The growing prominence of marketing intangibles in TP regulations and disputes in Latin America

Gustavo Sanchez-Gonzalez, Armando Cabrera-Nolasco and Katia Huezo of Baker McKenzie describe the key concepts surrounding marketing intangibles and the way tax regulations and tax authorities in the region are tackling these issues.

The transfer pricing (TP) landscape in Latin America has been constantly evolving ever since the introduction of the first TP regulations in Mexico and Argentina around 25 years ago. After a long period of enforcement focused on the formal TP compliance obligations, the tax authorities in the region have generally become more sophisticated and TP audits are now habitual in the major jurisdictions.

Following the global trends in the international tax arena shaped by landmark TP court cases in the US and in Europe, as well as the evolving TP guidance published by the OECD, the concept of marketing intangibles has become a fundamental one when it comes to TP audits in Latin America. Marketing intangibles are a focus point in virtually all TP audits as it is viewed as a key element in determining the allocation of taxable income among members of multinational groups conducting intercompany transactions.

Ongoing OECD work on the global minimum tax and other global tax initiatives are expected to reinforce the importance of marketing intangibles, further limiting tax planning around intangibles and giving tax authorities more tools to scrutinise companies and transactions where intangibles play a key role.

In view of the relevance of these trends for companies doing business in Latin America, this article provides an overview of the key concepts surrounding marketing intangibles and the way tax regulations and tax authorities in the region are tackling these issues. Practical considerations are provided at the end of the article.

Marketing intangibles in the context of TP

The concept of intangibles extends to a broad range of categories that can be viewed from various perspectives depending on the relevant context. Hence, intangibles can be studied from the legal, accounting, tax, or business strategy perspectives, among others.

The International Financial Reporting Standards define intangible goods (assets) as those financial resources that do not have physical substance but are identifiable and controlled by the company through legal rights or physical custody. Local accounting associations, such as the Mexican Institute of Public Accountants, generally coincide in pointing out that the main characteristics of intangible assets are the following: Lack of physical substance (incorporeal); identifiable; controllable; and source of economic benefits controlled by the owner.

In the specialised literature, there are different categorisations of intangible assets. For accounting purposes, intangibles can be grouped in two broad categories depending on how they were acquired: (i) acquired intangible assets, that is, those resources arising from onerous transactions carried out with third parties other than the owner; and (ii) intangible assets generated internally by the owner.

On the other hand, intangibles can be divided into three categories according to the functions and type of expenses or investments that created them, such as: Intangible manufacturing assets, which are created in the production and development activity; intangible market assets, which are created through the functions of marketing, distribution and post-sale services; and super intangible assets, which correspond to patents which are created through dedicated research and development functions and that create a monopoly or a quasi-monopoly.

Within the aforementioned types of intangible assets, the category that has become more prominent for TP purposes corresponds to marketing intangibles.

According to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD TP Guidelines), which latest version was published in January 2022, a marketing intangible is "An intangible that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. (…) marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers."

With the exception of Brazil, most countries in Latin America have adopted TP regulations that are explicitly or implicitly based on the OECD TP Guidelines, and therefore the definition above becomes relevant for taxpayers doing business in the region and should be considered together with specific local regulations, tax audit practices and legal precedents.

Value creation and marketing expenses: Guidance and regulations

In the post-BEPS TP era, the guiding principle of the OECD TP Guidelines is the alignment of TP outcomes with value creation. This means that the most current guidance on TP matters is oriented towards assuring that the allocation of taxable income across members of a multinational enterprise is consistent with the contribution to value creation of each member.

The OECD TP Guidelines state that in transactions involving intangible assets, the remuneration under the arm's-length principle, and therefore the resulting allocation of taxable income among related parties, depends upon the functions performed, assets used, and risks assumed by all contributing members in connection with the development, enhancement, maintenance, protection, and exploitation (DEMPE) of such assets.

In short, the aforementioned guidelines imply that (i) the legal owner is entitled to all returns of intangibles exploitation if performs all DEMPE functions of the intangibles; and (ii) entities participating in DEMPE functions must get an arm's length compensation. For instance, in a typical trademark license agreement, the Licensor my legally and economically own the trademark, but it is important to also recognise that the license to use it in connection with manufacturing, marketing and distribution of products is an intangible by itself and this intangible is owned by licensee.

Marketing activities performed by the licensee may potentially affect the value of the trademark owned by the licensor, the value of the license owned by the licensee, or both. As explained in the next section, value creation for marketing intangibles through advertising and promotion expenses in an intercompany trademark license arrangement, represents a challenging issue that taxpayers are currently facing in various Latin American countries.

As the relevance of marketing intangibles becomes more prominent around the word, tax authorities in the region have started to adopt specific regulations in addition to the standard OECD-based TP regulations.

