

Audit trends regarding transfer pricing

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Helping companies do business in Latin America®

Transfer pricing – Audit trends




Recurring Losses

Recurring Losses

- **Economic principle** – An independent company would not operate with losses indefinitely.
    - Activity would end.
    - It would leave the market.
- In addition to transfer pricing, tax requirements need to be taken into account.



Recurring Losses

Example 1 (Text from a transfer pricing audit):

The source and origin of the tax loss amortized on the annual tax return for the fiscal year has not been proven

The taxpayer is bound to provide the documentation requested ***in order for this Administration to verify the source and origin of the tax loss generated****, case contrary, the amortization of the tax loss for prior fiscal years applied against the taxable profit of the fiscal year in question shall be rejected.*



Recurring Losses

Origin and source of the losses

In the event the tax authority is exercising verification powers regarding fiscal years where tax losses for prior fiscal years are decreased, taxpayers shall provide **documentation evidencing the origin and source of the tax loss**, regardless of the fiscal year when the loss originated.

- Figures submitted on prior annual returns
- Correct loss update
- Application of amortizations since the origin of the loss
- Accounting records
- Other



Recurring Losses

Example 2 (Text taken from a transfer pricing audit):

The Authority, upon review of form 10-k reported by corporate, observed the group reported consolidated operating profit… and states the following:

"... Upon comparing the profit margin of the distribution activity, it has become visible that the Taxpayer's behavior is not consistent with what was reported by the Multinational Group".

"…It is possible to appreciate that XXX is a Group company showing constant losses, while other companies with whom transactions are carried out show profitability margins".

"The Taxpayer's behavior is not consistent with the financial results of the other members of the Group individually and in the aggregate. The taxpayer has not proven the operating loss reported is due to factors outside the conditions under which transactions were executed with related parties, notwithstanding said transactions were very relevant (purchases, royalties, services and interest in the results obtained as explained on this document."

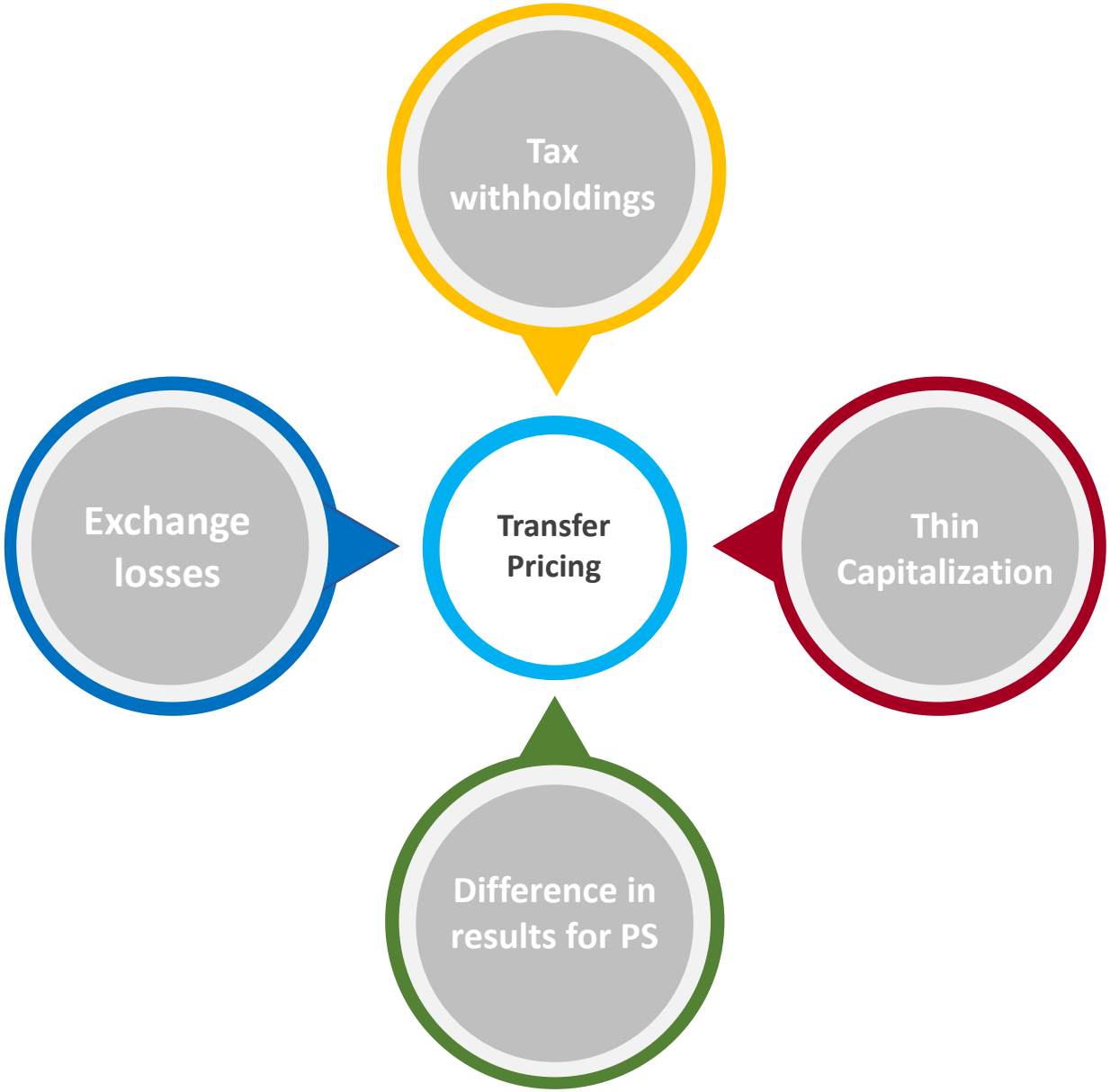




Excessive inter-company balances

Excessive inter-company balances

If it is considered that regarding transfer pricing the purpose is for companies part of a group to act as independent third parties in similar situations, then it is understood that a third party invoices and charges for services within a reasonable period.



