asociación de economía para el desarrollo de la argentina

VI Congreso

"El futuro del desarrollo argentino"

19 y 20 de Mayo de 2015
Ciudad Autónoma de Buenos Aires

TRANSFER PRICING MANIPULATION AND CAPITAL FLIGHT

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ABSTRACT

This study[1] offers an initial overview of the problem of transfer pricing in Argentina. It reviews how regulatory changes have evolved, the various mechanisms supported by legislation for calculating pricing for intragroup operations, the way in which legal mechanisms become routes for avoidance, evasion and capital flight, the conflicts and results of cases linked to transfer pricing which have come before the courts in Argentina and possible recommendations for policy in the present international context, taking into consideration some alternatives practised by other countries.

I. Introduction

Transfer pricing is usually defined as the price at which transactions are conducted between economically related entities, although this implies that a "price" exists for a contract between legally independent parties, which is not the situation within an economic group.

The fiscal significance of this is that the valuation of operations between related entities has an impact on the balances and income statements of each entity in the group, and therefore in order to increase their global profits economic groups use transfer pricing mechanisms to increase costs in high tax jurisdictions and transfer profits to the final beneficiaries, often through tax havens, which are important due not only to their low or zero tax rates, but also to the high level of secrecy with which they protect their investors.

As a consequence, multinational groups succeed in paying a lower effective tax rate than other companies in the same sector.[2]

Although the main objective of transfer pricing manipulation is usually tax avoidance, in developing countries it has a significant impact on capital flight, as these methods make it possible to transfer assets abroad as if they were part of normal business activity, sometimes avoiding exchange restrictions through legal mechanisms which allow foreign payments to be made as remuneration for intragroup operations.[3]

In this context, Gaggero, Rua and Gaggero [2013: 64 to 74] estimated the value of capital flight and put forward a hypothesis on the impact of transfer price manipulation

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[1] This study is an amended and abbreviated version of Working Document No 58 (Fuga de Capitales IV. Argentina, 2014. La manipulación de los precios de transferencia) written under the supervision of Jorge Gaggero (Coordinator of the Capital Flight Program ("Fuga de Capitales") of the CEFID-AR) and published by the Centre of Economy and Finance for Development in Argentina (Centro de Economía y Finanzas para el Desarrollo de la Argentina) (CEFID-AR) dated June 2014; and in collaboration with the "Systems of Tax Evasion And Laundering" (STEAL), project (#212210) of the Research Council of Norway (NUPI). The complete document is available at http://www.cefid-ar.org.ar. An abbreviated article on this topic, also extracted from Working Document No 58, has been published *in Spanish* in the January-February 2015 edition of the Journal Ola Financiera, and is available at http://www.olafinanciera.unam.mx/

[2] Gutman [2013: 37] gives a very clear example of this in the case of Chilean mining companies, observing that for the period 1990-2001, the state company CODELCO paid 10 times more tax to the Treasury than the private companies, when the production of the private companies was 25% greater than that of the state company.

[3] Broadly speaking, capital flight covers the portion of both legitimate and illicit capital located abroad (or inside the country, outside the formal economy), owned by local residents.

and other foreign trade manoeuvres, suggesting that in 2012 it would correspond to 9% of the total international trade of Argentina, representing US$13.22 billion.[4]

The use of these mechanisms therefore not only results in an increase in inequalities within countries like Argentina, but also between developed and developing countries.

II. Legal Framework

Between 1973 and 1976, Law 20.628 on income tax, Law 20.557 on foreign capital investment and Law 20.794 on technology transfer were enacted, passing into law the legal doctrine which arose out of five rulings of the National Supreme Court of Justice (Corte Suprema de Justicia de la Nación) (CSJN) relating to the Parke Davis, Mellor Goodwin, Rheinstahl-Hanomag Cura, Compañía Swift de La Plata and Ford Motor Argentina cases [5], in which the higher court determined that it was the substance (the "economic reality") and not the legal form which was relevant, and that in view of this it was valid to disqualify contractual arrangements between entities belonging to the same economic group, and to consider payments between related parties (in the form of financial contributions, royalties and services) as corporate contributions and profit transfer. As a consequence it was clear that such contracts had not been made between legally independent parties, either for operations within a country or with entities located abroad. [6]

After the civilian-military coup of 24th March 1976, the achievements of previous years were dismantled and a new foreign investment law 21.382 was passed on 13th August 1976 whose article 20 validated contracts between related entities when they conformed to normal market practices between independent parties; on 17th December 1976 article 14 of the income tax law (LIG) was amended to validate the deductibility of payments made within the framework of intragroup contracts and to consider it reasonable to compare them to those made by independent parties; and in 1977 a new Law 21.617 on technology transfer, and another regulating tax on capital were passed, all of which legitimised contracts between economically related companies.

Thus the principle of transfer pricing, or as it is known internationally the "arm's length" principle, substituted that of economic reality. Since then and until now operations conducted within the same economic group have been treated as if they were economically independent, and it has been possible to send remittances abroad in the form of "royalties", "fees for technical advice", "services", "interest on loans", and similar "contractual" benefits.

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[4] Calculated according to the Residual Model (which does not include flight through transfer pricing and other foreign trade mechanisms), capital flight would have reached US$15.07 billion in 2012 [Gaggero, Rua and Gaggero, 2013].

[5] A description of these rulings, their implications and an analysis of the regulatory changes which resulted can be found in Martínez de Sucre and Corti [1976], Corti [1985], and Corti [2012].

