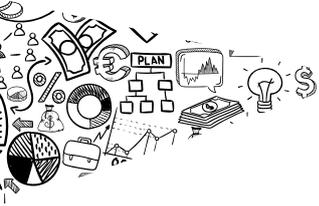


# Tax Alert

## Ecuador



### A. At a glance.-

On Friday July 10, 2015 the website of the Internal Revenue Service (SRI, Tax Administration or TA), posted an update for the Technical Guidelines for standardization of transfer pricing analysis, referred in the Resolution NAC-DGERCG15-00000455 of the same institution, published on 29 May 2015. The Guidelines were originally published the same day that the resolution in question, and has been established to guide the development of comprehensive transfer pricing reports in Ecuador including the presentation, content, calculation formulas and analysis to be performed for a standardized application of transfer pricing. Its application is mandatory for all transfer pricing annexes and reports being delivered, to the TA, from now on.

The highlights in the Guidelines are:

- ▶ It eliminates reporting of transactions that do not add up to define the obligation to submit reports or annexes.
- ▶ Significantly modifies the structure of Integral Transfer Pricing Report.
- ▶ Makes detailed requirements of the type of information that should be included are established, especially regarding the economic substance of the transactions and the functions, assets and risks analysis of each related party and each transaction.
- ▶ Details the default application of the methodologies and the requirements for not using them, with focus in comparable companies and profit level indicators (PLIs) used in the Transactional Net Margin Method (TNMM) as well as in the asset intensity adjustments.

### B. Our comments

Some of the possible impacts we identified regarding these changes and the resulting implications for documentation and methodological aspects are:

- ▶ The Guidelines show the methodological preferences of the TA and seek to standardize the applications of the transfer pricing methods, especially regarding the implementation of the TNMM.
- ▶ Using these preferences is mandatory, according to Resolution NAC-DGERCG15-00000455. To use any different application, a detailed proof should be included in the documentation, where a technical equivalence or superiority should be evident to limit disputes with the TA.

- ▶ The methodological preferences of the TA, especially in the use of only one year of financial information and contemporaneity of this information to transactions may compromise the predictability of compliance with the Arm's Length Standard if such information is not subject to ongoing review.
  - ▶ The information preferences of the TA may involve complex decision making in terms of the information used for documentation and how it represents the transfer pricing position of the company.
  - ▶ Similarly, the model of asset intensity adjustments preferred by the TA could have effect in the PLI of the taxpayer and the comparable companies, which could be useful to generate a specific policy for management of the accounts implied in that model.
  - ▶ The application of the TA's preferences for operations in 2014 and all prior years, of which the documentation of transfer prices has not yet been submitted could hinder the substantiation of the Arm's Length Standard compliance for previous years.
  - ▶ In case of controversies, it would be expected that TA, regardless of the year under review, could use the methodological basis defined in the Guidelines.
  - ▶ The use of global or regional documentation models may be compromised, requiring significant adaptations to achieve compliance with the requirements and preferences of the TA.
- ▶ The most significant changes in terms of documentation are directed to the economic substance of services transactions and additional requirements for functional analysis of transactions and related parties.
- ▶ These changes may pose a greater exposure to companies in Ecuador on the deductibility of charges for services received from abroad under the scenario of not having enough information and that they may be challenged on the basis of lack of economic substance.
- ▶ As for the information to be provided, the requirements of contracts and working papers will force taxpayers to a detailed review of the overall consistency, concurrently with all implied methodological decisions on them, to ensure control of the information being filed, as well as assurance that the implied methodological decisions adequately represent the company and its transfer pricing practices.
  - ▶ While, under certain conditions, domestic transactions has been removed from the transfer pricing report and annex, the obligation to gather and preserve documentation of such transactions remains binding in all cases, jointly with the obligation to comply with the Arm's Length Standard, so they are still subject to possible requirements additional to the transfer pricing report and annex.

**C. Information required in documentation of transactions with related parties**

The content of the comprehensive report, in the descriptive part of the transactions, requires that the information follows this structure:

- ▶ An **"Intra-group transactions"** section, where all transactions require:
  - ▶ Description of the economic substance or rationale of the transaction and its contractual conditions.

- ▶ Preparing a table and a graph with the amounts, margins, timeframes, related parties and its jurisdictions of residence.
- ▶ A “**Features of the transaction**” section, where information of each transaction will be included whenever it contains relevant information on matters affecting significantly the price value of the consideration or profit margin, such as:

For tangible goods	<ul style="list-style-type: none"> <li>▶ Physical characteristics, quality and availability of the good.</li> </ul>
For services	<ul style="list-style-type: none"> <li>▶ Involvement of experience or expertise.</li> <li>▶ Milestone reports of the service should be attached to the filing.</li> </ul>
For intangibles	<ul style="list-style-type: none"> <li>▶ Details of the operation, asset type, timeframe, degree of protection and benefits derived from the use of the asset.</li> </ul>
For transactions involving shares	<ul style="list-style-type: none"> <li>▶ Net assets updated, of the issuer, its equity, present value of profits or projected cash flows or the share price in its last transaction.</li> <li>▶ The settlement of each transaction must be attached to the filing.</li> </ul>
For financing transactions	<ul style="list-style-type: none"> <li>▶ Detail of guarantees and the creditworthiness of the debtor.</li> <li>▶ Documentation of the economic substance of the transaction.</li> </ul>

- ▶ A “**Functional analysis**” section, where, for each related party documentation should include information having relation with relevant characteristics that significantly affect the price or the margin, for example:
  - ▶ Functions of each related party.
  - ▶ Risks borne.
  - ▶ Tangible and intangible assets used by each party, nature and degree of use.