Excessive inter-company balances

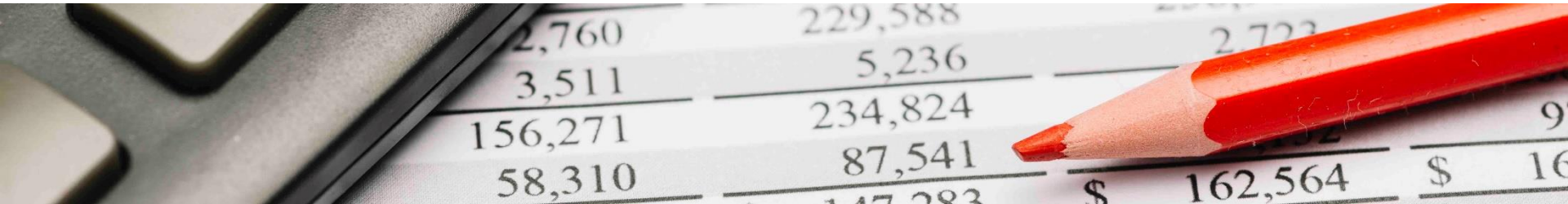
Example 1 (Text from a transfer pricing audit):

Financial cost of excessive accounts payable

It is important to highlight that the taxpayer under revision finances its activity, in addition to long term liabilities as a result of the debt with XXX, with accounts payable in dollars with other related parties… and they produced Exchange losses during the fiscal year under revision for the amount of $XXX…

…As shown below, XXX financed its activity with funds obtained from its related parties in foreign currency, with short-term accounts payable and with long-term loans. The company's equity is negative…

…Regarding the reason why XXX has lost its entire capital stock as of 20XX, the legal representative for XXX stated on the document on the revision of work papers, that the cause has been principally due to the difference in Exchange rates, which has caused the company accounting losses. Notwithstanding the foregoing, XXX continues to operate normally, this is possible as the precarious financial situation it presents is created skillfully by its financing with related parties, in lieu of contributing capital, accounts payable with accruable interest and Exchange losses were granted to it.

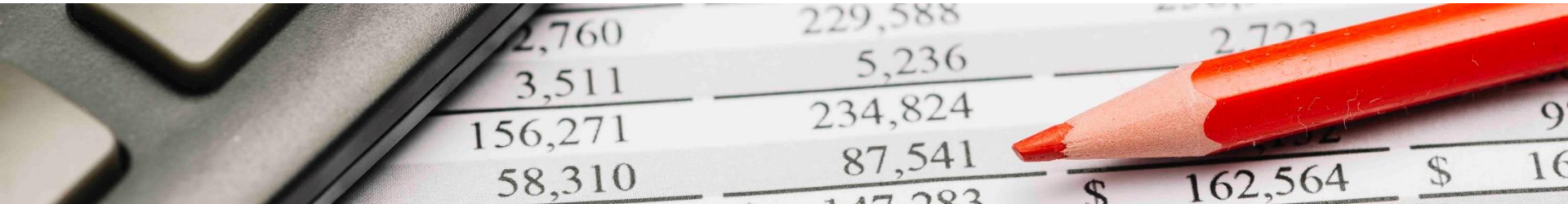


Excessive inter-company balances

Example 1 (cont.):

…To calculate the financial cost incurred by XXX due to the excessive indebtedness due to accounts payable, the financing sum of XXX consistent with that maintained by comparable companies was obtained, for these purposes the median of the proportions for comparable companies was multiplied times the costs and total expenses of the Taxpayer. Upon comparing said result to the accounts payable maintained by the Taxpayer, the excess financing kept in short term accounts payable was obtained, and from which the Exchange loss that proportionately corresponds was obtained…

…The underlying reality behind the leverage scheme used by the taxpayer is that excess debt maintained by transactions with related parties residing abroad corresponds to the financing received from these, which holds more similarity with capital contributions, considering its content and XXX's financial situation. However, taking into consideration article 32, section XXVI, of the Income Tax Act for 2008, allows taxpayers to maintain an indebtedness ratio of 3 to 1 in connection with its capital, the excess accounts payable together with other interest-bearing accounts payable shall be subject to the proceeding established in said provision to determine the corresponding deductible interest…



Excessive inter-company balances

Thin Capitalization

This figure has signified the abuse of minimal equity with excessive debt.

Income Tax Act establishes applicable treatment shall be given to interest on Exchange losses, generated by the fluctuation of foreign currency.

1. Non-deductible Interest
2. Greater tax
3. Increase in profit coefficient
4. CUFIN decrease
5. PS Base Increase

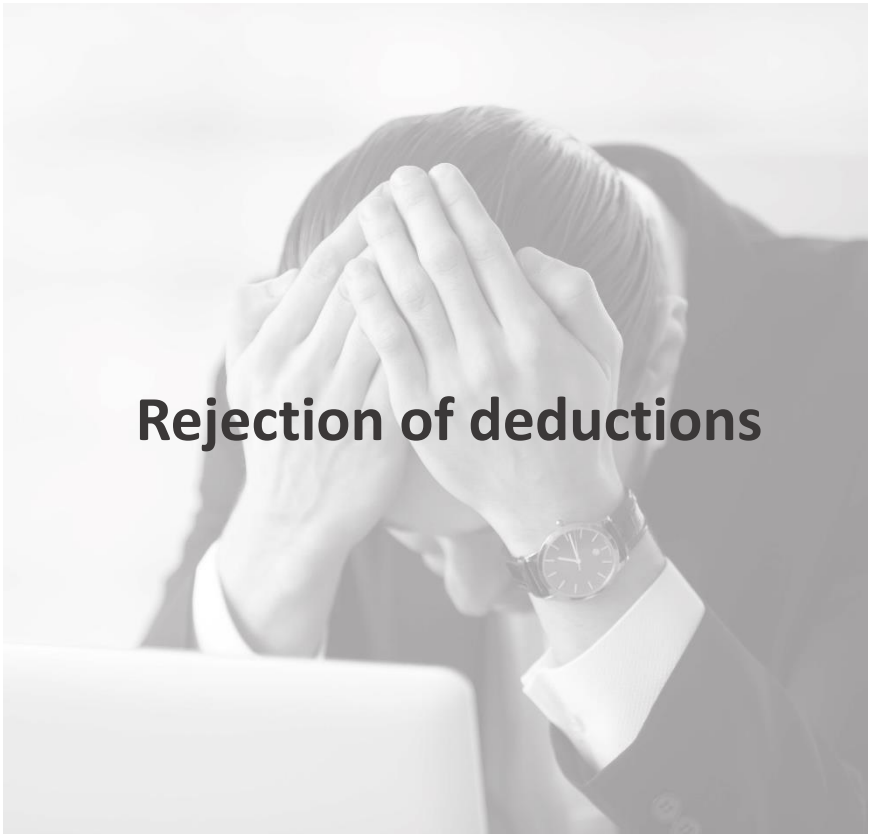


Accrued Interest

Accrued Interest

A company with a deficient financial performance: **No credit from a third party.**