[6] These laws formed part of a package of 20 laws proposed to Congress during the third Perón government (12/10/1973-1/7/1974) which aimed to achieve long-term sustainability for Economy Minister José Ber Gelbard's plan (25/05/1973 – 21/10/1974). As Arceo and De Lucchi [2012:27] point out: Law 20.557 on foreign capital investment also stated in its article 19 that foreign investors could not receive more favourable treatment than that accorded to domestic investors; and in its article 18 that foreign capital companies making use of promotional arrangements would not be able to repatriate profits for the duration of the benefits or obligations derived from such arrangements. Although this did not in itself prevent tax avoidance and capital flight through transfer pricing mechanisms, it did succeed in reducing the use of such mechanisms by considering payments between related parties (in the form of financial contributions, royalties and services) as corporate contributions and profit transfer.

In 1998 Law 25.063 amended the LIG and introduced methods in its article 15 to be applied to determine Argentine-source income[7], based on the 1995 OECD Guidelines for Multinational Enterprises and Tax Administrations.

Decree 1037/2000 amended the LIG regulations, establishing in article 21 that income and deductions for transactions conducted with *"...individuals, legal persons or other entities domiciled, constituted or located in low or zero tax countries..."* should be determined by considering the prices which would have been used between independent parties. The 88 dominions, jurisdictions, territories, associated states or special tax regimes which would be considered "low or zero tax countries" are listed in the seventh article following article 21. It is important to mention that a paragraph is added to the end of the list of these "countries or territories" in this article, establishing that "those dominions, jurisdictions, territories, or associated states which implement an information exchange agreement signed with the ARGENTINE REPUBLIC or, where relevant, make amendments to their domestic income tax legislation in order to bring it into line with international parameters such that they are no longer characterised as a low or zero tax country, will be excluded from the aforementioned list". [8]

General Resolution 1122 of 2001, among many other provisos, required a report on transfer pricing to be presented, certified by an independent public accountant, in cases where an economic relationship was established or where operations had been conducted with entities located in low or zero tax countries.

In 2003, article 8 of the LIG was amended to include a sixth method for estimating transfer pricing for cases of commodities exports where international intermediaries were involved, according to which *"the trading value of the goods in a transparent market on the date on which the goods are shipped*" must be taken, removing the rule which had been more or less in force since 1943 which stated that when the agreed export price was lower than the current wholesale price in the destination then the latter would be taken in order to determine the value of the exported products, and the reverse for imports; the difference was considered to constitute the net Argentine-source income.[9]

In addition, the application of this sixth method would be required only when the foreign intermediary could not demonstrate economic substance; for this reason economic groups have made efforts to show that their intermediaries have economic substance so as not to apply the sixth method. [Echegaray, Michel and Barzola; 2013].

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[7] The 1998 reform of the LIG - amended by Decree 649/97 - also added an article after article 15 defining the criteria which would constitute an economic relationship. Since the AFIP General Resolution Nº 1122/2001 the assumptions for economically related parties have been defined, including in addition to cases where a party owns more than 50% of the capital of the other, cases where for example two or more parties have directors, high level employees or managers in common; a party enjoys exclusivity as an agent, distributor or dealer for the purchase and sale of goods, services and rights of the other; a party provides the other with technological property or technical knowledge which forms the basis of the activities on which the latter conducts their business; and various other cases which overall prove the existence of economic collusion between two or more parties.

[8] The impact of this article has changed since 2009, as since then the national revenue collection and customs agency (AFIP) has begun to implement an active policy of signing Tax Information Exchange Agreements (TIEA). In 2009 agreements were signed with several countries and territories on the list, plus San Marino, Bahamas and Andorra; in 2010 with China (including Hong Kong); in 2011 with Bermuda, Guernsey, Jersey, Cayman Islands and Monaco; and in 2012 with the Isle of Man and Uruguay. Similar agreements have also been signed with countries and territories which did not appear on the list of low or zero tax countries, such as Spain, Chile, Costa Rica, Ecuador and India, and a Multilateral Convention has been signed with the OECD. The list of international agreements signed by the AFIP and the corresponding PDFs can be consulted at: http://www.afip.gov.ar/institucional/acuerdos.asp

[9] Baistrocchi et al. [2011] analyses in detail the regulatory changes relating to transfer pricing.

In May 2013, Decree 589 replaced the article added by Decree 1037/2000, in which the low or zero tax countries were listed, with a positive list of jurisdictions "cooperative" with fiscal transparency; cooperation being established by information exchange agreements or signed conventions to avoid double taxation, or where negotiations had been started to sign such agreements.[10]

These agreements are not automatic.[11] Furthermore it is interesting to note that in the case of the agreement signed with Switzerland in March 2014, even when article 26 of the OECD Model Convention [OECD, 2012] (article 25 of the agreement between Argentina and Switzerland) was used, which expanded information exchange opportunities between countries, its application was limited when a clarification was included in the "Protocol" of the agreement which expressly prevents the parties from trying to "fish for information" and which states "*It is understood that Article 25 does not require the Contracting States to exchange information on an automatic or spontaneous basis"*.

Signing these agreements allows those jurisdictions to be included in the list of cooperative jurisdictions, thus releasing them from information requirements relating to transfer pricing and also to foreign exchange transactions. This is worrying, as information is lost on operations conducted with many jurisdictions which are often the destinations selected for capital flight.

