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TRANSFER PRICES

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¿What do we understand by transfer prices?

- Prices agreed upon between several business units belonging to the same economic group and located in different countries, for services and/or products, rendered or sold.

- That is to say, prices negotiated for transactions within the same economic group.

¿Why have transfer prices currently turned into such a significant issue?

- Because of a global increase in business exchange
- Due to strategic decisions at worldwide level (for example: Plant location)

- Due to the multi directional transactional complexity.

- Because 70 % of international trade is found in multinational companies .

- Due to a greater tax pressure by tax authorities on several countries.

¿Why do we need clear rules on such issue?

- To avoid double taxation
- To protect tax collection in each country
- To make an adequate tax planning
- To eliminate contingencies
- To foster economic development

ORIGIN AND DEVELOPMENT OF THIS ISSUE

• 1915	First formal legislative background
• 1928	US tax legislation incorporates this issue to its income tax
•1961	The Organization for the Economic Cooperation and Development is created (OECD) This entity acknowledges the benefit of having rules on transfer pricing
• 1979	The OECD issues its first report whereby the arm's length principle is established as its guiding principle.
• 1984	The OECD publishes its second report called "transfer pricing and multinational enterprises". Three taxation issues
• 1994	The principles already established are ratified
• 1995	The first chapter on transfer pricing guidelines is published.

DEVELOPMENT OF THIS ISSUE IN LATINAMERICA

New rules concerning the transfer pricing issue have been incorporated to tax rules in several Latinamerican countries.

- 1996 — Brazil modifies its income tax rule by introducing this issue.
- 1997 — Mexico included this issue within the tax reform it made during that year.
- 1998 — The Argentine Congress included this issue within a tax reform
- 2000 — In force as of that year, Venezuela introduced modifications to its income tax.
- 2001 — Colombia, Chile and Perú

ARM´S LENGTH PRINCIPLE

The universal rule to evaluate those results obtained by multinational companies among related parties is the Arm´s length principle.

This principle constitutes the international standard as regards transfer prices. Its purpose is to consider transactions performed between related parties as performed among unrelated parties.

ARGENTINE LAWS

It is rather new.

Development as regards rules and laws:

- Law 25.063 (effective as of 31.12.98)
- Decree 485/99 (published on 12.05.99)
- General Resolution 702/99 (published on 15.10.99)
- Law 25.239 (effective as of 01.01.00)
- National Decree 1037/00 (published on 14.11.00)
- General Resolution 1122/01 (published on 31.10.01)

Ratification of the Arm´s Length principle

Enforcement of the methods recommended by the OECD guidelines

CURRENT LAWS - LAW 25.239

Section 8º:
Modified by Law 25.239 (currently enforceable in the case of independent companies, that is to say, unrelated companies).

<u>EXPORTS:</u>

Whenever the prices are not established or those agreed upon are lower than the wholesale price at the place of destination, the latter shall be taken into consideration in order to determine the value of exported goods. Tax Authorities are empowered to determine export values.

<u>IMPORTS:</u>

Whenever the prices of goods to be introduced into the country are higher than those existing at the place of origin, this difference shall be considered as an Argentine source net profit for the exporter. Tax Authorities are empowered to determine import values.

CURRENT LAWS - LAW 25.239

SECTION 15º

TRANSFER PRICES:

•Related companies may determine their taxable income and expenses according to those values arising out of business relationships as if performed between independent parties in comparable transactions.

•In order to determine whether transfer prices are consistent with customary market practices among independent parties, the MOST APPROPRIATE method of the following ones shall be applied.