Consequences otherwise:





Accrued Interest

Example 1 (Text taken from a transfer pricing audit):

"… this Authority requested XXX to indicate the business that generated the loans and to provide information and documentation evidencing these were invested in the corporate purpose of XXX. In this regard, the Taxpayer only stated in the Brief … that "… The resources from these funds were used to cover the company's daily operations (Interim Payments, Payment for Services, ETC)" … However, XXX omitted to submit the supporting for its claim, that is, the documentation and information supporting the loan was effectively used to cover the company's daily transactions …

It was upon XXX to obtain, preserve, and upon request from the authority, provide the documentation evidencing the sum of its income and deductions were made in accordance with the prices or consideration used by independent parties in comparable operations …



Accrued Interest

Example 1 (Text taken from a transfer pricing audit):

….XXX failed to provide evidencing documentation to allow verification that the loan generating the payment of interest was for the business purposes and it did not evidence it was strictly indispensable …

Due to the foregoing, for this operation, the payment of interest between XXX and its related parties does not call for the deduction of $ XXX pesos, in accordance with the provisions of item a), section I of article 179 of the Income Tax Act…, and sections I, VIII and XIV of articles 31 and 92, section 11 of aforesaid act, in connection with the provisions of section IX of the first paragraph of article 76 of the same Act.



Accrued Interest

Income Tax Act establishes the deductibility of accrued interest shall be as follows:

01 They were invested for business purposes

02 Establish interest rates if loans are granted to third parties

03 In the event of investment acquisitions or expenses, these shall be deductible to the extent said expenses or investments are.

J.A. Del Río

Accrued Interest

The thesis issued by the Second Section of the Superior Court of the Federal Court of Tax and Administrative Justice (TFJFA) on the origin and deduction of interest accrued payable by taxpayers and Exchange losses, **establishes the evidencing of said transaction by producing the agreement shall not suffice.**

INCOME TAX. DEDUCTION OF INTEREST ACCRUED AND EXCHANGE LOSS ON LOANS GRANTED SHALL BE EVIDENCED WITH RECEIPTS SHOWING THE PAYMENTS ORIGINATING THESE WERE MADE. *Pursuant to the provisions of article 31, first paragraph, section III of the applicable law, deductions shall be supported with documentation in compliance with the requirements from the respective tax provisions, in the case of payable interest accrued, and Exchange loss whose source is loans granted by a taxpayer, in order for the deduction on these items to apply, the existence of payments made and supporting the deductions shall be unequivocally accredited. Consequently, the intent to support this deduction with the submitting of the agreement, in the case of loan agreements or with schedules payments shall not suffice as these instruments do not prove the payments in question were effectively made, they only prove the obligation accepted by the borrower, therefore under no circumstance they may be used as grounds to consider these were effectively made, as there is no certainty as to the date, amount and specific conditions under which they were granted, therefore said proof is not ideal to document said deductions.*





Services

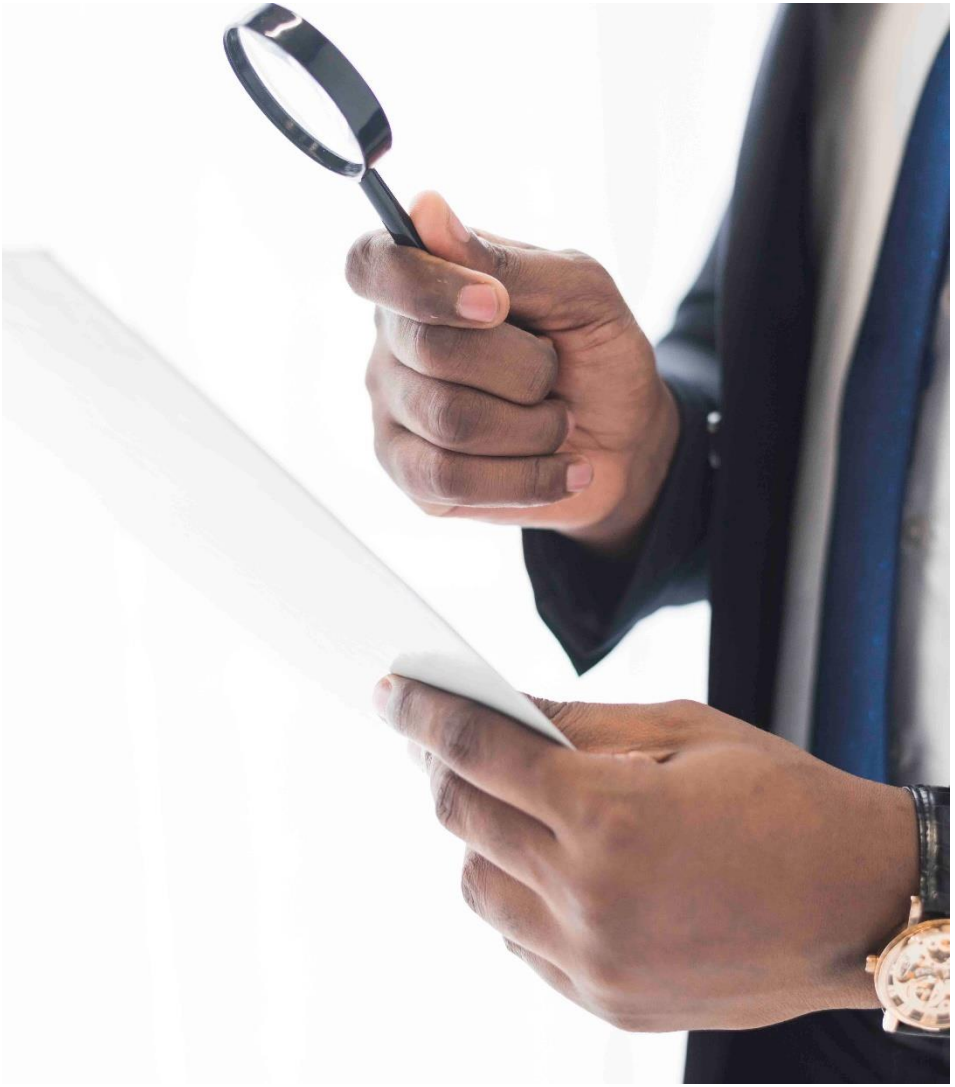
Services

It is assumed, among other things, that companies could be receiving consideration for services that are unnecessary and/or not rendered.