In March 2012 the Central Bank of Argentina (BCRA) had issued Communication "A" 5295 establishing that BCRA approval would be required to access the local exchange market for payments greater than 100,000 dollars in the calendar year for services and royalties[12], rent or leasing of buildings located in the country and owned by non residents, and non-produced non-financial assets, when the beneficiary was a related entity[13] and/or incorporated in countries listed in Regulatory Decree 1344/98 of the LIG and amendments thereto. After the changes created by Decree 589/2013, the BCRA issued Communication "C" 65366 of February 2014, replacing the reference to "low or zero tax" jurisdictions of Decree 1037/2000 with one to countries considered "non-cooperative on fiscal transparency."

It should be noted that today the "positive list" includes 109 jurisdictions, among which are 8 out of the 10 top jurisdictions listed by the Tax Justice Network (TJN) in 2013 in their "Financial Secrecy Index" for their level of opacity: Germany, United States, Switzerland, Luxembourg, Cayman Islands, Singapore, Japan and Jersey, as well as many other jurisdictions which combine low or zero tax with a high degree of secrecy,

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[10] To access the complete text of the regulation, see http://www.infoleg.gob.ar/infolegInternet/anexos/215000-219999/215605/norma.htm The complete list of jurisdictions considered "cooperative" by the AFIP (as of June 2014) may be found in Grondona [2014] were it was compared with the jurisdictions which were considered as "low or zero taxation" by Decree 1037/2000 and the Financial Secrecy (or "opacity") Index produced by the Tax Justice Network (TJN).

[11] According to interviews held personally with the AFIP (see Grondona, [2014], the organisation uses these agreements to automatically exchange information relating to foreign beneficiaries (of dividends, income, income distribution, ownership etc.), from individuals and legal entities. This is not covered by the provisions of the agreements however, and when automatic exchange of information exists (for example with Spain), it is not undertaken to check intragroup operations and transfer pricing. It is worth noting nevertheless that Argentina is among the early implementers which committed to using the new OECD automatic information exchange standard from 2016.

[12] These "services and royalties" are defined in the BCRA communication as: other information and computer services, professional and technical business services, royalties, patents and brands, premium payments for lending players, copyright, personal, cultural and recreational services, commercial guarantee payments for exports of goods and services, exploitation rights for foreign films, video and audio, and technology transfer services according to Law 22426 (except patents and brands).

[13] Economic relationship is defined by BCRA Communication "C" 40209.

such as Panama, Bermuda, Mauritius, the British Virgin Islands, Uruguay, the Bahamas, the Isle of Man, Liechtenstein and others.[14]

Finally, in December 2013, through General Resolution 3572, the AFIP created a "Register of Related Parties" where taxpayers with related parties incorporated in Argentina or abroad must be registered. Multinationals and consultants have already argued however that they do not know all the companies included in the economic group to which they belong, and if they do not know them they cannot provide the information.

III. Estimation of Transfer Pricing

As stated in section II, since 2003, for cases of commodities operations through foreign intermediaries without economic substance, the "sixth method" has been applied in Argentina, which consists in comparing the price agreed between related parties with the "trading value of the good in the transparent market on the date on which the goods are shipped".

In all other cases, Argentine legislation and Chapter II of the 2010 OECD Guidelines suggest a number of methods which can be used to establish the prices between related parties as if they were between independent parties. These methods are also recommended in the United Nations Transfer Pricing Practical Manual for Developing Countries [2013], and to a large extent in each country where the legislation has been drawn up according to the 1995 and 2010 OECD Guidelines, as is the case with the current regulations in Argentina.

Except when the Profit Split Method is used, the application of the "arm's length" principle requires a search for operations or financial results of independent companies to be undertaken in order to compare them with the operations conducted by the entity being analysed with its related parties.

Operations conducted by the company with independent entities are usually disregarded because it is usually found that operations with related parties involve fewer functions, assets and risks than operations with independents[15], or because of geographical market differences.[16]

Once it has been determined that operations conducted by company A with independents are not comparable with operations conducted by company A with related parties, comparable prices or profits must be found externally.

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14 All jurisdictions considered "cooperative" on fiscal transparency by the AFIP are listed in Grondona [2014] together with their respective ranking in the TJN "Financial Secrecy Index".

15 For example, if company A sells pencils to company B in the same group, company A is not making any marketing effort to achieve the sale, neither does it probably involve any inventory risk, because it is possible that the related entity habitually buys the same quantity; and the decisions on sales to related parties are probably made at the parent company or another entity in the group. When conducting the operation with an independent entity on the other hand, company A had to have made a marketing effort, and it is possible that it has to have a certain level of minimum inventory - which will depend on the industry to which the company belongs and the nature of the local market - and the decision for the operation is probably taken in company A.

16 According to Felitte [2003], audits conducted by the AFIP discovered "on several occasions, in spite of the existence of internal comparables, that is similar operations conducted both with related companies and with independent companies, it was decided not to use these because of geographical market differences, as some operations, those with non-related entities, were conducted in the local market..." whereas those conducted with related parties were with companies located in another country".

Searching for external comparables involves a number of difficulties, the first of these being the lack of available financial information about local companies in developing countries which are not linked to transnational groups of foreign origin.

Therefore although local comparisons are sometimes used, in most cases a search for comparables is usually conducted on international databases which contain data from companies listed on the stock exchanges in various parts of the world.

In any case, choosing independent comparables in order to make an artificial comparison between operations conducted between related companies and those between independent companies involves a certain degree of manipulation of data on the part of whoever is performing the search.[17]

Given the limitations of comparing operations between related companies with those between independent companies, or the results from subsidiaries of transnational groups with results from independent companies, the OECD [OECD, 1995 and 2010], United Nations [2013] and local regulations suggest a number of adjustments to reduce the differences arising from using different accounting criteria, from the specific nature of the markets and from the distinct economic conditions in different geographical markets.

