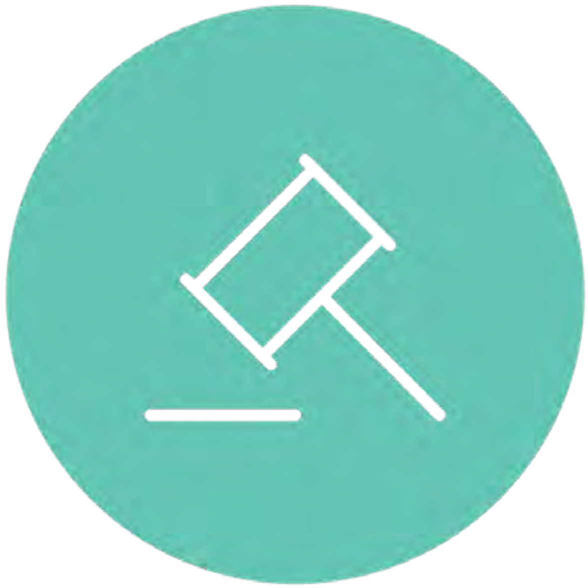

Tax Administrative Court issues first transfer pricing ruling

On 24 November 2017, the Tax Administrative Court of Panama (TAT) issued its first-ever decision in a transfer pricing case (Resolution No. TAT-RF087). The case involved the use of comparables, and the ability of the tax authorities to make a transfer pricing adjustment and an additional income tax settlement on the taxpayer.

The TAT's decision provides useful guidance to both taxpayers and the tax authorities on the choice of appropriate comparables for transfer pricing purposes.

Background

- The taxpayer in the case had filed a transfer pricing report (Form 930) and prepared supporting documentation on transactions with related parties located abroad, as required by Panamanian regulations.
- The taxpayer used the transactional net margin method (TNMM) and the operating margin (operating profit/sales) as the profit level indicator. The taxpayer's analysis showed that its operating margin was

-6.95%, which was below the interquartile range calculated from the financial information of five selected comparable companies.

- The tax authorities conducted a comprehensive audit of the taxpayer's tax returns for fiscal year 2012, which resulted in the issuance of an additional income tax settlement because the authorities rejected certain costs and deductible expenses and made a transfer pricing adjustment.
  - The taxpayer appealed the issuance of the settlement to the TAT.

Tax authorities' findings

The tax authorities had approved the methodology and criteria used by the taxpayer to identify independent comparable companies, but during the audit, after analyzing the financial and business information of those selected, it determined that three of the five did not comply with the comparability requirements specified in Panama's Tax Code. As a result of the rejection of the comparable companies, the interquartile range median for which the taxpayer had to make an adjustment increased. The tax authorities' reasons for rejecting the companies selected as comparables varied but included the fact that the majority of one of the company's turnover was derived from sales to the US military under different contractual terms and risks from those of the taxpayer in the case before the court; in another, the activities were not considered equivalent and the geographic market was held to significantly affect the degree of comparability; whilst the third company had suffered a downturn in its business and closed operating units. The tax authorities then determined a new operating margin, taking account of the adjustments resulting from the audit, which decreased the operating loss in fiscal terms and benefited the taxpayer.

The taxpayer filed reconsideration proceedings as it disagreed with the tax authorities' decision to reject the comparable companies selected for the analysis. In addition to providing the supplementary documentation requested by the tax authorities to support the suitability of the comparables, it also provided counterarguments to those put forward by the authorities.

Decision of the TAT

The TAT based its analysis on a detailed evaluation of the comparables according to the five comparability factors specified in the Tax Code, and also defined in the [OECD Transfer Pricing Guidelines:]

- Characteristics of the goods: The TAT considered that differences in the products impact other factors and affect the assets used and the costs of the company.
- Functions performed, assets used and risks assumed: The TAT conducted a comprehensive review of the functional analysis performed

by the taxpayer for each rejected comparable, and the reasons given by the tax authorities for its rejection.

- Contractual terms: Different contractual terms involve different risks. The TAT agreed with the tax authorities that differences in geographic markets can affect comparability when no relevant efforts are made to adjust for those differences.
- Economic circumstances: There were no comments of note.
- Contractual terms: There were no comments of note.

Decisión del Tribunal sobre la falta de comparabilidad de las The TAT concluded that the tax authorities reasons for rejecting the comparables were valid, based on the following:

- Significant differences in the characteristics of the products: The TAT emphasized that similarity in the products is a key driver in considering whether two transactions are comparable, stating that marketing different products involves different functions and risks.
- Differences in activities: When a company within its regular business performs different activities or, for example, distributes a variety of products and segmented information by activity or product is available, the taxpayer should use the financial information corresponding to the segment or activity comparable to its own, to improve comparability and enhance the reliability of the analysis.
- Unadjusted differences in geographic markets: The TAT ruled that the tax authorities acted appropriately in refusing to accept as a comparable the company operating in a geographic market other than the taxpayer's, since the necessary adjustments were not made to improve the comparability. The TAT emphasized that a comparable company should not be rejected solely on the grounds that it is located abroad but that the taxpayer must perform the necessary adjustments to mitigate the impact on the results of the comparables.

Although the TAT agreed with the arguments put forward by the tax authorities, it revoked the original decision to issue an additional income tax settlement since, after making the transfer pricing adjustment and adjusting for other deductible costs disallowed as a result of the audit, the taxpayer still generated a tax loss.

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