



## Tax Newsletter

Timely news and information on national tax issues

# Transactions that do not comply with the arm's length principle or market value. What are the consequences? What should be done?



As we know, the premise of transfer pricing is that transactions performed between related companies are agreed upon at similar prices to those that would have been agreed upon between independent companies, as legally required by article 62-A of the Tax Code (TC), and which is known as the **arm's length principle**.

After almost 15 years since the Transfer Pricing Regime went into effect in El Salvador, we can still observe transactions between local and foreign related companies that do not comply with the arm's length principle, which implies tax contingencies for these companies.

Among some of the most common intercompany transactions in which the arm's length principle or market value is not yet applied, we can mention the following examples:

1. The providing of specialized services between related companies in which only the cost associated with these services is affected without any profit margin, and in some cases, the cost incurred is not transferred;

2. Loans or transfers of funds are provided without agreeing on a market interest rate and the recovery of the funds is deferred over time;
3. Sales of assets made at book value;
4. Sales of inventories below the production/acquisition cost, among others.

These situations would not occur in the same way if they were transactions between third parties. In this article, we will specifically discuss the providing of services without charging an arm's length margin on the costs incurred.

Mainly, but not always, in multinational groups or groups of local companies, one of the companies (generally the controlling company or parent company) usually provides a set of specialized services to the other entities of its group, or performs coordinating, management and control functions of the group, as mentioned in Chapter VII of the OECD Guidelines. Therefore, it is first necessary to define whether this is a

transaction consisting of the providing of services (for more details on this process, please consult the following publication: [Intra-group service transactions](#)).

Once it is defined that it in fact refers to the providing of services between related companies, the company providing the services should transfer the costs associated with the service (salaries, travel expenses, and resources, among others) by adding a market margin that compensates the functions performed and the risks assumed in favor of its related company. However, as we have mentioned, there are still cases where only the costs are transferred without any margin, and sometimes the service provider even assumes the costs involved, thus generating a clear contingency that could result in an income tax adjustment.

## What do the OECD Guidelines indicate?

The chapter mentioned above indicates that *"the charge for intra-group services should be that which would have been made and accepted*

*between independent enterprises in comparable circumstances. Consequently, such transactions should not be treated differently for tax purposes from comparable transactions between independent enterprises...”*

In addition, it mentions that: *“In trying to determine the arm’s length price in relation to intra-group services, the matter should be considered both from the perspective of the service provider and from the perspective of the recipient of the service. In this respect, relevant considerations include the value of the service to the recipient and how much a comparable independent enterprise would be prepared to pay for that service...”*

Therefore, the arm’s length price should be based on the costs associated with the services, plus the profit margin that compensates the type of functions and risks assumed by the service provider.

### **What is the position of the Tax Administration?**

The Tax Administration’s course of action in its making of transfer pricing adjustments has been based mainly on

articles 62, 62-A, 199-A and 199-B of the TC. These articles give it the authority to determine the tax base and the market prices that should have been agreed upon by the taxpayers in the providing of the services, whether through comparisons to other service providers of the same nature, or other methodologies.

The tax authorities have applied many adjustments to the obtaining of income due to taxpayers not having determined market prices when agreeing upon a transaction between related parties, with such authorities subsequently applying the respective additional income tax. In our experience, we have been able to observe adjustments to taxpayers’ income, costs and expenses because they cannot prove that their transactions have been agreed upon at market values.

### **What do we recommend?**

If you find yourself in any of the situations described in this article, it is important to start rectifying the prices agreed upon in your transactions with related companies, in order to mitigate tax contingencies.

Depending on the nature of the transaction performed, that is how a tailored solution should be sought. For example, for charges for specialized services, a guide that could be followed for its rectification is:

- 1. Identify the type of service:** This refers to validating if there is in fact a providing of intra-group services or if corresponds to shareholder activities.
- 2. Classify the services according to their nature:** Based on the functions performed, there are different services that are usually provided between companies, for instance, administrative services, marketing services, and technical services, among others.
- 3. Determine the market price:** First, the costs associated with the services provided, among these, salaries and travel expenses, among other benefits, should be identified. Subsequently, the market margin is allocated, based on the nature of each service, identified in point 2.
- 4. Invoice the services to the related company:** Finally, once the market value of the services is determined,

these should be invoiced to the related entity and the corresponding must be taxes paid.

Additionally, based on our experience, we can confirm that as a result of this advisement for the mitigation of contingencies, it is also possible to identify tax optimization opportunities for the companies.



It is important that **taxpayers rely on their transfer pricing advisors**, with the purpose of rectifying any transaction that is being performed outside of compliance with the arm's length principle, or simply validating whether their transactions with related parties are being appropriately performed, in order to mitigate any risk of adjustment by the tax authorities.

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Tax Obligations before the Tax Office (Ministerio de Hacienda)



Municipal Tax Obligations



Payroll Management Obligations

July 2024

S	M	T	W	T	F	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30	31			

To learn more about **July's** obligations:



Download the 2024 Tax Calendar

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