One of the many problems which result from the use of adjustments in combination with external comparables is that it is very costly to analyse in detail the tax, sectorial and macroeconomic context of the country of origin of the comparables used, because of the difficulty in accessing the data. Furthermore it is not clear who bears the responsibility for carrying out these checks. [18]

Also, instead of analysing the economic activity of the local company as a whole, it is analysed sector by sector or operation by operation, because it is recognised that by doing so it is possible to arrive at the level of the "least complex" related operation.

In Argentina the Parke Davis Doctrine[19] in fact considered it inappropriate to interpret the results of a subsidiary as being independent of its parent company, because of the existence of the economic group, and if this analysis is applied to financial segmentation it would be equally inappropriate given the existence of an economic unity, which the local company overall could be considered to be.

In short, the application of transfer pricing calculation methodology can be summarised as follows: an attempt is made to compare operations conducted within an economic group with operations conducted by independent companies, who clearly do not have the same economic links between them; when the attempt is made, it is observed that the independent company acts in a different way from the economically related

[17] To the extent that sometimes comparables are included which have had low or negative results, lowering the average profit with which the result obtained by the company or segment of the company being analysed will be compared. It is very difficult if not impossible to understand if recurrent negative results from these companies chosen as comparables originated from their economic activity or were for tax reasons. The OECD Guidelines [1995 and 2010] note - although in relation to the entity being analysed - that independent companies would not be prepared to tolerate losses which continue indefinitely. Nevertheless when the tax authority in Argentina questioned such a choice in the case of Aventis Pharma, the National Tax Court (Tribunal Fiscal de la Nación) (TFN) ruled in favour of the taxpayer (see section IV).

[18] See the Toyota case in section IV

[19] See section IV.

company; for this reason comparison adjustments are made to reduce those differences. In other words it falls into a conceptual muddle riddled with flaws in the arguments, which in the end invalidate any questioning by the AFIP, as will be seen in the next section.

IV. Rulings by Argentine Courts[20]

In 1964 the CSJN recognised that in the case of Refinerías de Maíz, royalty payments should be considered a contribution to the profits of the parent company. In the same context, between 1972 and 1974 the CSJN ruled in 5 cases: Parke Davis[21], Compañía Swift de la Plata S.A.[22], Mellor Goodwin[23], Rheinstahl Hanomag Cura[24] and Ford Argentina[25], creating a doctrine for how payments between parties in the same economic group should be treated as corporate contributions and profit transfer. This doctrine, which prioritises "economic reality" over legal form, has since been known as the "Parke Davis Doctrine".

Even after the regulatory changes which took place after the civilian-military dictatorship (1976-1983), in 1985 the CSJN again ruled in the Kellogg case[26], explicitly recognising the Parke Davis Doctrine and applying it to operations between related companies within the country. [Corti, 1985].

In 1983 the CSJN ruled in favour of Loussinian[27] in a case relating to the 1974 and 1975 fiscal years. The case referred to purchase and sale contracts undertaken in 1974 by Eduardo Loussinian SACIFIA with the foreign company A.C. Israel Rubber Company, a subsidiary of ACLI International Incorporated, for the monthly supply of natural rubber and latex at a fixed price. In spite of the fact that there had been a sharp fall in the price of rubber on the international markets, the Eduardo Loussinian company continued to import the products at their original prices. The Tax Administration Department (Dirección General Impositiva) (DGI) denounced schemes to over-invoice imports, noting - according to Article 8 of the LIG in force at that time - that a difference between the price paid and the current wholesale price in the place of origin supposes the existence of an economic relationship between the foreign company and the local importer; and that therefore said difference in prices constituted a net Argentine-source profit for the exporter. Nevertheless the CSJN recognised that it was not possible to check whether there was an economic relationship between the foreign entities and Eduardo Loussinian SACIFIA.

Since the regulatory amendments of 1998, which went deeper than those of 1976 which explicitly accepted the validity of contracts within an economic group, a large number of rulings related to transfer pricing came before various courts (the TFN, the Federal

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[20] Note that this section does not claim to conduct an analysis of the legal doctrine or certainty with which the different courts have interpreted Argentine transfer pricing regulations; it is merely a study of the difficulties encountered in Argentina in successfully dealing with tax avoidance by multinational groups.

[21] Parke Davis y Cía. De Argentina SAIC, 31/7/1973, CSJN

[22] Compañía Swift de La Plata SA Frigorífica, 04/09/1973, CSJN

[23] S.A. Mellor Goodwin, C.I. y F., 18/10/1973, CSJN

[24] Rheinstahl Hanomag Cura SA, 17/12/1973, CSJN

[25] Ford Motor Argentina S.A., 02/05/1974, CSJN

[26] Kellogg Co. De Argentina SACIyF, 26/02/1985, CSJN

[27] Eduardo Loussinian S.A.C.I.F.I.A., 20/09/1983, CSJN

Appeals Court (Cámara Nacional de Apelaciones en lo Contencioso Administrativo Federal) (CCAF) and the CSJN).

In this regard, in 2012 the TFN ruled in favour of Cisco Systems Argentina SA[28], in relation to the 1999 fiscal year, accepting the deductibility of payments for intragroup business services rendered to Cisco Systems Inc. located in the United States.[29]

The Ericsson case,[30] resolved by the TFN in favour of the taxpayer in 2007 in relation to the 1996 and 1997 fiscal years, was one in which the local entity had taken out a loan of 12 million pesos[31] from Ericsson Treasury Services of Sweden (the conditions of which were agreed in an internal company memorandum). The tax authority had questioned the loan because of the informality with which it had been supported by the company (via a memo) and the level of undercapitalisation. The TFN did not accept any of the tax authority's arguments and ruled in favour of the company.