In the case of Mexico, the SAT has issued non-binding, normative criteria in connection with the application of the Mexican TP regulations established in the Mexican Income Tax Law through the issuance of certain non-binding criteria in the Miscellaneous Tax Resolution (RMF for its acronym in Spanish) that relate to marketing intangibles.

Rule 39/ISR/NV of the RMF on the Recognition of Valuable and Unique Contributions states that the following will be considered as "improper tax practices":

- When taxpayers do not recognise their own valuable and unique contributions and those of the companies or transactions employed as comparables when performing a TP analysis;
- To consider as comparable those companies or transactions having significant differences with the intercompany transaction under analysis attributable to valuable and unique contributions; and

- To advice, render services or participate in the realization or implementation of any of the practices mentioned above.

In line with the BEPS project, with the issuance of this criterion, the SAT seeks that taxpayers perform deeper functional and comparability analyses when addressing intercompany transactions, putting special emphasis on intangibles and contributions to value creation. This position puts more pressure on taxpayers that select unilateral profit-based methods (e.g. the transactional net margin method), as the applicability of one-sided methods would usually be questioned when the tested party makes unique contributions to value.

On the other hand, Rule 4/ISR/NV of the RFM considers as an improper tax practice the deduction of royalties for the licensing of intangible assets that were migrated out of Mexico at a price below its arm's-length value and the deduction of investments that relate to intangible assets that belonged to a related party, under certain circumstances.

In the case of Argentina, the Argentine tax authority recently issued a resolution R. (4717) with detailed aspects to consider in testing the arm's length principle in situations involving intangibles assets, that span from the analysis of the local entity's contribution in the value chain of the asset, to the analysis of an appropriate level of advertising and sales promotion expenses.

Finally, Colombia has established specific deductibility limitations on royalty payments to abroad related parties related to intangibles formed in Colombia. This brings additional challenges since, in addition to acknowledge an arms'-length remuneration for DEMPE functions related to marketing intangibles, the interplay with this tax deductibility limitation should not be overlooked.

Gustavo Sanchez-Gonzalez

Partner

Baker McKenzie

T: +57 60 1 634 1571

E: gustavo.sanchez-gonzalez@bakermckenzie.com

Gustavo Sanchez is a member of Baker McKenzie's Tax Practice Group in Bogota. He is responsible for the TP practice in Colombia and the Andean Region.

Gustavo counsels companies from different industrial sectors in Latin America on TP, and advises on local and regional projects. He advises on TP policies to improve tax efficiency, facilitates advance price agreement negotiations with tax authorities, assists in technical and legal defense on TP disputes, and performs financial and economic valuation of shares, businesses and intangible assets.

Gustavo has been awarded the Tlacaelel National Award for Economics Consulting, the Inter-American Award for Research on Social Security, and the Consuelo Maeyer Award in Economics Research.

International audits and court cases related to marketing intangibles

Global disputes related to marketing intangibles became highly relevant in the last decades due to the growing importance of marketing intangibles worldwide. The US, Australia and India lead the list of jurisdictions with most cases or litigations related to the license, use or transfer of marketing intangibles between related parties.

In the US, the most relevant cases correspond to DHL (2002), Glaxo (2006) and Coca Cola (2020). In the first case, DHL US was required to make a TP adjustment and pay additional taxes for the sale of its 'DHL' trademarks to a foreign related party.

The IRS rejected the original price used by DHL and determined a new transfer price based on a valuation of such marketing intangibles, which was later affirmed by the US appellate court. In the Glaxo case, the IRS determined that taxes reported by Glaxo US were not consistent with significant investments in AMP activities made by Glaxo US during the audited years, which according to the IRS contributed significantly to increase in the local market the value of marketing intangibles (owned by Glaxo UK).

In 2006, the IRS announced it had reached an agreement ending the long-running dispute that forced Glaxo US to pay a record amount of taxes in the US. Finally, in the Coca Cola case, the IRS rejected the allocation of profits regarding the license and use of some marketing intangibles by Coca Cola US to Coca Cola Mexico.

The IRS proposed a TP adjustment based upon on the application of a residual profit split methodology (instead of the CUP and CPM methods selected by Coca Cola US), and then reallocated more profits and taxes to Coca Cola US, which was partially confirmed by the tax court.

In India, the tax authorities have conducted more than 20 audits related to marketing intangibles in the last decade. The most important cases involved Maruti Susuki (2010), LG Electronics (2013), Sony Ericsson (2015), Pepsico (2015), Whirpool (2016), Bausch & Lomb (2016), and BMW (2017).

In the aforementioned cases, the disputes focus on advertising, marketing and promotion (AMP) expenses incurred

Armando Cabrera-Nolasco
Partner
Baker McKenzie
T: +52 33 3848 5350
E: armando.cabrera-nolasco@bakermckenzie.com

Armando Cabrera is a partner and member of the Baker McKenzie firm since 2004. His practice focuses on TP documentation for regulatory purposes, controversy resolution, MAPs and negotiation of APAs for preventing or avoiding disputes with tax authorities. Armando also has extensive experience in valuation of business enterprises, tangible and intangibles assets for tax and non-tax purposes.

