities propose a transfer pricing adjustment, the taxpayer may appeal to different justice courts. The order of appeal for an adjustment proposed by the tax authorities is as follows: first level: National Tax Court; second level: National Court of Appeals; and third level: Supreme Court of Justice. To date, there have been several rulings by courts at the first and second levels of appeals.

10. Peru

Peru has a very unique situation. The transfer pricing regulations were amended to include the so-called sixth method for testing commodity transactions. The initial idea was to use this method for auditing exports of commodities in the mining industry. However, despite the effort to change the transfer pricing regulations, as yet there are no known outcomes of transfer pricing audits based on the use of the sixth method.

Another hot topic for transfer pricing audits which might also represent a trend in the region, is the focus on service transactions. As discussed regarding the Mexican experience, an audit of services transactions tests not only the arm’s length nature of the intercompany compensation, but also and foremost the intra-group nature of the service. Even though it will be necessary to wait for additional final resolutions, it seems that the documentation needed to support the intra-group nature of services, specifically the fact that the service was actually rendered, will be very difficult to obtain.

11. Ecuador

In recent years, transfer pricing audits conducted by the tax authorities (Servicio de Rentas Internas, SRI) were focused on those taxpayers the business activity of which consists in the export of commodities, specifically, exporters of bananas. By the same token, transfer pricing audits have targeted companies in the pharmaceutical sector, as well as companies dedicated to the export of tuna, shrimp and flowers.

The most relevant transfer pricing audit conducted in Ecuador involved taxes due of nearly USD 82 million from an exporter of bananas. Specifically, the SRI made a transfer pricing adjustment for fiscal year 2005 so as to increase the revenue of the taxpayer. The SRI concluded that the taxpayer sold the finished products at a lower price than that which would have been agreed by third parties conducting similar transactions under comparable circumstances. The main points argued by the SRI concerned the selected transfer pricing methodology and the limited analysis of the characteristics of the bananas conducted by the external advisor.

Based on the author’s experience, other transfer pricing audits conducted in Ecuador by the SRI have focused on the transfer pricing method used, comparable companies and profit level indicators.

12. Uruguay

In the case of Uruguay, transfer pricing audit activities focused on companies from all sectors. Initially, the audits were focused mainly on large taxpayers, but now they include all taxpayers. With regard to technical issues, the use of the transactional net margin method instead of an analysis of the different transactions is sometimes questioned. The choice of comparable companies, and also of comparable prices (in particular, in commodities transactions) are also frequently scrutinized.

Transfer pricing audits are also focused on intercompany services. In this regard, supporting evidence is required regarding not only the arm’s length nature of the payments, but also the fact that they correspond to services that were actually rendered and that provide an effective benefit for the local taxpayer (not being duplicative or merely the result of shareholder or stewardship controlling activities). Again, it does seem that the auditing of the intra-group nature of inbound services is a hot topic for transfer pricing audits in the Latin American region.

13. Conclusion

Among the various trends, there are two main aspects to be highlighted. First, there is a certain consistency in the approaches followed by the different tax authorities in Latin America, although each tax authority customizes its approach to the specific economy. Second, relevant transfer pricing audits have significantly increased in recent years.