Nevertheless one year later, in 2008, neither the TFN nor the CCAF accepted the deductibility of interest in the case of Litoral Gas SA, because the actual date of the loan contract could not be found.[32]

As regards the comparability criteria, the comparables selected and the adjustments used, most of the verdicts went in favour of the taxpayer.[33] For example in the cases of Volkswagen[34], Aventis Pharma[35], Boehringer Ingelheim[36], Nidera and Laboratorios Bagó[37], the TFN found that either the tax authority had not presented sufficient arguments to defend its position or that its position was wrong.[38]

In the Aventis Pharma case for example, the tax authority challenged the choice as a comparable of a US company which submitted accounts showing recurring losses. The company appealed this decision saying that it considered *"...the exclusion of a comparable for the mere fact that it is showing recurrent losses is arbitrary and unfounded"*, alleging that *"such a reason for exclusion is not found in the relevant legislation or the OECD guidelines*". The tax authority responded by saying that including this *company "...among the comparables has the effect of inappropriately reducing the revenue ratio of the comparables, according to the transactional net margin method*". But the TFN considered that *"...the tax authority claim (...) is based on its disagreement with the transfer pricing report presented by the appellant, but no*

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[28] Cisco Systems Argentina SA, 23/10/2012, TFN

[29] It is worth noting that in this case the Treasury questioned the expenses, but did not question the transfer pricing structure used by the company, which could be classified as a contracted provider of marketing services. See section V.

[30] Compañía Ericsson SACI, 15/08/2007, TFN

[31] Equivalent to 12 million US dollars at the time.

[32] Litoral Gas SA, 17/04/2008, CCAF

[33] An exception was the case of Daimler Chrysler Argentina relating to the 1998 fiscal year, when the TFN (in 2009) confirmed the adjustment made by the tax authority, "...applying to all the exported units the difference in value between the price of the car in the domestic market and the export price of the same car." [D'Agostino, 2010]

[34] Volkswagen Argentina SA, 12/07/2010, TFN

[35] Aventis Pharma SA, 26/02/2010, TFN

[36] Boehringer Ingelheim SA, 13/04/2012, TFN

[37] Laboratorios Bago SA, 16/11/2006, TFN

[38] Some of these rulings, like the Aventis Pharma and Volkswagen cases, have been ratified by the CCAF.

results obtained from any systematic research have been attached which could base the disqualification on serious conclusions rather than mere rhetorical argument...".

Then in the Toyota case, the tax authority had objected to the comparability adjustment made by Toyota Argentina SA because of the extraordinary level of idle capacity it had had in 1999 relative to the comparables. The CCAF found that the tax authority could not base its argument on mere assertions; in other words it had to provide information on the level of idle capacity of the comparables (passing the burden of proof from the court to the tax authority in this respect). It is very difficult to do this when the comparables selected are in another country. The CSJN confirmed the verdicts of the CCAF and the TFN.[39]

In the Nobleza Picardo case (a TFN ruling of 2010 relating to fiscal years 1999 and 2000)[40], in which a practice of under-invoicing exports to Chile via triangulation through a tax haven (Switzerland) was observed, the tax authority initially requested that the local entity adjust the prices to bring them in line with the price charged by the Swiss intermediary to the end client in Chile, but later introduced a number of inconsistencies in an attempt to adapt the adjustment request to the regulation in force at the time when the operation was conducted. In the end it lost the case against the taxpayer, through arguments relating to comparability.

Some rulings (Nidera S.A.[41] and the aforementioned Boehringer Ingelheim SA) illustrate the difficulty of finding independent comparables, and highlight how few tools the tax authority has to refute the arguments of the multinationals when the "arm's length" principle is applied.

In a recent ruling (of 2013), that of Molinos Río de La Plata[42], the TFN ruled in favour of the tax authority, using the principle of "economic reality" in its argument, after finding that an abuse of the double tax treaty with Chile had occurred. The company had established a holding company in Chile and taken advantage of so-called investment platform companies which do not pay taxes in Chile on income from foreign sources received or earned. Because of the double taxation agreement with Chile, Molinos Rio de la Plata SA considered that the income should not be taxed in Argentina either.

It would seem however that in general the current legal framework does not provide the AFIP with the tools to successfully challenge tax avoidance and evasion through transfer pricing manipulation in the courts, which also lack expertise on this issue.

[39] Toyota Argentina S.A., 2/9/2014, CSJN.

[40] Nobleza Piccardo S.A.C.I. y F., 15/07/2010, TFN

[41] Nidera S.A., 06/06/2013, CCAF

[42] Molinos Río de la Plata S.A., 17/08/2013, TFN

V. Mechanisms for Tax Avoidance and Evasion [43]

Transfer pricing structures are not linear or standalone. Generally they are part of an overall strategy.

One mechanism which serves to erode the tax base and lead to capital flight, is that of mixed hybrid agreements, which for example allow an operation to be deductible in one jurisdiction when it is not recorded as income in another, (for example in the case of a loan with interest payments deductible in one jurisdiction but which is recorded by the other entity as a dividend payment).