SAT, in connection with these transactions, reviews both substance and form.

SAT's requirements are aligned with the prorate expenses rule.

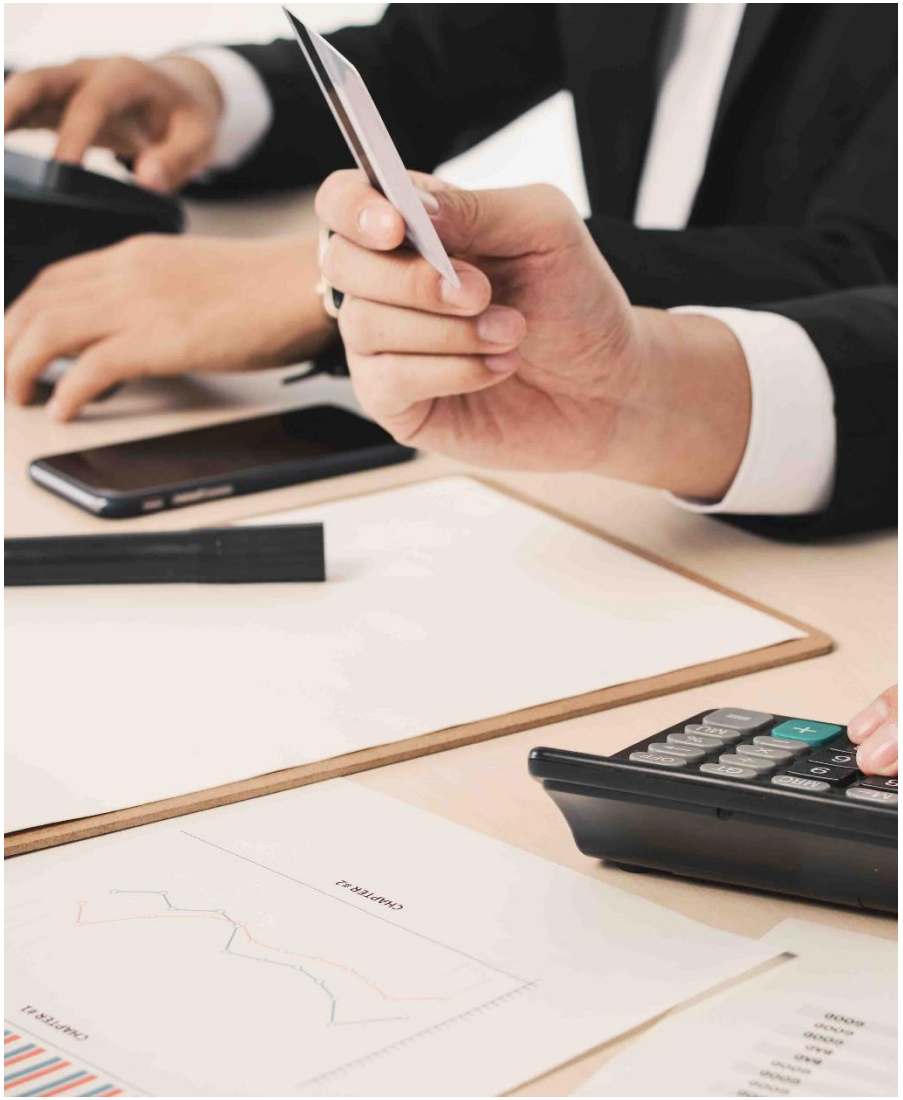
If SAT determines the transaction was not performed as independent third parties would or that there is a duplicity in the service received, said expenses would become non-deductible.



Services

Considerations within rule 3.3.1.27 prorate expense deductions (some examples):

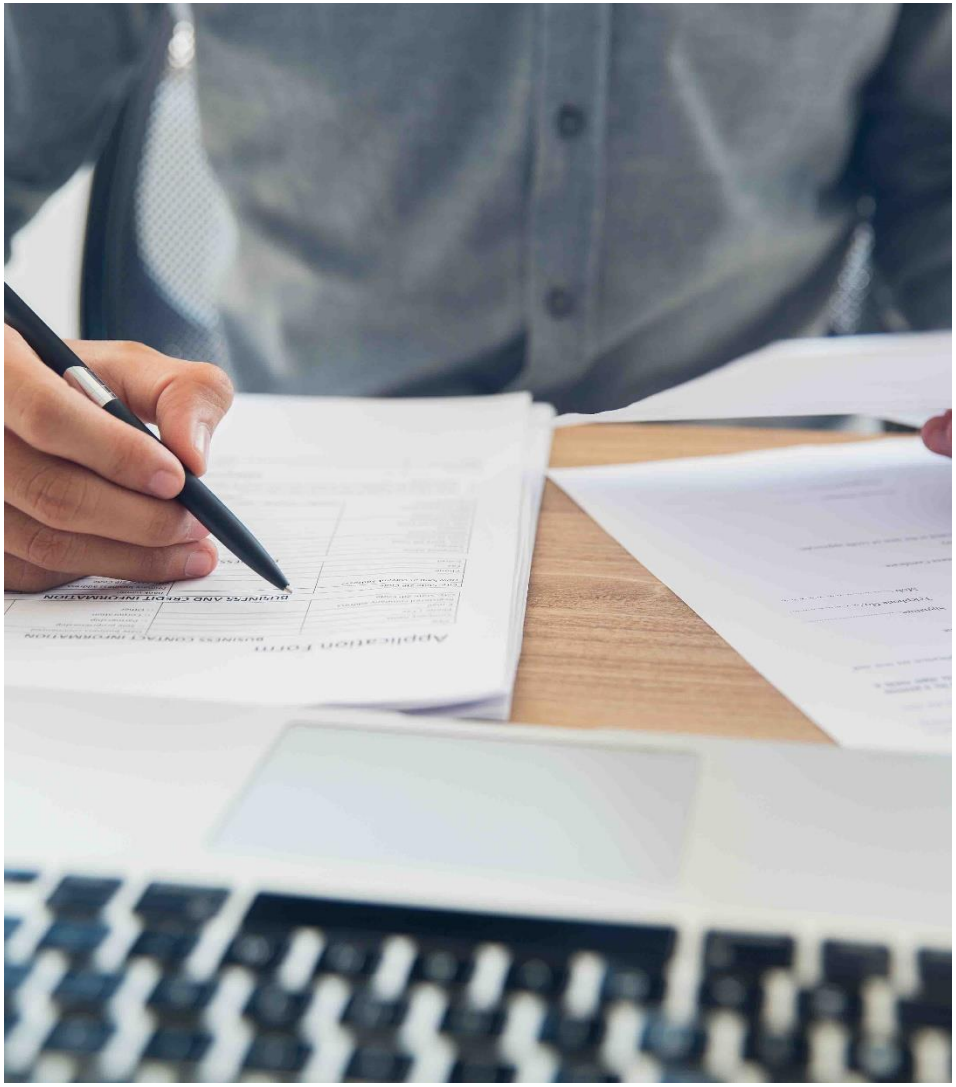
- Strictly indispensable expense.
- Prove the service was effectively provided.
- The service rendered was given under the same conditions than by an independent third party.
- Under no circumstance invoicing and/or the payment prove, by itself, that a service was effectively rendered.
- Comply with transfer pricing guidelines.
- There shall be a reasonable relation between the expense paid and the benefit received or to be received.