CURRENT LAWS - LAW 25.239

Methods based on comparable transactions:

• Uncontrolled comparable price

• Resale price

• Cost plus

Methods based on profits obtained by comparable companies:

• Profit split

• Residual profit split

• Transactional net margin

MOST APPROPRIATE METHOD

"THAT WHICH SHOWS THE ECONOMIC SITUATION OF TRANSACTIONS IN THE BEST MANNER POSSIBLE"

- It is the best method compatible with business and corporate structure

- It has the best quality and amount of available data

- It includes the most adequate comparability level

- It requires the lowest adjustment level

TRANSACTIONS REACHED BY TRANSFER PRICING RULES

- Purchase and sale of tangible goods
- Royalties for trademark use
- Royalties for technological transfer
- Technical assistance
- Rendering of services
- Financing transactions (interest)

ECONOMIC RELATIONSHIP

ASSUMPTIONS

- Whenever there exists control
- Significant influence:
  - Constitute corporate will
  - Joint directors, officials or administrators
  - Sole supplier or customer
  - Technological dependence, etc..

COMPARABILITY CRITERIA

Comparability of transactions and/ or companies, referred to in section 15 of Income Tax Law, shall be determined considering, among others, the following elements:

a) Characteristics of financing transactions; rendering of services; use, enjoyment or alienation of tangible goods; transmission of intangible goods

b) Functions or activities performed

c) Assets used and risks assumed

d) Economic circumstances such as geographic location, market, supply and demand levels, scope of competition

e) Business strategies

f) Contractual terms

ACTIVITIES PERFORMED BY TAX AUTHORITIES

- Creation of a specialized department in order to supervise transfer pricing issues. Tax Authorities have a team of professionals trained on such issue.

- Personnel training

- Tax audits on transfer pricing issues divided per sector, industry, up to now.

  Automotive industry (terminals)
  Pharmaceutical industry
  It is expected that the oil industry shall follow.

TAX AUDITS

- Impossibility to supervise all taxpayers reached by this rule
- Requeriment for transfer pricing documentation:

  Within the framework of a tax inspection

  For revision of agreements filed with the INPI

  Por revision of transactions with entities located in countries with low or no taxes

  For direct transfer pricing audits in specific sectors.

IN PRACTICE, IT IS A COMPLEX ISSUE

Let's see an example: Foreign capital pharmaceutical industry.

- High competitiveness, by virtue of which it is vital to discover new products in order to improve existing ones
- Companies are increasingly obliged to invest important amounts of money in Research and Development
- Importance of Research and Development expenses incurred by Parent Company (about 25% of cashflows, annually)
- Impossibility for Research and Development expenses to be included in finished products costs
- Existence of few successful products, although very notorious
- Profits must cover the cost of failures
- Profits go hand in hand with the risks involved
- The time frame required for the Research and Development of an effective molecule is of about (10 to 15 years)
- Existence of competitors who do not invest in Research.

Difference between sales prices and transfer prices

- **Sales prices**
  - ☞ specific for a country, "price at which a product leaves a lab"
    - ☞ **price to the first customer outside the group**
  - ☞ based on the creative experience of local management together with strategic group considerations
  - ☞ result of competitive forces and impact of regulations from several governmental entities

- **Transfer prices**
  - ☞ price between group companies
  - ☞ to be defined in accordance with national regulatory matters and internationally accepted rules
  - ☞ result of an examination process as regards performance between group companies

Therefore, we should talk about TRANSFER CONDITIONS

- **Transfer prices: it only constitutes the guideline for transfer conditions**
- **Transfer conditions : they include a wide variety of :**
  - **Services:**
    - **Research and Development**
    - **Raw Material Centre**
    - **Logistics**
  - **Rights:**
    - **Trademarks and patents**
  - **Risks:**
    - **The local company has almost no risks, are covered by Parent Company: stocks, currency exposure, financing**

SIMPLE BUT COMPLEX

The abstract notion of this issue may be simple, but in fact, businesses, within a global economy where they cannot be considered in isolation but as regards the development taking place all over the world, make this issue a very complex one.

Transfer prices represent a new chapter within this new scenario and therefore, the following people are deeply concerned with this matter:

- Tax authorities in each country
- Corporate groups

TRANSFER PRICING IS A NEW ISSUE IN OUR COUNTRY WHICH SHALL BE USED:

As a means to increase collection?

As a tool to foster economic development?

The attittude observed up to the present by tax authorities provokes legal insecurity?