1. Business restructuring, simplification of activities and intangibles

Business restructuring in the context of transfer pricing planning usually means transfer of functions, assets and risks from high tax countries to tax havens. For example, a taxpayer undertaking complex production activities becomes a contract manufacturing service provider [44] and a contract distribution service provider [OECD 2010: 261], and thereafter charges for costs incurred plus a margin, limiting its profits instead of gaining the full benefits for the activities performed. To achieve this transformation, locally generated intangibles such as marketing intangibles (brand, customer portfolio, local entity reputation and so on) or manufacturing intangibles (local know-how) are transferred to another jurisdiction, explicitly or implicitly(that is, they are not always recognised on the balance sheet)[45].

Many multinational groups which require some kind of research and development process, such as laboratories for example, use structures such as "contract research and development" by which an entity typically located in a tax haven, but which could also be the parent company, decides for the other entities in the group what investigation and research and development processes they must use, and pays these subsidiaries based on incurred costs plus a margin, which could be around 5-10%; thus retaining the ownership of the intangible assets for itself[46].

2. Triangulation, under-invoicing of exports, over-invoicing of imports, provision of marketing and/or logistical services from abroad, commission agents

Some of the triangulations typically observed by the AFIP in relation to large concentrated export groups (principally linked to the oil and oilseeds sector) are shown in table 1 below.

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[43] Although most of the mechanisms described in this section are for the purpose of tax avoidance and evasion, they also effectively contribute to capital flight.

[44] Extreme cases of these structures are known as "toll manufacturers" and "stripped distributors", where even the inventories remain in the hands of the "principal", and are placed on consignment on the taxpayer's premises during the manufacturing process or at the time of the sale to the end client.

[45] Most of the wealth is based on intangible assets which represent rights to future revenue streams. Because of their intangible nature however, it is easy to manipulate rights to future revenue streams and where they are recorded in the accounts.

[46] It is worth pointing out that intangible assets are in most cases generated from global activities. For this reason recording the ownership of an intangible in a single entity is questionable.

Table 1. Various triangulation situations found by the AFIP since 2009

Argentina	Intermediary	End Client	Price Diff.
Dutch Capital	Related company Asia	China -Europe- Brazil	5%
US Capital	America Branch	China, Spain, Malaysia, India	5%
German Capital	Parent Company Europe	China, Spain, Brazil, Chile	5% - 10%
Argentine	America Branch	China – Spain	5% - 10%
US Capital	US Parent Company	China, Saudi Arabia, Syria	5%

Source: Echegaray, Michel and Barzola [2013: 86]

Some triangulation cases such as Nobleza Picardo and Bagó have come before the courts for exports via an intermediary, the first via Switzerland [47]and the second via Panama, whilst others have become public knowledge such as those of the Bunge and Cargill companies which were triangulating through Zonamerica (a free trade zone in Montevideo, Uruguay) [Tiscornia, 2012].

This triangulation is generally justified by arguing that the foreign intermediary provides marketing and/or logistical services[48] for which it needs to be paid.

Also, it is quite common to use commission agents located abroad, and sometimes such an agent is not even involved: a contract is simply drawn up in such a way that the foreign importer transfers part of the total amount to Argentina and another part to an account typically located in a tax haven [Argibay Molina, 2013: 78 to 82].

3. Sales from abroad

This seems to have been the strategy implemented by Despegar.com, as the company transferred 93% of the shares to Despegar.com INC, a company located in Delaware[49], thus making it easier to conduct operations from there for a value 10 times greater than what was declared locally [Premici, 2014]. On the practical level there must have been a business restructuring on the basis of which future sales were transferred to the Delaware company, but also the local entity, situated where the economic activity took place (Argentina), stopped receiving any income from this activity, reducing its tax base, and shifting profits, and thus capital, to a foreign jurisdiction.

4. Intragroup and business services

More and more commonly, as part of transfer pricing structures, a number of services for the rest of the group (difficult to verify and value when not purely artificial) are typically located in one centre to which the rest of the group's subsidiaries send payments to reimburse expenses under cost contribution arrangements or as payment for services provided (calculated based on costs plus a margin).

[47] Cobham, Jansky and Prats [2014] point out that income from international trade traffic through Switzerland increased 15-fold between 2001 and 2011; most of the products traded by the Swiss being commodities (94%), especially energy sources (59%), minerals (20%) and agriculture and livestock (15%), bringing Swiss companies 35% of the world oil trade today. Switzerland is particularly attractive for these kinds of operations due to its level of banking secrecy and the tax incentives which it offers.

[48] See Argibay Molina [2013: 82 to 87].

[49] Delaware is a tax haven located in the north-east of the United States, where the law allows tax exemption for limited companies owned by non-resident foreigners. The State has around 650 thousand companies registered, about one per resident, and around 217 thousand at the same address. See also the report on Delaware written by "Tackle Tax Havens" available at http://www.tackletaxhavens.com/the-problems/delaware/

Even when the individual expenses are not large amounts, they constitute another mechanism for tax avoidance and capital flight, especially when done through tax havens with which Argentina has a double taxation agreement[50] [51].

5. Level of debt or expenses caused by excessive interest and other financial instruments

Financial expenses are typically used between related entities to transfer income directly from subsidiaries to tax havens or to their parent companies.[52] Sometimes these financial operations only exist on paper and do not mean there has been an actual asset transfer.

As well as direct loans[53], what have come to be known as "cash poolings" are often created in a foreign subsidiary, preferably in a tax haven. This subsidiary receives funds from other entities in the group which it repays at a low interest rate. Sometimes this same "cash pool" grants low-interest loans to other entities in the group (among which are the same entities which deposited their "surpluses" in the "cash pool"), by way of which local entities can deduct interest. These operations are conducted by companies in all sectors, from the oil industry to consumer goods.[54] In this way the company who administers these funds for the purposes of transfer pricing works like a financial entity, without incurring the risks of a bank.

