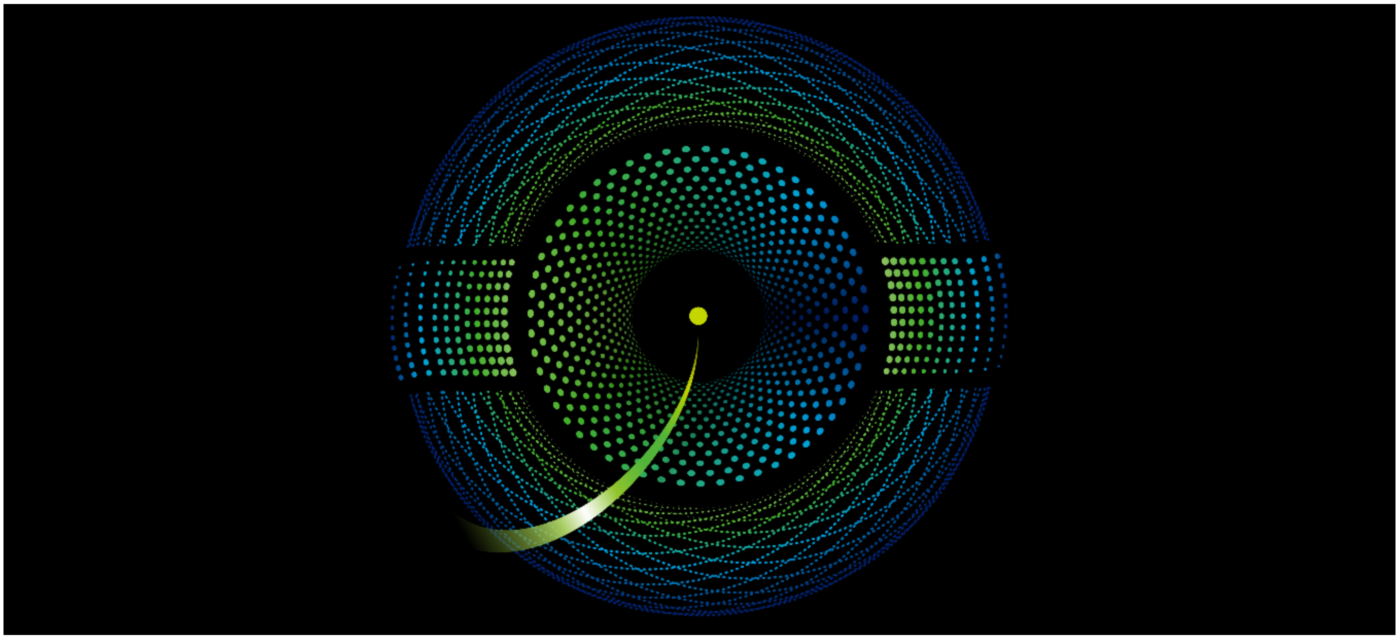


Tax Newsletter

Timely news and information on national tax issues

Cost Contribution Arrangements and analysis of compliance with the arm's length principle

During the normal course of the various transactions between companies, there are some types of transacions that can be carried out jointly. These types of joint business ventures may include development activities (for example, R&D and marketing), development of intangibles, tangible assets and other joint services.

Based on the above and as a common practice, domestic and international business groups require and benefit from the performance of these types of activities. Strictly speaking, independent companies will require that the value of each participant's proportionate share of the total contributions to an arrangement be consistent with its proportionate share of the overall expected benefits to be received under this arrangement.

The economic principle of Cost Contribution Arrangements (CCAs) is exactly the same as the economics of a Profit Split. Therefore, an arm's length CCAs should replicate the results of a transactional or residual profit split instead of the results of a series of transactions.

Through this document we shall analyze the different reasons that allow for determining whether the conditions established by related parties for transactions covered by a CCAs are consistent with the arm's length principle, mainly based on the OECD Guidelines[1] and on compliance with the local Transfer Pricing regulations.

[1] OECD Transfer Pricing Guidelines, January 2022.

Main issues to be analyzed in CCAs

By definition, a CCA is a contractual arrangement among business enterprises to share the contributions and risks involved in the joint development, production or the obtaining of intangibles, tangible assets or services with the understanding that such intangibles, tangible assets or services are expected to create benefits for the individual businesses of each of the participants.

Based on this definition, the main issues to be analyzed in terms of Transfer Pricing are focused on (a) the commercial or financial relationships between the participants and (b) the contributions they make, verifying that such contributions are consistent with the expected benefits.

The main characteristics of these CCAs include:

1. Sharing the contributions: the contributions to the CCA should be consistent with the proportionate share of the expected benefits.

2. Benefits (income): future and in some cases immediate benefits.

3. Compensation: additional consideration or balancing payments

4. Simplification: A CCA could be the means for replacing a series of intragroup payments, with a mechanism for more streamlined payments.