- ▶ A “**contractual terms**” section, in which, whether a contract is available, or not, each transaction should document:
  - ▶ Distribution of responsibilities.
  - ▶ Distribution of risks and benefits.
  - ▶ Where contracts are available, they should be attached.
- ▶ A section of “**market analysis**” will be included when this analysis relates to important characteristics that significantly affect the price or margin. If a market analysis is performed, the calculation and quantification of the effect must be documented, and a specific analytical framework should be followed, according to:
  - ▶ Behavior and evolution of the industry at global and local levels.
  - ▶ Location and size of the market.
  - ▶ Market level (wholesale or retail).
  - ▶ Level of competition in the market.
  - ▶ Competitive position of buyers and sellers.
  - ▶ Availability of substitute goods and services.
  - ▶ Levels of supply and demand in the local and global markets.
  - ▶ Purchasing power of consumers.
  - ▶ Government Regulations.
  - ▶ Production costs.
  - ▶ Transportation costs.
  - ▶ Date and time of the operation.

#### D. Methodological Requirements

Regarding the economic analysis of transactions, documentation should follow the structure detailed below, as well as the corresponding methodological applications, unless it can be demonstrated based on facts and evidence, that a different application provides more accurate results:

- A. Operations to be analyzed:** Identify each transaction with the method used for analysis, explaining the tax regime applicable to the related party and the selected PLI, if applicable.

**B. Method selection:** Reasoned application of the methods hierarchy which is mandatory in Ecuador.

**C. PLI Selection:** If the selected method requires a PLI, it must not use a denominator that contains the operations that are being tested, unless it is duly verified that its use does not influence the outcome.

- ▶ The PLI should be calculated using just the financial information for the year under review. In absence of financial data of at least one operation, segment or comparable company of the tested year, the financial information of the year immediately preceding the review may be used, provided it is shown that the relevant conditions were similar in both periods.
- ▶ The use of financial information of more than one year to calculate the PLI should be factually justified on the basis of business cycles or other comparability criteria.

**D. Comparable set selected:** Besides the regular details for this type of search, it is needed:

- ▶ Screen captures of each search and its filters for each sequential step followed in obtaining the comparable set.
- ▶ Comparability factors: Detailed analysis for each one of the comparability criteria established in the Law.

**The comparable companies or transactions must:**

<p>Have enough financial information in the year under review.</p>	<p>Not having operating losses in the year under review, unless it is evidenced in detail that they are business-related only.</p>	<p>Not having various business segments that influence the profit margin or, if segments are present, having segmented information or being able to give proof that the lack of segmentation is not having effect in the analysis.</p>
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**E. Adjustments made:** It should be substantiated, in detail, the need for application of any comparability adjustment, showing the effect in prices or Arm's Length range.

- ▶ The asset intensity adjustments, if made, should follow the formulas established by the Technical Guidelines, which use average levels of the accounts of the Balance Sheet and adjust rotation to zero in both, comparable and tested companies, using interest rates of the country of the entity being adjusted.

**Asset intensity adjustments:**

<p>Active or passive rates apply depending on the cash cycle.</p>	<p>The Technical Guidelines indicate that companies having their financial statements under IFRS should not need making asset intensity adjustments.</p>	<p>The use of formulas different to those proposed in the Technical Guideline require a technical rationale proving that they do not affect the analysis outcome.</p>
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**F. Rejected companies:** Detail of rejected companies including general and specific considerations for rejection.

**G. Information of accepted companies:** Description of the business activity and characteristics of the companies, including its country of residence and source for such information.

**H. Median and Arm's Length range calculation:** The median and Arm's Length range should be calculated with regular statistics formulas.

**I. Financial Information:** Balance Sheet and P&L of the segment or comparable company obtained from official sources, in its original version (translated into Spanish or English) indicating the source of such information, and also, after adjustments made by the database provider or after specific adjustments made for each analysis.

**J. Conclusions:** The conclusions reached by the application of the selected methods.

**K. Additional Information:** Additional analyses - similar in content to that outlined in the Guidelines - providing information of related parties, as well as any other information that will support the transfer pricing analysis may be submitted.

- ▶ Taxpayers must submit to the tax authorities all working papers of the analysis contained in the report, in Excel format, including cell references, without any protection and including the sources of information used for the analysis for each of the operations that have been evaluated.

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