VERIFICATION POWERS BY THE TAX AUTHORITIES. IN EXERCISE THEREOF, THE FORMER MAY VALIDLY NOT RECOGNIZE THE TAX PURPOSE OF THE LEGAL ACTS INCLUDED IN ACCOUNTING, WHEN THEY LACK MATERIALITY.- …Now, the basic hypothesis of financial information standard A-2 is that economic substance shall prevail over form, regarding economic events registered for a company. In this sense, article 28 of the Federal Tax Code and other precepts regulating the form and terms whereby a taxpayer shall carry its accounting, all start from the same hypothesis, that is, only existing transactions shall be registered, and, in addition, economic substance shall prevail over legal form on said record. Therefore, if, as a result of a review the authority realizes transactions on accounting records have no material substance, the non-existence thereof may be determined for tax purposes, that is, the effectiveness thereof may be unrecognized for the determination, return or crediting of contributions, without this implying the annulling, for general purposes, the legal act in question, much less exceed the purpose of the visiting order.



Services



Information usually requested by the tax authority is:

- Work papers integrating the transaction amount and supporting documentation for determining said amount.
- Detail of activities or services received, indicating the personnel who provided the services and the associated activities and/or services.
- Supporting documentation of the services received proving these were effectively rendered.
- Copy of bank conciliations or of payments via wire transfer.
- Copy of the documentation proving the services were received from abroad.



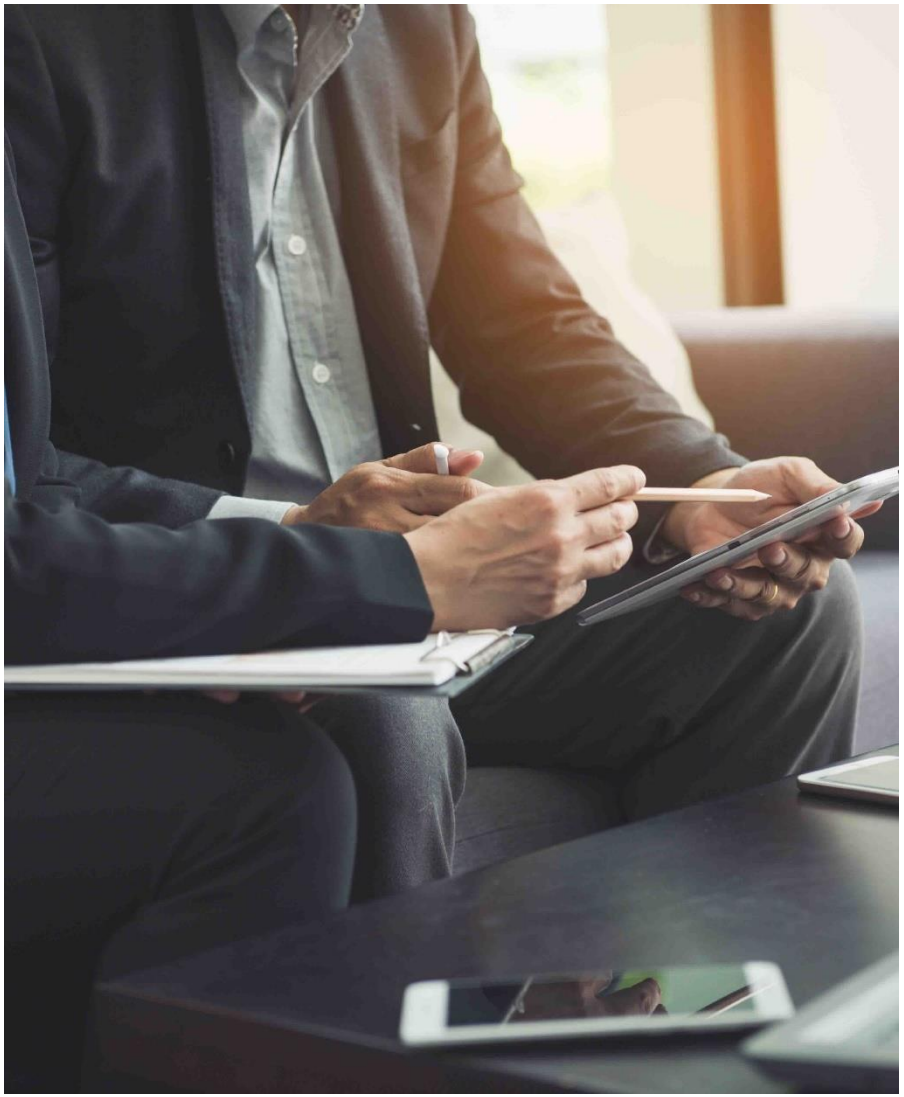
Royalties

Royalties

An independent third party would not pay a royalty for a trademark, technology or intangible in general that would not generate tangible benefits for an entity.

SAT reviews both content and substance regarding these transactions.

If SAT establishes the transaction did not take place as independent third parties would, the non-deduction of these expenses would apply.



Example 1 (Text taken from a transfer pricing audit):

A company shall be paid for improving the value of trade names and other intangibles as a consequence of the functions performed, assets used and risks undertaken.