5. Types of CCAs: The first type ise related to the development of assets, and the second type is related to the providing of services.

Once the nature and characteristics of the CCAs are defined, as mentioned above, it is necessary to determine the application of the arm's length principle to the transactions covered by those agreements. According to the OECD Guidelines:

"For the conditions of a CCA to satisfy the arm's length principle, the value of participants' contributions must be consistent with what independent enterprises would have agreed to contribute under comparable circumstances..."

Application of the arm's length principle

Given the above, in order to apply the arm's length principle in these transactions, it is necessary to follow the following steps:

1. It is necessary that all parties to the CCA have a reasonable expectation of obtaining benefits. Therefore, this step involves the analysis of the commercial and financial relationships of each participant, including the capacity to assume risks in the transaction.

2. Calculate the value of each participant's contribution to the joint activity. All the contributions of the participants, whether of pre-existing rights or of development activities, should be recognized at their fair value instead of cost (unless there is some exception).

3. Determine whether the allocation of CCA contributions (as adjusted for any balancing payments) corresponds to the share of expected benefits.

Expected benefits

In services CCAs, this consists of determining the proportionate share of the benefits that the participants expect to obtain by using a relevant allocation key. The possibilities for allocation keys include sales (turnover), profits, units used, produced, or sold; and number of employees, among others.

In development CCAs, the allocation of contributions will take into account projections about the participants' shares of those benefits, which should be periodically reviewed.

Value of each participant's contribution

According to the arm's length principle, the contributions should be valued based on their value at the time of the contribution. To determine the fair value of the transactions, different alternative valuation methods may be used.

One of the most used techniques is Discounted Cash Flow (DCF) or Net Present Value (NPV), which is based on various financial projections and assumptions and uses a discount rate to determine the value of an asset at a specific date. For the case of intangible assets, companies may follow the guidance in the OECD Guidelines, in Chapters I to III and Chapter VI, including when applicable, the use of the alternative valuation techniques.

Relevant information for the initial terms of a CCA

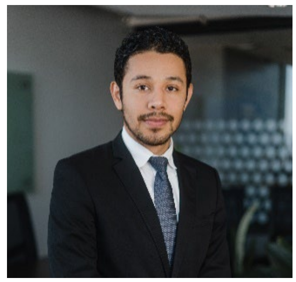
In general terms, CCAs between related parties must meet the following requirements:

- Identification of the parties.
- Definition of the scope of the activities and specific projects covered by the CCA.
- Manner in which the expected benefits will be measured.
- Form and value of each participant's contributions (balancing payments).
- Nature and interest of each participant in the outcomes and benefits of the activity.
- CCAs must be reported in the Master File and Local File. The transactions deriving from a CCA should be included in the corresponding informational returns.

Local legal framework

In El Salvador there is no specific legislation for the analysis of transactions under a CCA; however, in the context of the Salvadorian legislation, in accordance with article 62-A of the Tax Code, and just as for any other type of transaction performed between related parties, the transactions deriving from a CCA (income, expense, asset or liability) must comply with the arm's length principle.

Finally, these transactions must be reported as part of the TP Form F-982. For the 2021 fiscal year, the deadline for the obligation to file this TP Form is 31 March 2022.



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Tax Calendar March 2022

The updated 2022 tax calendar is now available on the Tax Administration's website, which includes public holidays and deadlines for all tax obligations.

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		

Download the 2022 Obligations Calendar

March 14

VAT

Declaration and payment of the Tax on the Transfer of Movable Goods and the Rendering of Services (F-07).

Financial Income and Transactions

Monthly declaration of Payment on Account, and Tax Withheld on Income, Financial Transactions, and the Special Contribution for Citizen Security and Coexistence (F-14)

Specific and Ad Valorem Taxes

Declaration and payment of Specific Taxes, Ad Valorem Taxes and Special Contribution (F-06).

Other obligations

- Report on Donations (F-960)
- Report on Specific and Ad Valorem Taxes on Producers and Importers of Alcoholic Beverages, Potable Ethyl Alcohol and Beer, Carbonated Beverages, Isotonic Beverages, Fortified Beverages or Energy Drinks, Juices, Nectars, Soft Drinks and Concentrated or Powder Mixtures for the Preparation of Drinks (F-955).
- Report on Specific and Ad Valorem Taxes on Producers and Importers of Firearms, Ammunitions, Explosives and Similar Items, Producers of Tobacco and Producers, Importers and those that clear fuels through customs (F-988).
- Monthly Report of Sales to Producers, Distributors or Retailers of Tobacco and Tobacco Products (F-956)

March 21

VAT

Monthly Report on Withholdings, Collections, or Payments on Account of VAT (F-930).

Printing Presses

Monthly Report on Documents Printed for Taxpayers Registered under the VAT (F-945).

March 31

Other Obligations

- Report on transactions with related parties or parties domiciled, established or located in countries, states or territories with preferential tax regimes, of low or zero taxation or tax havens. (F-982)

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