Before joining Baker McKenzie, he collaborated with Ernst & Young and the Tax Administration Service (SAT) in Mexico.

Armando regularly writes and publishes articles on TP matters in local and international magazines. Armando also participates as a regular speaker on international tax-related events. He is a professor and teaches the MAPs and APAs course on the international TP programme coordinated by the Anahuac University, European Business School and Baker McKenzie.

Katia Huezo Ponce
Associate
Baker McKenzie
T: +52 33 3848 5301
E: katia.huezo-ponce@bakermckenzie.com

Katia Huezo is an associate at Baker McKenzie's Tax practice group in the Guadalajara office. She has more than seven years of experience advising multinational companies on TP and valuation issues in Mexico and Latin America.

Katia has a degree in financial administration from the Tecnológico de Monterrey and is currently in the process of qualifying to obtain a master's degree in valuation, from the University of Guadalajara. In addition, she is a member of the Transfer Pricing Commission of the Guadalajara College of Accountants.

Katia focuses her practice on TP dispute resolution issues, designing and implementing TP policies, customs valuation and financial valuation of intangible assets, economic and financial consulting, as well as preparing TP documentation for tax purposes in Mexico and Latin America.

by local companies that, according to the authority, contributed to the creation of marketing intangibles owned by foreign related companies.

According to the India IRS, any expenditure on AMP activities that exceeded the line of appropriate expenses must be considered 'non-routine' expense that contributes to increase the value of marketing intangibles and, therefore, has to be reimbursed by the owner of such intangibles. To determine excess AMP expenses, the India IRS calculated the ratio of AMP expenses to net sales and compared them to the same ratio reported by comparable businesses –the famous 'bright-line test'. In some cases, the India IRS considers this type of AMP expense as an international transaction subject to TP regulations.

In Mexico, the SAT has carried out dozens of tax and TP audits related to marketing intangibles in an ongoing program focused on companies in the consumers goods, electronics, retail and high-tech sectors, particularly taxpayers which use or license marketing intangibles from a foreign related party (even if on a free-of-charge basis) and also incur in AMP expenses.

In all cases, the SAT initially rejected the deduction of 100% of AMP expenses because – in the SAT view – companies did not comply with formal deductibility requirements or because the AMP expenses were not strictly indispensable or the local company was not adequately compensated for its contributions to marketing intangibles of its group.

For the SAT, AMP expenses are not essential for the local company because they mainly benefit the owner of marketing intangibles (by increasing the value of the brand), in addition to the fact that, in the majority of cases, the local company already pays royalties for the use of said intangibles. Most of these cases have been resolved through settled agreements between the SAT and taxpayers.

With regard to this trend, while the Mexican Supreme Court has ruled that the expenses incurred by taxpayers in advertising are strictly indispensable, provided that they are incurred for the development of their activity for the purpose of reporting profits, in an isolated decision, the Tax Court ruled that advertising and promotion expenses are non-deductible for a company that sells products whose trademarks have been granted through a non-exclusive licensing agreement.

In recent cases, deviating from the aforementioned trend of denying the deduction of AMP expenses, the SAT rejected the methodology used by taxpayers to allocate the profits attributable to local wholesalers responsible of the marketing and sale of branded products of its foreign related parties.

According to the SAT, the local companies were not appropriately remunerated for its valuable (DEMPE) contributions to marketing intangibles developed locally, and thus it proposed a residual profit split methodology (instead of TNMM method) to determine the adjusted taxable profits.

Final remarks

The number and complexity of tax audits and controversies regarding MAP expenses and marketing intangibles is expected to continue increasing across Latin America. As the regulatory and auditing trends discussed in this article show, even the most simple business models that multinational groups adopt in the region, such as buy-sell distributors and licensed manufacturers, can be subject to significant tax assessments as a result of this type of audits.

Therefore, it is recommended that companies doing business in Latin America adopt a proactive approach that entails the preparation of robust defense files regarding marketing intangibles in addition to the standard TP documentation that is prepared annually for local compliance purposes.

In particular, taxpayers would significantly benefit from maintaining defense files with evidence of the legal and economic ownership of the relevant marketing intangibles, as well as a clear description of the DEMPE functions associated with them. In addition, relevant legal documentation pertaining to marketing intangibles such as trademark registrations and intercompany agreements, should be kept up to date and in a way that is aligned with the business model and the asserted ownership of the marketing intangibles.

Finally, careful consideration should be given to the possibility of requesting and negotiating unilateral or bilateral advance pricing agreements, in jurisdictions where this is a possibility, in order to achieve a robust level of certainty regarding the allocation of taxable income in the presence of marketing intangibles.

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