"In addition to the above, this Administration "1" observes that, from the information provided by the Taxpayer, ***it is not possible to prove there is a relation between the royalty percentages indicated on table XX above, the value of said intangibles and the profit the Taxpayer would obtain from the use and exploitation thereof,*** *in order to infer that the transaction indicated on table XX above was executed in accordance with what independent third parties would have agreed in comparable transactions." (Added emphasis)*

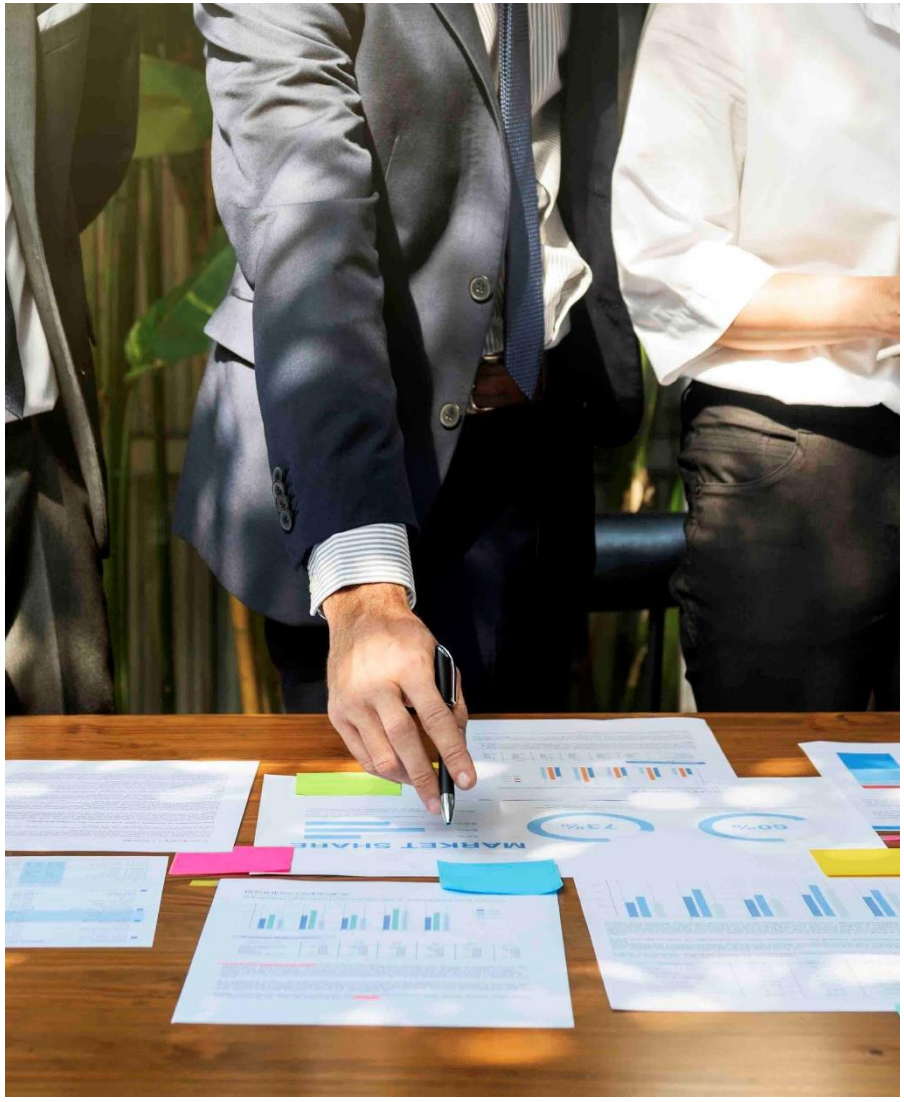


Royalties

The transaction for the payment of royalties on know-how, subject to revision, implies XXX continues, during the 201X fiscal year, executing expenses on this item when the latter refers to the technological transfer of the process that shall involve the manufacturing or marketing of a product, hence the question made by this Administration is: after all these years, XXX still does not know how to manufacture or market its products and needs to continue paying a royalty for the use of said knowledge? XXX did not prove that under full competition these payments are agreed in this manner."



Marketing, promotion and advertising expenses



The second section of the Superior Courtroom for the Federal Court of Administrative Justice (TFJA) informed its criteria on the deductibility of certain expenses carried out by companies under a non-exclusive trademark license agreement to market their products.

The deduction of marketing expenses is possible for Income Tax purposes as these are strictly indispensable expenses.

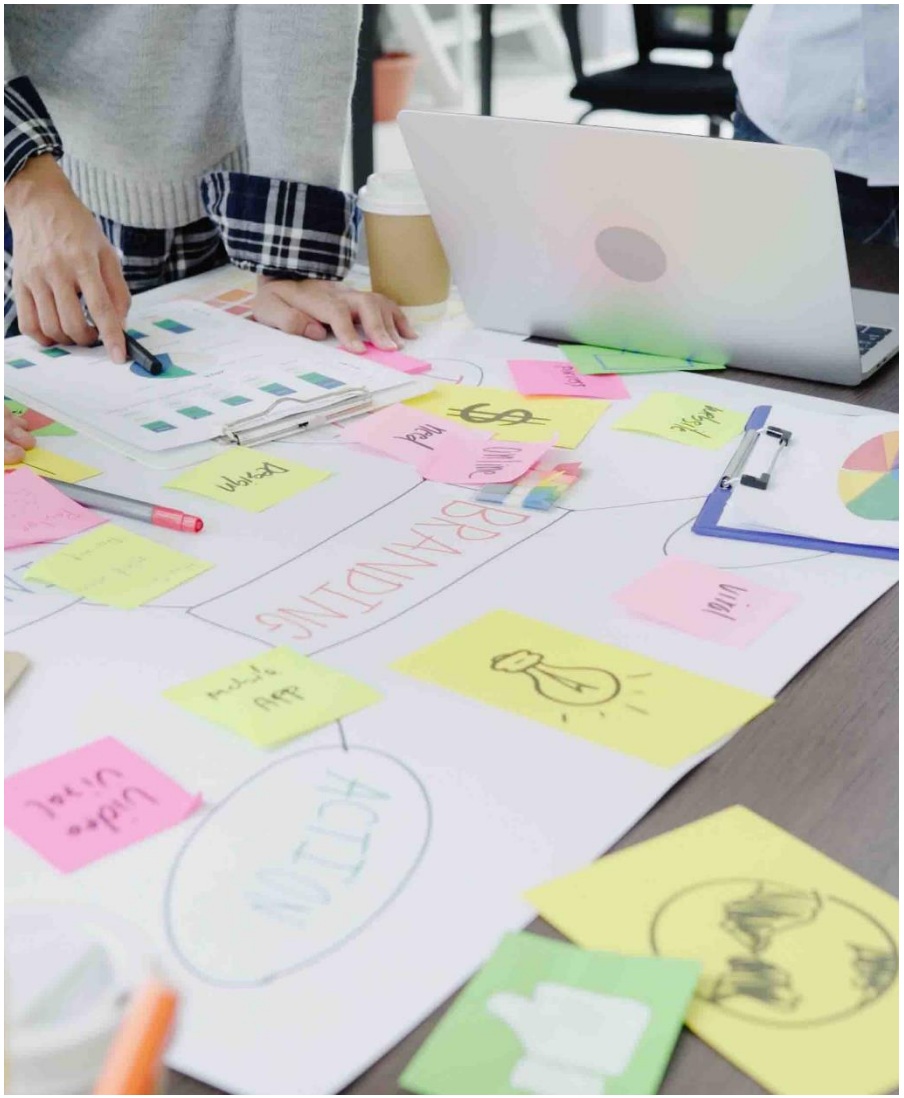
Marketing expenses. Expenses directly in connection with the company's activity, as it is through these that the product is granted the conditions and distribution channels for the sale thereof, notwithstanding the company does not hold title to the trademark under which the products are marketed.

