



**GUIDE**

# Puerto Rico

**TRANSFERS PRICING**



(787) 752-4545  
info@torrescpa.com  
cpatorres@torrescpa.com

www.torrescpa.com  
P.O Box 4846, Carolina,  
PR 00984-4846

## **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; its's a territory, with its own Business and Payroll laws and regulations.

The following White Pater 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 30 years. If you require any further information or help, please do not hesitate to contact us.

**CPA William Torres Torres**  
**CPA Saudhi Soto Pagán**

[info@torrescpa.com](mailto:info@torrescpa.com)

PD: You can call me at my mobile 787-508-4545

## **Doing Business Within Cross-Border Controlled Related Transactions (CRT)**

Due to growing government deficits, many jurisdictions are putting additional pressure on transfer pricing to secure an entity's profits for their tax bases. This can result in the risk of tax assessments, double taxation on the same income by two jurisdictions, and penalties for failure to allocate income among two or more jurisdictions properly.

### **Transfer Pricing**

"Transfer pricing" is the general term used for cross-border pricing, associated enterprises, and intra-firm transactions between control-related parties. Transfer pricing, therefore, refers to the setting of prices for transactions between enterprises involving the transfer of property or services.

These transactions are also referred to as "controlled" transactions, as distinct from "uncontrolled" transactions between companies that are not controlled and can be assumed to operate independently "on an arm's length basis" in setting terms for such transactions.

Transfer pricing applies to a wide range of related parties' transactions, including transactions that involve the following:

- tangible goods (e.g., manufacturing, distribution)
- services (e.g., management services, sales support, contract R&D services)
- financing (e.g., intercompany loans, accounts receivable, guarantees, debt capacity)
- intangible property (e.g., licenses, royalties, cost-sharing transactions, platform contribution transactions, sales of intangibles).

The main concern regarding transfer pricing is manipulating prices either by paying too little or too much for goods and services, resulting in "shifting profits" from one location to another.

Thus, it becomes crucial to establish the fair price, called the "transfer price," by any Puerto Rico entity engaged in Business with controlled entities, cross-border transfers of goods, intangibles, and services.

## **Control Entity**

In general, a control entity has more than 50 percent of its voting power or value is owned. To determine status, one must consider all the facts and circumstances on how a person may effectively have control or ownership of the corporation.

The regulation that defines "controlled" includes: "... any control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose. It is the reality of the control that is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted". Thus, parties can be considered subject to transfer pricing even if one party has less than 50%, or even 0%, ownership in another party.

Stock owned directly or indirectly by the taxpayer's spouse, children, grandchildren, or parents are considered constructive ownership.

## **Contemporaneous Documentation Requirement**

There is a contemporaneous documentation requirement, meaning that the documentation must exist when the tax return is filed. The existence of documentation alone is not sufficient to avoid penalties. Taxpayers must prepare such documentation with the tax return's timely filing. Upon request from the Internal Revenue Service during an audit, taxpayers must produce all documents within 30 days.

## **Pricing Rules**

Pricing Rules and the Arm's Length Principle Importance to the Determination Transfer pricing has become one of the most critical Puerto Rico/USA tax issues. Transfer pricing rules apply to all sectors of the economy involving transactions between associated parties.

Transfer pricing adopted through the Associated Enterprises Entities (CRT) has a direct bearing on the profit it derives in each location in which it has operations. If inadequate or excessive consideration is paid for the transfer of goods and services (including intangible property/loans) between the CRT members, the income of each member's will not be consistent with their relative economic contributions.

Transfer pricing rules allow for the tax authority's discretion to adjust transfer prices for income tax purposes. There is either excess consideration paid, or inadequate consideration received by a taxpayer regarding an associated party cross border transaction.



## Arm's Length Principle

The arm's length principle is fundamental to transfer pricing and requires that transactions between associated parties are conducted at arm's length. This means that the transaction should have the substantive financial characteristics of a transaction between independent parties where each one aims to get optimum benefit from the transaction.

The arm's length principle is based on the notion that the market forces the operation to result in a valid return to participants' economic contribution within a given transaction. It seeks to remove the effect, if any, of shared ownership (i.e., the impact of control.) The proper return for economic contribution by each member of the CRT is determined in this way.

In simple terms, the arm's length principle attempts to replicate what independent enterprises would have freely determined concerning commercial and financial outcomes. This means that profits accrue to parties commensurate with relative economic contributions.



## Self-Assessment Transfers Pricing Practical Guide

Establishing appropriate transfer prices for tax purposes often involves applying judgment, and it depends on the taxpayers' particular circumstances. Therefore, transfer pricing is not an exact science, and the guidelines have been drafted as a practical guide rather than as prescriptive rules. It is not possible or practicable to prepare prescriptive approaches that attempt to deal with every transfer pricing issue that may arise.

### Four-Step Process

- Step 1: Understand the cross-border dealings between the associated enterprises (CRT) in the taxpayer's business context.
- Step 2: Select the methodology or methodologies.
- Step 3: Apply the methodology or methodologies.
- Step 4: Determine the arm's length outcome.