A financial movement which completes the full circle is a true insider loan. Sometimes these insider loans are made through financial institutions as intermediaries, as is the case with "back to backs", where an entity deposits funds in a financial institution - typically in a tax haven - which is then used as a guarantee for a loan application to a local subsidiary of the same financial institution by a subsidiary of the transnational group.

Gaggero, Casparrino and Libman [2007: 61], mention "hedging contracts" with no basis (commercial, financial or any other linked to the company's own operation) on which to justify them as risk coverage, and which seem to be widespread in commodities trading and interest rate risk management (in case of variable rates for example).

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[50] Article 81 of the LIG, consolidated text 1997 (by Decree 649/1997) and amendments thereto, defines the cases where foreign beneficiaries actually should retain 35% from these operations. This retention can be avoided however if the operations have been conducted with jurisdictions with which Argentina has signed a double taxation agreement.

[51] Between 2003 and 2012, expenses for "business, professional and technical services" grew by 400%, according to Services Table 3 from the Balance of Payments Estimation (Cuadro 3 de Servicios de la Estimación del Balance de Pagos), reaching $US 3.25 billion in 2012, and royalty expenses grew by 260% in the same period, reaching $US 2.09 billion. (Source: http://www.indec.gov.ar/, to January 2014). Although this data represents all intragroup payments as well as payments to independent companies, considering the type of services and the fact that more than 60% of the largest companies in Argentina are subsidiaries of foreign groups*, it is reasonable to suppose that the growth in these payments could be due to the growth in this type of transfer pricing mechanism.

*according to the National Survey of Large Companies (Encuesta Nacional de Grandes Empresas) (ENGE)), published by the Report on large Companies in Argentina (Informe de Grandes Empresas en Argentina) and produced by the National Statistics and Census Institute (Instituto Nacional de Estadística y Censos) (INDEC) in January 2014.

[52] According to a BCRA report (Private Debt, table 3: Foreign Liabilities of the Private Non-financial Sector - by creditor type), debt obligations with companies in the same group grew by 80% between March 2003 and December 2013, from 17.08 to 30.67 billion dollars. Although further work remains to be done in order to analyse this figure in more detail, the level it has reached is significant.

[53] One local example is the Ericsson case described in section III.

[54] This assertion arises from the author's experience of transfer pricing between 2002 and 2007 and was confirmed in the interviews conducted for this study (see Grondona [2014]). Ireland is often one of the countries typically used to locate the "financial subsidiary".

The banking and insurance sectors also operate with related foreign companies. For example, insurance companies enter into reinsurance contracts abroad, for which it is difficult to find comparable contracts between independent parties. And the banking sector deals in swaps, bonds and securities sales, interbank lending and other operations with subsidiaries and branches, operations which are also sometimes conducted through tax havens and which are as difficult to value as those of the non-financial sector.

VI. Policy Recommendations

Some countries such as Brazil, and in recent years China and India, have applied the OECD recommendations on transfer pricing with some variations which merit consideration.

Even though Brazil's transfer pricing regulations are based on the OECD recommendations, they differ in their application as they require fixed market spreads to be used for income from the import of goods, services and rights; and the export of goods, services and rights[55] to related companies abroad, and do not accept transactional methods for income operations such as the Transactional Net Margin Method or the Profit Split Method.

Intangible transactions (transfer of technical, scientific or administrative support or royalty payments) are not subject to transfer pricing regulations in Brazil, but to a specific earlier regulatory framework with a deduction limited to 5% from the local entity's income, and tax withheld at source.

In general all transactions between a Brazilian company and its related foreign parties, and with tax havens and preferential regimes whether or not related, would be subject to the transfer pricing legislation.

Chinese and Indian law is also based on the OECD Guidelines. Recently however, they have incorporated the concept of "Location Specific Advantages" (LSA), under which it is argued that some investments by multinationals in those countries are more profitable than in other countries as a result of specific location advantages such as a comparatively skilled and low-cost workforce, a large growing market and a relatively relaxed legislative framework, all of which need to be taken into account when using comparables from other countries which do not have the same advantages. [Committee of Experts on International Cooperation in Tax Matters, 2013].

Also, as regards intangibles, Chinese and Indian transfer pricing regulations consider that marketing intangibles are inexorably linked to the market where the products are sold,[56] and as regards "know-how" royalties, Chinese regulations recognise that these should not be payable forever, as after some time running production in the country the company will acquire this knowledge, and develop and improve it.[57]

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[55] Instrução Normativa RFB No 1312 of 28 December 2012.

[56] For example, these regulations recognise that a multinational arriving in China for the first time, even if it is well-known internationally, is not going to sell anything in China until the Chinese subsidiary acquires the knowledge and experience of the Chinese market needed in order to place the product. For this reason, instead of paying royalties for use of a brand, Chinese subsidiaries should be compensated by the parent companies for the locally created intangibles, without which they would not have been able to sell in China.

[57] For example, if a Chinese subsidiary was charged a royalty of x% for the use of a manufacturing process (know-how) when the subsidiary started operating, after some time it will not be reasonable for the subsidiary to continue paying the same royalty,

In July 2013 the OECD [2013] launched its Action Plan on "Base Erosion and Profit Shifting" (BEPS), identifying 15 actions to be carried out in 24 months to equip governments with the national and international instruments required to deal with the challenges of base erosion and profit shifting.