Marketing, promotion and advertising expenses

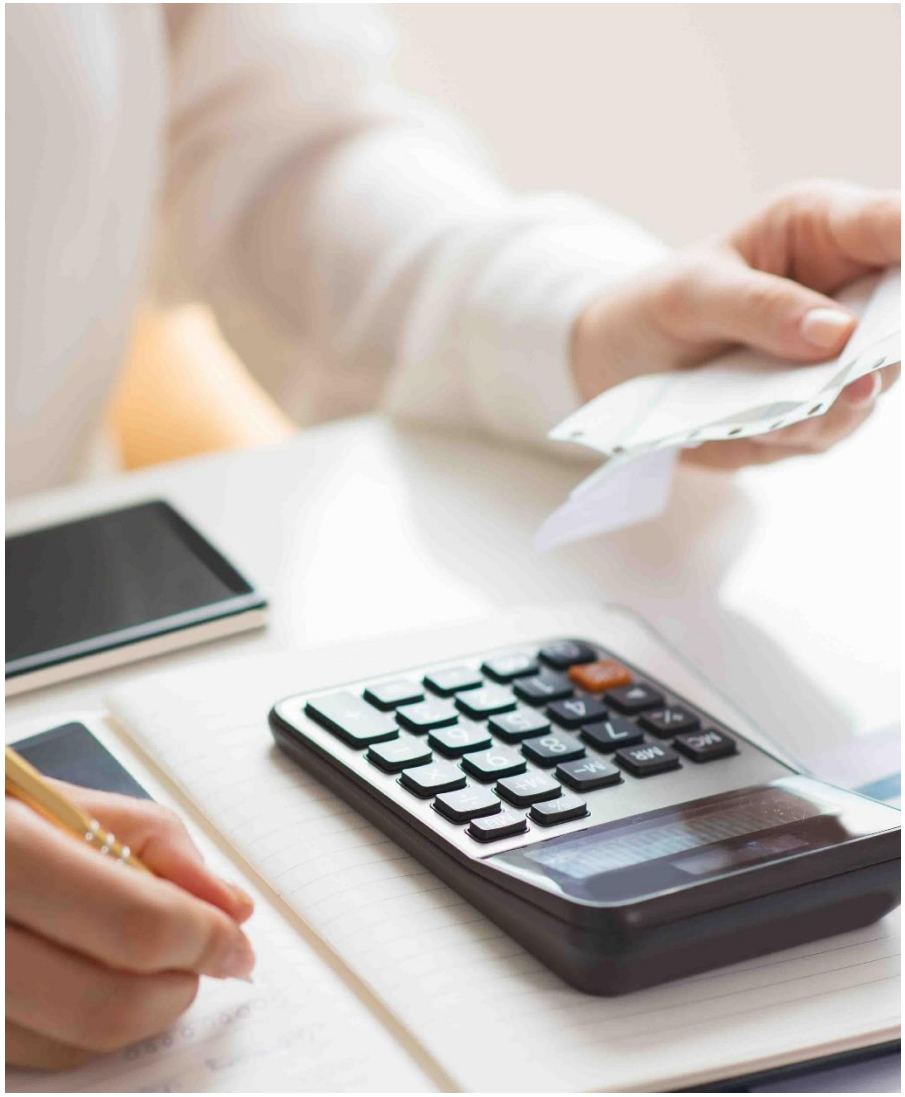
Expenses for **promotion and advertising <u>are not deductible</u>** in terms of Income Tax Act **as these are not strictly indispensable**.

It was stated that they are deemed non-deductible as they increase the value of the trademark for the holder of said trademark, as the purpose of these expenses is to position the trademark in the market, in order to place the product among consumers

Promotion and advertising expenses. Acts whereby something is made known in order to obtain followers or buyers through the media used to divulge or disseminate things or facts-



Marketing, promotion and advertising expenses



Income Tax Act establishes that in order to deduct royalties, taxpayers residing in the territory shall prove:

- The expense is strictly indispensable for the purposes of its activity
- Have the agreement supporting the payment of said royalties
- Where the use of said royalties is found
- The expense shall take place in the corresponding fiscal year
- The expense shall be carried out during the year corresponding to the deduction.



