

TRANSFER PRICING AND ITS IMPLICATIONS IN THE AIR TRANSPORTATION INDUSTRY IN CENTRAL AMERICA

Special features and challenges for companies in the air transport industry in developing countries around compliance with transfer pricing rules.



For the last two years, numerous legal measures have been introduced in different countries in a coordinated manner to be able to establish the appropriate channels and foundations for the G-20 member countries to adapt to the suggested measures, in coordination with the Organisation for Economic Co-operation and Development (OECD), through its plan of action to avoid eroding the tax base and profits shifting, better known as the BEPS Plan. **These measures have coerced the multinational groups to accelerate the pace of their business strategies and information systems in order to be able to understand, adapt to and alleviate the administrative and financial impact of the plan of action.**

This plan has triggered changes in different industries, pushing consultants and advisors towards developing new solutions and ideas to address the new challenges, which have emerged from complying with the tax duties, along with planning how to optimize resources. In this document, the passenger air transportation industry is reviewed, due to the particular characteristics of the fulfillment of their tax duties, their revenue distribution and their value production, which are worth analyzing.

The International Civil Aviation Organization (ICAO), as well as the International Air Transport Association (IATA), are making separate and, at the same time, coordinated efforts to build a consensus concerning different aspects that surround the aviation industry, as well as to serve as a referee of the interests of the industry with the different authorities that regulate them.

One of the main topics which both the ICAO and the IATA have dedicated their efforts to is the international taxation issue. On its behalf, the ICAO has adopted a consolidated resolution about international air transportation taxation. The main principle of the ICAO international taxation policy is that countries must apply a mutual tax exemption of the revenues generated by the airline companies related with the international air transportation of passengers. This principle can be found in article 8 of the OECD Tax Agreement Model, which establishes that the profits of a company in a contracting country originated from the aircraft operations in international traffic will only be subjected to taxes in the aforementioned country.

With regards to this consensus, the ICAO and the IATA have forwarded recommendations to achieve that the tax authorities from various countries grant this mutual tax exemption of the revenues generated from the international air transportation service delivery, whether by means of measures established within the local income tax legislation or through the application of international treaties.

In jurisdictions where established measures for the mutual tax exemption of the revenues arising from international passenger air transportation don't exist or where a treaty to avoid double taxation is not considered, airlines resort to apply arithmetic formulas to attribute revenues, costs and expenses to the particular jurisdiction (e.g. the Massachusetts formula or the marine formula).

Currently, in Central American countries such as Honduras, Guatemala, Nicaragua, Panama and El Salvador, the airline companies use this type of formulas to assign the global operational costs which each jurisdiction must have, relying upon organizations such as the IATA or other to reach agreements on assigning the global cost allocations, which have a direct impact on the taxable income.

However, the OECD, in action 13 of its BEPS plan, introduced the implementation of the now well-known three-tiered documentation approach regarding transfer pricing: the Master File, the Local File and the Country by Country Report.

These three-tiered documentation approach in conjunction with the creation of instruments for the automatic exchange of information between tax administrations aims towards increasing profits allocation transparency in MNE groups as well as the location of activities that generate value to the group. These reports have already been put into effect up to today and have been submitted by the taxpayers in different Latin American and European countries. In México, on December 31, 2017, 4 thousand 694 Local Files, one thousand 600 Master Files and 70 Country by Country Reports were submitted.

Thereunder, in 2016, IATA published its official opinion about the implementation of the three-tiered documentation approach with respect to transfer pricing, in the aforementioned document IATA states its point of view in favor of excluding airlines from submitting

the three-tiered documentation, arguing that due to the way companies linked to this industry pay taxes in each country, these business structures are not part of the objectives the OECD suggests in its plan of action, for its activities do not erode the tax base neither they aim towards shifting profits to countries with low or no taxation, whenever their revenues abroad are exempt of income tax pursuant to article 8 of the OECD Model.

Up to today, airlines in Central and South American countries are subjected to the provisions regarding local transfer pricing policies, which may include filing informative statements, filing and/or preparing transfer pricing studies and, in some countries, filing the Local and Master Files and the Country-by-Country Reports, as long as they are subject to such duties according with the income thresholds set by the local legislation of each country. This has led to arguing different points of view surrounding transfer pricing analysis for those companies that use arithmetic formulas to determine allocation of the global operational costs to the subsidiary companies in Latin American countries.

CHALLENGES IN THE AIR INDUSTRY PRICE TRANSFER DOCUMENTATION

Regarding transfer pricing, the arm's length principle establishes that prices or the amount to be paid in commercial transactions between related parties must be agreed upon taking into consideration the prices or compensations set between independent third party entities in similar business circumstances. However, OECD guidelines also establish that there are occasions when it is extremely difficult to measure the arm's length principle in transactions carried out by a MNE group due to the nature of their business.

As a result of the specific regulations which control the air industry, many airlines are forced to establish subsidiaries in a country without a particular business purpose but because of the need to comply with the administrative or legal regulations and requirements which are essential in order to be able to operate in that country. These legal requirements allow companies to carry out transactions between companies which are necessary for the operation of the airline in international flights. **OECD's BEPS Action Plan also establishes that the creation of value must be in line with profit distribution in the transactions carried out by a MNE corporate group.** For this reason, it is significantly important to be able to determine what is the role and what functions do subsidiary companies of an airline company have in the creation of value for the MNE group as a whole.

Following OECD's transfer pricing guidelines, the profitability of a company in a business transaction among companies must be determined based on the tasks that company performs in the aforementioned transaction, the business and operational risks it undertakes as well as the assets that are compromised or used in the transaction. The airline companies in Central America do not generally keep the ownership of the aircrafts or of significant assets to carry on with their business operations due to the fact that such assets belong to the foreign company, likewise, in many cases, local companies in Central America do not hire a significant amount of personnel nor they incur in significant business risks to manage the operations of the international airline in its country.

Accordingly, airline companies in Central America as well as the tax authorities have had difficulties in characterizing their operations, some advisors have decided to measure the profitability of the companies, comparing them with the profitability that the airlines would get, while some others have chosen to compare the profitability achieved with the profitability that the companies dedicated to providing similar services would get, generally of administrative and/or logistic nature.

Taking into consideration that air transport companies in Central America normally receive global operational costs calculated by a mathematical formula, it is normal to find companies with minimum profitability or even with operational losses; this complicates the arm's length principle analysis of transactions between companies because assigning those costs has regularly been determined based on a formula while the income is generated only by the local flights or local ticket sales. **In this case, the transfer pricing analysis would have to consider the nature of the tasks the local taxpayer performs related with the transactions between companies in order to determine if the profitability achieved is consonant with the profitability independent third party entities would obtain in similar circumstances.**

Currently only the Dominican Republic and Costa Rica have filed a formal obligation to comply with the three-tiered approach to transfer pricing documentation, however, it is estimated that during the years 2018 and 2019, Panama will start to make the necessary changes to adapt to these measures. **It will be of utmost importance for the air transportation companies to be able to define the correct analysis and characterization of their business operations to ensure timely and proper compliance.** Furthermore, it is necessary that the Central American companies begin to outline a working plan or an analysis and documentation strategy of their operations with associated enterprises. It is important to verify that, in case that arithmetic formulas are used to assign global operational costs, reasonable criteria is considered, especially in those cases where such expenses lead to a transactional loss for the taxpayer.

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