



Colombian TP-case highlights PLI-selection and proper substantiation of comparability adjustments

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Reading time: 10-15 minutes

Background

Industria Nacional de Gaseosas S.A. (“INDEGA”) filed its income tax return for 2010 and submitted a correction thereof in 2013. For transfer pricing (“TP”) purposes, INDEGA treated itself as the tested-party under the transactional net margin method (“TNMM”), using operating margin on operating costs and expenses (“ROTC”) as the profit level indicator (“PLI”). In 2013, the Colombian tax authority (“CTA”) issued a ruling proposing a higher tax payable, based on a revised analysis that substituted return on capital employed (“ROCE”) as the PLI. INDEGA appealed, defending (i) a comparability adjustment addressing differences in accounting presentation (Colombian GAAP vs. IFRS/US GAAP); and (ii) its use of ROTC as the PLI.

INDEGA had an advertising participation agreement with a related company, Coca-Cola Servicios de Colombia S.A. (“CCS SA”). The parties jointly funded marketing and advertising expenses related to brand positioning in the Colombian market. INDEGA received reimbursements from CCS SA for several advertising concepts, including purchasing refrigeration equipment and packaging, general marketing expenses, participation in sales discounts through promotional packages, and compensation for loss of marginal contribution due to price reductions.

In INDEGA’s financial statements, costs incurred for these items were recorded as expenses, and the reimbursements received were recorded as non-operating income. The expenses were therefore treated as pass-through items, intended to show no net effect on INDEGA’s profit and loss. Within INDEGA’s TP-model, INDEGA was the tested party for the TNMM with ROTC as the PLI.

The CTA questioned INDEGA’s TP-model, particularly the use of ROTC as the PLI. The CTA observed that INDEGA was working-capital-intensive and assumed significant risks. Based on this observation, the CTA concluded that ROCE was the appropriate PLI. Using its selected comparables and asset-based indicator, the CTA found INDEGA’s profitability to be below the interquartile range and concluded that INDEGA’s related-party transactions were not aligned with the arm’s-length principle. The CTA proposed an adjustment to INDEGA’s taxable income, using ROCE as the PLI. In the CTA’s view, the reimbursements that were treated as a pass-through element by INDEGA were relevant to the measurement of profitability.

Arguments of the taxpayer

INDEGA argued that ROCE was not the most appropriate PLI in its case, stating that the CTA had not considered the composition of tangible and intangible assets of the “comparable” companies. INDEGA further noted that, if the company’s situation were assessed using ROCE and the same comparables relied upon by CTA, the result would be consistent with the arm’s-length principle once a comparability adjustment was made.

INDEGA compared ratios involving non-operating income and noted that its non-operating income exceeded 9.0% in 2008 and 2009, and 7.0% in 2010, while the corresponding ratios for the comparable companies did not exceed 1.0%. According to INDEGA, the difference arose from the accounting treatment of the advertising

reimbursements from CCS SA. Under the Colombian accounting rules applicable to INDEGA, reimbursements for advertising expenses were classified as non-operating income. By contrast, the comparable companies applied International Financial Reporting Standards (IFRS) or Generally Accepted Accounting Principles (GAAP) accounting rules, under which reimbursements that were only linked to a company's income-producing activities were recorded as operating income.

INDEGA stated that this difference in accounting classification created a material comparability defect. INDEGA argued that an adjustment was required to treat the recovery of advertising expenses as operating income, so that the income/expenses (related to CCS SA) would be squared-off. This adjustment would effectively reduce the non-operating income of INDEGA. With this adjustment, INDEGA stated it complied with the arm's-length principle even if ROCE were accepted as the PLI.

Position of tax authorities

The CTA declined the proposed comparability adjustment, stating that INDEGA's TP-documentation did not support the adjustment. The CTA further argued that ROTC was not an appropriate PLI because INDEGA purchased raw materials from related parties.

Court judgement

The court considered expert evidence addressing differences between Colombian accounting regulations and IFRS/GAAP accounting rules, finding that the difference between INDEGA's accounting classification and the classification used by the comparable companies was attributable to the application of different accounting standards. The court noted that the marketing and advertising expenses shared between INDEGA and CCS SA were, by nature, operating expenses; due to domestic classification rules, their recovery appeared as non-operating income in INDEGA's accounts.

On this basis, the court concluded that INDEGA's operating profit could not be compared, without adjustment, to the operating profit of the comparable companies reporting under IFRS/GAAP accounting rules. Accordingly, the court ruled that the adjustment proposed by INDEGA was reasonable and justified to achieve better comparability between INDEGA and the comparable companies. The court observed that the adjustment would align the numerator and denominator of the relevant PLI(s) by ensuring that operating costs/expenses were compared against operating income across all entities in the set.

Observations

- Cost-based PLI (*e.g.*, ROTC) or asset-based PLI (*e.g.*, ROCE) mustn't be "tainted" by controlled transactions, such as reimbursements, raw materials purchased from affiliated companies, shared assets, etc., as this can distort the cost or asset base and undermine comparability.
- The case emphasizes comparability and financial statement presentation over the choice of PLI. By accepting the comparability adjustment, the Court implicitly recognized that accounting classification (expense vs. capitalized; COGS vs. OPEX) can materially swing outcomes under an OPEX-based PLI (*e.g.*, ROTC) and an asset-based PLI (*e.g.*, ROCE).

- The judgment indicates that the CTA did not evaluate the comparable companies proposed by INDEGA, nor did it provide a rationale for their rejection. At the same time, the CTA's own selection approach raised several methodological concerns that are instructive for practitioners.
 - o The CTA applied a quantitative filter excluding companies with an intangibles-to-sales ratio below 5% or above 20%. The record does not explain why both a floor and a cap were necessary, nor why 5% and 20% were selected. In a comparability analysis, such thresholds should be clarified.
 - o The CTA included a "comparable" companies (such as, National Beverage Corp.) that, based on the CTA's own search criteria, should have been excluded. In addition, it appears that data was used in determining interquartile ranges even though the data reported negative expenses due to a database error.
- Comparability adjustments can play an important role in aligning the tested party with the selected comparables. However, such adjustments must be fully substantiated in the transfer pricing documentation.
- In addition, comparability adjustments should not go beyond what is necessary to address material differences.

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