Growing Together

GUIDE

# Puerto Rico
## TRANSFER PRICING

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# Puerto Rico Tax Compliance Guide

By Torres CPA Group
**CifrasPR**

Understanding the Puerto Rico tax system and its interrelation with United States is crucial for individuals and entities doing business in Puerto Rico. Puerto Rico is not a state; it's a territory, with its own Business and Payroll laws and regulations.

The following White Paper is designed to give an insight Tax Issues in Puerto Rico. It provides relevant background information, which will be of assistance to organizations considering establishing business in the Island. Nonetheless, it is highly recommended to seek advice and counsel from qualified professional sources before undertaking any business.

Certain exclusions and exemptions may apply and when specific problems occur in practice, it will often be necessary to refer to the laws and regulations of Puerto Rico, and to obtain appropriate accounting and legal advice.

It is understood that the following overview does not constitute any formal rendering of either legal, accounting, tax or professional services. If legal advice or other assistance is required, an attorney, CPA or tax adviser should be consulted.

Torres CPA Group is an Advice Certified Public Accounting Firm offering Audit, Tax, Consulting and Financial Outsourcing services for over 33 years. If you require any further information or help, please do not hesitate to contact us.

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# TRANFER PRICING FUNDAMENTALS

## OBJECTIVES OF TRANSFER PRICING DOCUMENTATION

There are three targets objectives for requiring transfer pricing documentation.

- To provide with the information necessary to conduct an informed transfer pricing risk assessment.
- To ensure appropriate consideration to transfer pricing requirements in establishing prices and other conditions for transactions between associated enterprises and in reporting the income derived from such operations in their tax returns.
- To provide with the information required to conduct an appropriately thorough review of the transfer pricing practices of entities subject to tax in their jurisdiction.

## INTERNATIONAL INTERCOMPANY TRANFER PRICING

A transfer price is a price charged between related parties (e.g., a parent company and its controlled foreign corporation) in an intercompany transaction. Transfer prices directly affect the allocation of group wide taxable income across national tax jurisdictions. Hence, a company's transfer pricing policies can directly affect its after-tax income to the extent that tax rates differ across national jurisdictions.

A controlled transaction needs to meet the arm's length standard, as the revenue from the transaction has to be consistent with the income that would be realized if unrelated taxpayers had engaged in a comparable transaction under similar circumstances.

Typically, value can be characterized, and the comparability of an operation between unrelated parties is determined by factors including the assets used, the risks assumed, and the functions performed by each group member in an intercompany transaction

## THE ARM'S LENGTH PRINCIPLE

If two independent companies trade with each other, a market price for the transaction will result. It is known as "arms-length" trading because it is the product of a genuine negotiation in a market. This arm's length price is usually considered to be acceptable for tax purposes.

But when two related companies trade with each other, they may wish to artificially distort the price at which the trade is recorded to minimize the overall tax bill. They might, for example, record the profit as much as possible in a tax haven with low or zero taxes.

Imagine a company with a one-man booking office in the Tax-Free Islands, with no local sales. Under current "arm's length" rules, it can shift billions of dollars of profits into this office, and use this to cut its tax bill sharply.

## HERE ARE THE KEY ISSUES:

### Revenue basis

The related entity treats it in much the same manner as if it would pay the price for product or service sold outside of the company.

### Preferred customers

The entity has the choice of selling either to downstream related or outside customers; therefore, an excessively low transfer price will lead the manager to sell exclusively to external customers and to refuse orders originating from the downstream related.

### Preferred suppliers

The manager has the choice of buying either from an upstream subsidiary or an outside provider; therefore, an excessively high transfer price will cause the manager to buy exclusively from outside suppliers.

## TRANSFER PRICING METHODS

Here are some ways to derive a transfer price:

### Market rate transfer price

The simplest and most elegant transfer rate is to use the market price. By doing so, the upstream subsidiary can sell either internally or externally and earn the same profit with either option.

### Adjusted market rate transfer price

If it is not possible to use the market pricing technique, then consider using the general concept, but incorporating some adjustments to the price. For example, you can reduce the market price to account for the presumed absence of bad debts, since corporate management will likely intervene and force a payment if there is a risk of non-payment.

### Negotiated transfer pricing

It may be necessary to negotiate a transfer price between subsidiaries without using the market price as baseline. This situation arises when there is no discernible market price because the market is small or the goods are highly customized. Transfer Prices are based on the relevant negotiating skills of the parties.

### Contribution margin transfer pricing

If there is no market price at all from which to derive a transfer rate, the alternative would be to create a price based on a component's contribution margin.

### Cost-plus transfer pricing

If there is no market price at all on which to base a transfer price, you could consider using a system that creates a transfer price based on the cost of the components being transferred. The best way to do this is to add a margin onto the cost, where you compile the standard cost of a component, add a standard profit margin, and use the result as the transfer price.

### Cost-based transfer pricing

You can have each subsidiary transfer its products to other subsidiaries at cost, after which successive subsidiary add their costs to the product. The final subsidiary that sells the completed goods to a third party will recognize the entire profit associated with the product.

## APPROACH

Effective risk identification and assessment are crucial in the early stage of selecting an appropriate base for transfer pricing review or inquiries, and in focusing such reviews on the most important issues.

Proper assessment of transfer pricing risk requires access to sufficient, relevant, reliable information at an early stage and periodically updated.