Nevertheless as Figueroa [2014] rightly says, "the action plan presents some proposals which need to be deeply analysed by the developing countries involved in it..." as among other things it advances the "universalisation of the criteria and concepts applied by developed countries", and seeks to ensure that "...all other countries should adopt the fiscal ideas and parameters of those who consider themselves the 'world".

In summary, given the difficulties that the Argentinian tax authority faces when it tries to bring issues to the courts relating to the comparability criteria selected by companies, the following would be interesting: to evaluate the possibility of a regulatory change to give greater preference to methods based on sharing income, which are already covered by local legislation; to consider including in current regulations issues around the generation of intangibles and use of avoidance structures such as contract manufacturing, distribution and research and development, like those adopted by India and China; to fix clear profit margins for each type of operation as Brazil does; or to take a few steps back and allow payments for royalties, loans and intragroup services in the context of national or foreign groups to be challenged, as was done in the past.

6. Conclusions

The overview of regulatory changes in relation to transfer pricing in this study showed that it is since the civilian-military dictatorship of 1976 that the "arm's length" principle of transfer pricing has been explicitly adopted in the country, which accepts as valid the artificial contracts and prices between companies which belong to the same economic group, and which in practice are economically related.

Even when the courts continued to adopt the principle of economic reality and the Parke Davis doctrine which emerged from the rulings by the CSJN between 1972 and 1974 and which had been reflected in the LIG of 1973, changes in favour of the "arm's length" principle were gradually further consolidated, and over time the verdicts became more and more favourable to multinationals.

Even though the idea that operations between related entities should be artificially treated as if they had been conducted between independent parties was and continues to be questioned by lawyers and local tax experts as well as by international non-governmental organisations, the “arm's length” principle is being adopted by more and more countries and continues to be recommended by the OECD.

Multinationals abuse the current system, creating very complex transfer pricing structures, moving real and artificial assets through tax havens, and abusing double taxation and information exchange agreements, thereby succeeding in reducing their

especially if the manufacturing process provided by the parent company has been improved through trial and error or by having been in operation for 10 years. In this case, there is a question whether it should not be receiving payments from the rest of the world for having shared its experience and the improvements made with the rest of the international group.

effective tax base to levels much lower than those of the countries where they recruit their workforce or where they sell.

Some countries like India, China and Brazil, have adopted the "arm's length" principle (the first two very recently), but with some specific variations, considering local advantages in cases like China which allow production at a lower cost than in other countries and which require compensation; or in cases like India where locally generated production and marketing intangibles must be remunerated as such. For its part Brazil has tried to simplify its system by incorporating fixed margins which companies in different sectors must adhere to when conducting operations with related parties abroad, thus making taxation less complex and addressing the issue on the level of economic activity.

Given the global importance of base erosion and profit shifting to tax havens, the OECD, mandated by the G20, is currently immersed in a discussion on the subject which seeks to provide tools with which tax authorities can take on the multinationals more successfully. Nevertheless, and even though Argentina as a member of the G20 has been invited to participate in these discussions, one should be cautious with regard to the outcomes of this BEPS Action Plan, basically because an organisation like the OECD is usually guided by interests which are not in line with those of developing countries.

Argentina could consider challenging payments for royalties and intragroup services in the context of national or foreign economic groups, as it has done in the past. At least the clause could be removed which exempts operations from being valued according to the trading value of the goods in a transparent market on the date on which the goods are shipped, when the intermediary can show it has "economic substance"; and again consider, as was done before by the regulation in force until 1998, that the wholesale price in the destination should be taken when this was higher than the export price, and vice versa for imports.

Instead, strategies have been adopted which would not appear to help avoid capital flight via transfer pricing, but rather quite the opposite as happens when information exchange agreements are signed with tax havens, which although they can provide tools to take on individual evaders, deprive the country of the chance of fighting the large multinationals, which succeed in reducing their effective tax base through various layers located in different tax havens and thus compete under different conditions on the global level.

The significance of these mechanisms goes beyond fiscal matters and capital flight, as the profit transfer which multinational groups manage to achieve through mechanisms designed by legal and tax consultants and facilitated by the banks gives these groups advantages arising from the lower effective tax rate which these groups obtain by moving their operations through tax havens, or by using hybrid mechanisms which place them in a more competitive position than the local companies, thus contributing to an increase in national and global inequality.[58]

[58] Piccioto [2013] lists the many effects of the current system through which multinationals currently assign income to different countries.

In the end transfer pricing mechanisms affect the whole production chain[59] if in practice a company produces locally, taking advantage of lower costs, production and consumer subsidies, and the local level of education or infrastructure for example, but then uses transfer pricing mechanisms to erode the tax base and move the capital out of the country, like importing parts from abroad for tax rather than productive reasons, under-invoicing exports, contracting administrative or transport services from related parties abroad located in tax havens, to mention just a few in this study.

The value of the losses involved for the national economy [Gaggero, Rua, Gaggero; 2013: 70 to 72] seems to be crucial in the context of the severe "external restriction" faced by the development of the national economy, the specific problems of macroeconomic management and also the attempts to improve income distribution [Gaggero, Rua, Gaggero; 2013: 55 to 58].

[59] Seabrooke and Wigan [2014] point out the importance of beginning to evaluate production chains as "global wealth chains" instead of value chains, because of tax evasion and avoidance, and profit shifting or capital flight, the motivations which lead to multinationals locating their subsidiaries and production in one jurisdiction or another.

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