### Step 1: Understand the cross-border dealings between related parties in the context of the business

Identify cross-border dealings with associated enterprises and collect or maintain relevant documentation to explain the nature of those dealings in the context of the taxpayer's Business.

Undertake a preliminary functional analysis of the functions undertaken, risks assumed, and the assets employed to understand the Business, the selection, and the method that applies.

Taxpayers must understand the nature and extent of the cross-border transactions between the taxpayer and the associated parties within the taxpayer's business context.

A taxpayer needs to be able to explain the following at a high-level review:

- How the international related-party dealings of the enterprise are undertaken
- The purpose or object of the dealing
- What the taxpayer obtains from his participation in the dealings, such as products, services, or strategic relationships.
- The significance of the dealings to the taxpayer's overall business activities and those of the CRT.

## **Functional Analysis**

At this stage of the process, the taxpayer should consider a functional analysis and comparability in applying the arm's length principle. The taxpayer should develop a preliminary functional study to assess the broad functions performed by the relevant associates of the CRT. This will help determine an appropriate pricing method or the method stated in step 2 of the process.

The functional analysis should be broad and not comprehensive at this stage. The detail included in a fuller functional analysis is affected by a taxpayer's pricing method or methods. At this stage, the functional analysis aims to determine which method or methods are likely to be appropriate in the circumstances and the information that will be required to apply that method.

## **Comparable**

A taxpayer should now assess the potential comparable, which may be identified internally within the CRT if a member of the CRT transacts with an independent external party or by reference to transactions between independent external parties.

## **Step 2: Select the pricing method or methods**

Broadly identify any comparable uncontrolled dealings. Assess the reliability of the data on similar deals or comparable enterprises.

Determine the most appropriate methodology or methodologies based on the facts and circumstances of the case.

Ensure that sufficient documentation and data are available to support the application.

The arm's length principle is fundamental to transfer pricing and requires that transactions between associated parties be conducted at arm's length. This means that the transaction should have the substantive financial characteristics of a transaction between independent parties where each aims to get optimum benefit from the transaction.

## **Transfer Pricing Methods**

Several pricing methods have been developed in international practice for determining and appraising a taxpayer's transfer prices. These methods are based on measuring a multinational's pricing strategies against a benchmark of the pricing adopted by independent companies in uncontrolled transactions.

The regulations require that the application of a method or methods for determining an arm's length price must be made according to:

- The degree of comparability between the uncontrolled transactions used for comparison and the controlled transactions of the taxpayer
- The completeness and accuracy of the data relied on
- The reliability of all assumptions
- The sensitivity of any results to detect possible deficiencies in the data and assumptions.

### **Quality of the Data**

The application of these criteria will depend on the quality of the information available to the taxpayer. Thus, at this stage of the process, the taxpayer will need to assess its available data quality. This assessment should be made to determine which pricing method (or methods) is likely to provide the best reliability.

### **Step 3: Application of the pricing method or methods**

When a pricing method (or methods) has been decided, the preliminary functional analysis prepared in step 1 can be extended to reflect the method's choice.

Use the detailed data to extend and improve the functional analysis of the taxpayer and any comparable.

Refine, examine, and organize the data to enable comparability can be assessed.

Data points or a range of results may emerge.

### **Step 4: Determine the arm's length outcome**

Record practical considerations such as any judgments made and how data points or ranges were interpreted.

The taxpayer will be required to demonstrate how his data has been used to apply the chosen pricing method to determine an arm's length amount.

The updated process will allow the taxpayer to deliver an objective, documented, and well- thought review of the available material and possible choices for arriving at an arm's length outcome.



However, the nature of the arm's length principle could bring several practical problems in its application. Transfer pricing will always require an element of judgment, and taxpayers and FRCA need to bear this in mind in undertaking transfer pricing analysis.

It also needs to be noted that transfer pricing does not end with the initial analysis. Taxpayers will need to implement appropriate processes to:

- Ensure the availability of data for subsequent review analyses, and
- Allow modifications to be made in choosing and applying a pricing method that reflects changes in their circumstances or market conditions.

## Documentation

Documentation requirements establish that there must be a record in writing with sufficient information that verifies that controlled transactions are consistent with the arm's length principle.

While it is not possible to prescribe adequate documentation to cover all cases, the following may help ensure documentation packages' quality.

- Statement of the facts: Analysis of functions, risks, and assets including intangibles
- Industry analysis that identifies the key profit drivers, the performance of major competitors, and whether the value-added arises for the company
- Consideration of each category of associated party transactions
- Discussion on internal comparable, which means transactions with independent parties that allow comparison
- The reasoning for the selection of the most reliable pricing methods available
- Full details as to the comparable search undertaken, databases utilized, criteria employed
- Accept/reject list including reasons for rejection
- An analysis of why the companies selected are indeed comparable.
- An unadjusted income statement for each comparable with adjustments explained in detail.
- Conclusions, including sanity checks to demonstrate commercial realism

## Transfer Pricing Key Flag Indicators

In determining cases for review/audit from a transfer pricing perspective, the following are particularly relevant in the preliminary evaluation process. Note that a company with associated party cross-border transactions and any of the features listed below does not mean there are transfer pricing issues and automatic case selection.

