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

In the context of the various tax and transfer pricing discussions taking place currently internationally, the OECD recently issued a "Revised Discussion Draft on Transfer Pricing Aspects of Intangibles."¹ 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.

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 transfer pricing guidelines available today) 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. 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 local-country infrastructure;
- The relative availability of a pool of trained or educated workers; and
- Proximity to profitable markets.

Those 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.

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, because 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 those 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.²

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 transfer pricing guidelines include a detailed analysis of transfer pricing comparability adjustments that eventually could be performed even in situations when virtually no local comparable companies are available.

² OECD, supra n. 1, at 6.
Local Market Features in Latin America

As mentioned above, many factors 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, discussed below, are especially significant in light of the major impact they have on Latin American firms.

Volatility and Business Cycles – The OECD transfer pricing guidelines contain scarcely any references to the business cycle as one of the factors that affects comparability 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.”\(^3\) Chapter III, paragraph 3.77, regarding the use of multiple-year data when 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,”\(^4\) 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.”\(^5\)

The study of the effect of the evolution of the business cycle\(^6\) on comparability in transfer pricing analysis has not been addressed 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 analyzing 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,\(^7\) 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 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.

Figure 1

GDP Growth Evolution LAC-7: 1980-2012
(percent, based on constant 2005 US dollars)

* Based on World Bank data.

URL: http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG

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\(^3\) OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD Guidelines)* ch. I, (The Arm’s Length Principle), D 1.2.4; 1.56, (OECD 0210), International Organizations’ Documentation IBFD.

\(^4\) OECD Guidelines, ch. III (Comparability Analysis); B.5; 3.77.

\(^5\) Id.

\(^6\) In this article, the term “business cycle” is used as a synonym for “economic cycle” according to the specialized economic literature.

\(^7\) The LAC-7, which refers to the seven largest Latin American economies, is comprised of Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela.

\(^8\) The G7 is comprised of Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

\(^9\) For OECD economies, see http://www.oecd.org/general/listofoecdmembercountries-ratificationoftheconventionontheoecdh.htm
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 double than in developed countries.

**Figure 2**

![LAC-7, G7 & OECD: Standard Deviation of GDP Growth, 1980-2012 (annual percent growth rates based on constant 2005 US dollars)](image)

* Based on World Bank data.

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 that differ according to the specifics of each country, but that commonly include issues such as the level of participation in 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.

**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 factor of production.

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. This relatively poor progress in human capital is expected to affect the productivity of Latin American companies, especially those that are labor intensive, as discussed below.

Another significant difference to be considered is labor productivity in Latin American 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 from 1980 to 2012 are used for OECD member countries and LAC-7 countries.

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

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

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 the 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) in a relatively better position in the World Bank ranking.

<table>
<thead>
<tr>
<th>Economy</th>
<th>Year</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td></td>
<td>116</td>
<td>124</td>
</tr>
<tr>
<td>Brazil</td>
<td></td>
<td>128</td>
<td>130</td>
</tr>
<tr>
<td>Chile</td>
<td></td>
<td>33</td>
<td>37</td>
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<tr>
<td>Colombia</td>
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<td>44</td>
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<tr>
<td>Mexico</td>
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<td>53</td>
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<tr>
<td>Peru</td>
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<td>43</td>
<td>43</td>
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<tr>
<td>Venezuela</td>
<td></td>
<td>179</td>
<td>180</td>
</tr>
<tr>
<td>Average OECD</td>
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<td>31</td>
<td>31</td>
</tr>
<tr>
<td>Germany</td>
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<td>18</td>
<td>20</td>
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<tr>
<td>Canada</td>
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<td>15</td>
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<td>France</td>
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<td>United Kingdom</td>
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* Based on World Bank data. URL: http://www.doingbusiness.org/rankings

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 facts 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 show the enormous economic differences that should be considered in a transfer pricing analysis, when one is comparing companies that operate in “different worlds.”

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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.
The OECD, in its Latin American Economic Outlook 2014,\textsuperscript{12} places special emphasis on the above-mentioned disparities, specifically the high logistics costs in Latin America, which lead to inefficiencies and therefore render those countries less competitive than countries in other regions. The logistics performance index (LPI) is mentioned, which takes into account factors such as:

\begin{itemize}
  \item Efficiency of the clearance process (speed, simplicity, and predictability of formalities) by border control agencies, including customs;
  \item Quality of trade- and transport-related infrastructure (ports, railroads, roads, information technology);
  \item ease of arranging competitively priced shipments;
  \item Competence and quality of logistics services (transport operators, customs brokers);
  \item Ability to track and trace consignments; and
  \item Timeliness of shipments in reaching their destination within the scheduled or expected delivery time.
\end{itemize}

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 labor productivity of 35 percent. 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.

Final Considerations

This article has considered some of the principal systemic 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 to a Latin American enterprise compared with a firm that operates in a G7 country.

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

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

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