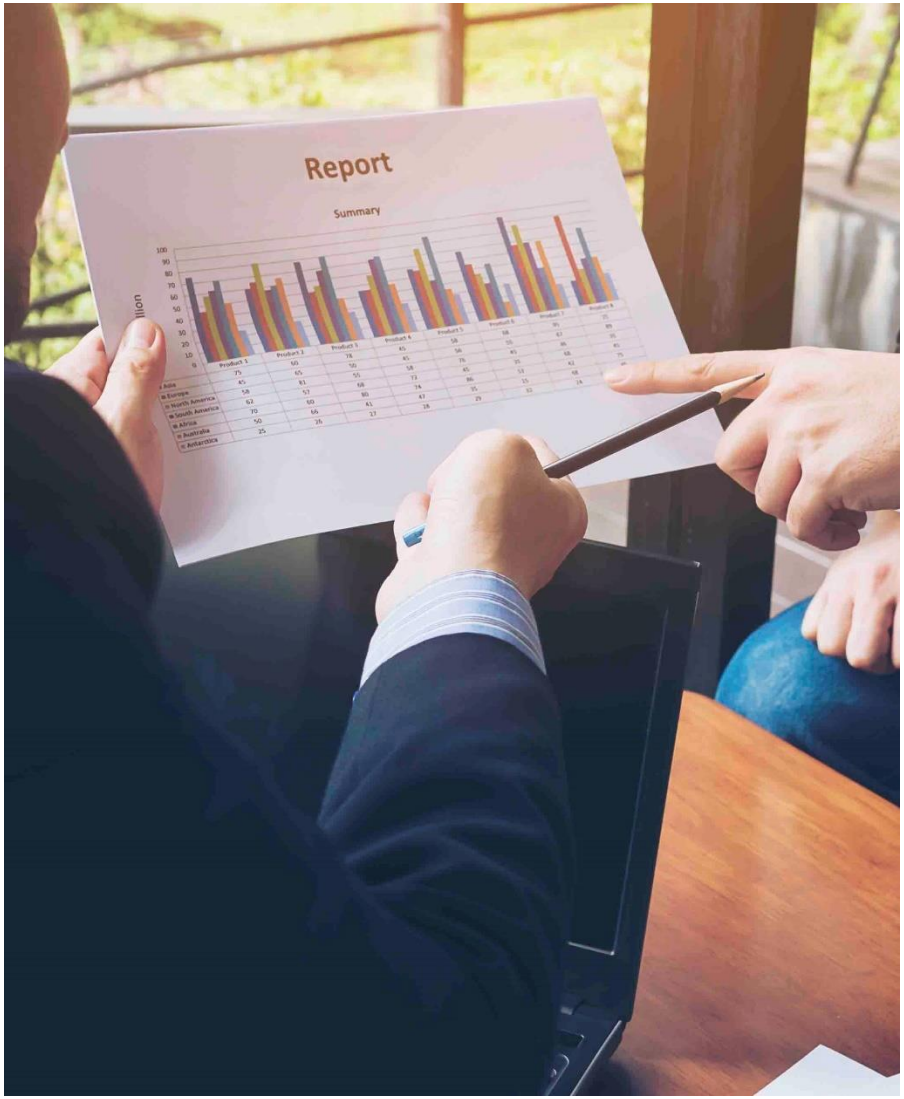
Other issues

Other issues

- Business restructures
- Atypical behaviors in tax payment.
- Omissions in transactions indicated on Exhibit 9 of the DIM / Balances; Different Returns submitted to SAT – cross referencing consistency between them.
- Significant transactions with related parties in low taxation jurisdictions.



Consider



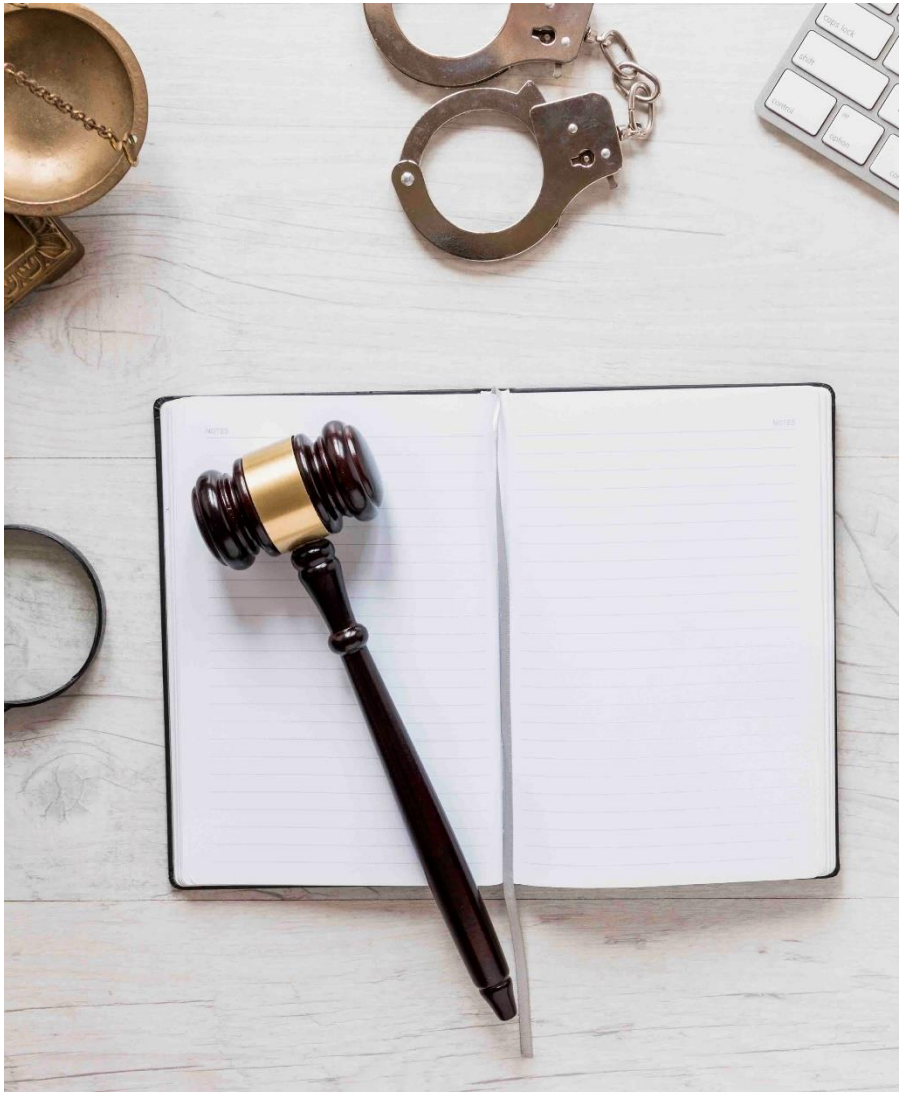
- Differences between the content of intercompany agreements and reality.
- Importance of functional analysis.
- Economic substance of transactions.
- Deficient / non-existing documentation.
- Filed tax returns.
- Form requirements pursuant to Federal Tax Code.

Sanctions

Some sanctions regarding transfer pricing*:*

- ***Exhibit 9. DIM.-*** *If the informative return is not filed or if it is filed with errors or omissions, the taxpayer shall be sanctioned with a fine ranging from* ***$77,230 to $154,460 pesos.***

- ***Local, master and country by country Informative Return Exhibit.*** *If the referred information is not submitted or if it is submitted incomplete, with errors, inconsistencies, or other than as established on tax provisions, the taxpayer shall receive a fine ranging from* ***$154,800 to $220,400 pesos****.*



Questions



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