- Company incurring ongoing losses
- Lower than expected profitability
- Dealings with associates in tax haven jurisdictions
- Poor compliance processes and records: the taxpayer has little or no documentation to support his dealings with associates or does not know the amount of reason for charges imposed.
- Intragroup charges, e.g., management/technical fees
- Large royalty payments and excessive debt levels (i.e., interest payments)
- Transfer of Intangibles
- Restructure of the Business

## Transfers Pricing IRS FAQs

Internal Revenue Service (IRS) has published the new Frequently Asked Questions (FAQs) list.

The United States (US) Internal Revenue Service (IRS) has published new, frequently asked questions (FAQs) that describe the best practices and common mistakes in preparing transfer pricing documentation.

The guidance is designed to encourage and help taxpayers prepare improved documentation to decrease the number of issues selected for examination and improve the chosen topics' examination efficiency.

The FAQs should be viewed in the context of the IRS's continued focus on improving transfer pricing compliance and the effectiveness of its transfer pricing enforcement rulings. While the IRS has done little to change the substantive transfer pricing rules during the last several years, it has changed to a risk-based issue identification process and has modified its examination process.

Taxpayers that wish to minimize the transfer pricing audit exposure and expenditures for audit defense may want to evaluate whether their transfer pricing documentation is consistent with the recommendations included in the FAQs.

### Summary of FAQs

The FAQ document includes six questions and answers, which are summarized below.

#### **Q1. What are the benefits of investing in robust transfer pricing documentation?**

According to the IRS's answer to this question, "robust transfer pricing documentation facilitates more efficient transfer pricing risk assessments and examinations for both taxpayers and examiners."

In addition to protection against penalties under Section 6662(e)(3)(B), the IRS notes that transfer pricing reports that comprehensively document the reasonable selection and application of a transfer pricing method help demonstrate low compliance risk and support early deselection of the transfer pricing issue from further examination.

## **Q2. How can a "self-assessment" help identify potential issues?**

The IRS encourages taxpayers to consider conducting a "self-assessment" of potential indicators of transfer pricing non-compliance to anticipate concerns that the IRS might raise. The self-assessment should start with a sensitivity analysis of the parameters used

(e.g., removing just one company from the comparable company set to cause the tested party's results to fall outside the benchmark range). The self-assessment could also include comparing the tested party's results against various profit level indicators (PLI) to ensure the taxpayer's selection of PLI is fully supported. A self-assessment might also include proactively evaluating how system profits are shared between related parties and addressing whether such allocations are reasonable based on each party's contributions.

## **Q3. What is the IRS's "guiding principle" in evaluating arm's-length pricing?**

The IRS states that its "guiding principle" ensures that taxpayers comply with Section 482 and its regulations. Under the arm's-length standard, taxpayers must determine the best method and use that method to check that the controlled prices applied achieved results consistent with those that would have been achieved if uncontrolled parties had engaged in the same transactions.

The IRS acknowledges this is often complicated by the inability to find direct and close comparable companies. The IRS states that when there are imperfect but good, similar companies, comparability adjustments should be applied rationally and consistently and follow the basic economic principles included in Section 482 regulations. Also, taxpayers must have a thorough analysis of how and why comparability adjustments were selected and applied.

## **Q4. In what areas of transfer pricing documentation have the IRS identified the need for improvement?**

The IRS describes several specific areas of transfer pricing documentation that could benefit from improvement:

1. Industry and company analysis sections of the report should be clear and provide context for related-party transactions.
2. Functional analysis narratives should be robust and link facts to analysis.
3. Risk analysis should be consistent with intercompany agreements.
4. Support for best method selection must be provided, and the reason for rejecting specified methods.

5. Analysis should be provided to support the PLI conclusion.
6. Complete comparability analysis should be provided.
7. The impact of differences in risks or functions between the tested party and the comparable companies should be provided.
8. Detailed, well-reasoned support for proposed adjustments to applying a specified method should be provided.

**Q5. How can a taxpayer present its intercompany transactions in a way that will facilitate an examiner's risk assessment?**

In general, the IRS advises that making transfer pricing documentation more "user friendly" will cause the IRS's review and assessment more efficient. Providing a simple summary of the intercompany transactions at the beginning of the transfer pricing documentation can help IRS examiners understand the taxpayer's trades and focus on the most significant transactions.

**Q6. Can you provide an example of a presentation of a company's intercompany transactions that would be a helpful summary for examiners to use in risk assessment?**

Providing a simple summary of the intercompany transactions at the beginning of the transfer pricing documentation helps IRS examiners understand the taxpayer's transactions.