

Tax Newsletter

Timely news and information on national tax issues

Common errors in Transfer Pricing documentation and analysis

As of the closing of the fiscal year 2020, the taxpayers that have had 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, should consider and review the Transfer Pricing related aspects of these transactions in order to comply with the formal obligations for such fiscal year.

In general terms, local regulations require that taxpayers that have performed intercompany transactions have the documentation, information and evidence that support their compliance with the obligation established in article 62-A of the Tax Code.

Part of this documentary evidence consists of the preparation and presentation of the Report on Operations with Related Parties (Report F-982) and preparation of the local Transfer Pricing Study (local file). Such TP study should be performed taking into account

the complexity and volume of the transactions, and include all those technical aspects applied for determining the correct valuation of the intercompany transactions, to ensure proper compliance with the arm's length principle.

To that end, following, we describe some common errors that we have observed in the preparation of the documentary evidence and/or in the Transfer Pricing analysis.

1. Incorrect selection and rejection of the Transfer Pricing Method

The selection of a transfer pricing method always aims to select the most appropriate method for the specific circumstances being analyzed. In order to achieve this objective, the taxpayer and/or transfer pricing consultant should consider, at a minimum, the following:

- the advantages and disadvantages of the different methods;
- the correct nature of the transaction (determined through the functional analysis);
- the availability of reliable information (financial information and comparable information); and
- the degree of comparability (including the reliability of the making of reasonable adjustments).

Based on the above, it is necessary to indicate that although there is no single method that is appropriate for all situations, it is essential to analyze the characteristics of each method in order to apply the most appropriate one for the conditions of the tested party.

In this respect, one common mistake is to resort to a profit-based method (for instance, the TNMM) just because the data related to the transactions with non-related parties (internal comparable) are difficult to obtain or are incomplete in some aspect.

On the other hand, once you have internal comparable information and apply a direct transaction-based method (for example, CUP), it is necessary to consider whether the selected comparable reliably meet the comparability criteria. A common mistake here is related to the inappropriate selection of the internal comparable information or a selection of samples without taking into account an objective assessment.

It is very common that in transfer pricing analysis based on internal information, a sample of the available information is used, mainly due to the amount of information that could be generated due to the circumstances. This aspect should be treated with care and precision since the results obtained based on samples could differ from those obtained based on one hundred percent of the potentially comparable information. In any event, the rejection of any potentially comparable information should be justified in the analysis performed.

2. Functional analysis versus characterization

In transactions between two independent companies, the remuneration usually reflects the functions

performed by each company (considering the assets used and risks assumed). Therefore, in order to define the nature of the transaction (characterization), it is necessary to perform an adequate functional analysis, which should be focused on what the parties involved actually do and on the capabilities they contribute to the value chain of the economic group.

In this respect, one of the main errors is the little consideration given to risk analysis. Unless the main risks assumed by each party are considered and identified, the functional analysis is incomplete since effective risk taking influences prices and directly affects the profitability of the transactions.

In addition, it is very common to find Transfer Pricing Studies with a specific characterization of the tested transaction that is not supported with a proper functional analysis, or a functional analysis that contradicts the type of characterization given to the transaction.

This means, for example, that the taxpayer concludes that the company, business segment or transaction corresponds to a full-fledged distributors (that is, enterprises with a relatively higher level of functions and risks) when the functional analysis indicates that it refers to a transaction with a limited-risk distributors (that is, enterprises with a relatively lower level of functions and risks).

Consequently, these items would alert the Tax Authority to reconsider the analysis performed and/or the Transfer Pricing Method applied.

3. Omission of the use of internal comparables

The comparability analysis, constitutes the core of the application of the arm's length principle. In this analysis it is important to consider two key aspects. The first one is to identify the commercial or financial relationships between the related-parties, and the second one is to compare the economically relevant conditions and circumstances with those of the comparable transactions performed between third-parties.

In Transfer Pricing analysis, a common mistake that has become a practice is the use of external comparables,

without a previous analysis of the possibility of the use of internal comparables.

Therefore, it is important to remember that internal comparables may be more directly and closely related to the tested transaction than external comparables. The financial analysis would be simplified and more reliable because it is supported with practices and criteria “theoretically” identical to the internal comparables and the intercompany transaction.

Notwithstanding the use of internal comparables, when these are available, the taxpayer or consultant should ensure that they satisfy the comparability factors in the same way as the external comparables and that guidelines have been applied to the comparability adjustments that may be applicable.

As a matter of principle, whenever there are reliable internal comparables, they should prevail over the use of external comparables. Thus, the use of external comparables could end up being unnecessary.

4. Incorrect selection of external comparables

In the absence of reliable internal comparables or any internal comparables, in the Transfer Pricing analysis it is possible to apply the methodology by making use of external comparables (usually obtained from international databases).

One common mistake in the process of selecting comparables from external data sources is that the results obtained from the comparable information do not objectively and reasonably satisfy the comparability criteria in accordance with the circumstances being analyzed.

In general terms, these types of errors are related to the following aspects:

1. Incorrect characterization (functional analysis). The selected comparables do not have functions, assets and risks similar to those of the tested party.
2. Incorrectly applied search strategy. This process should consist of focusing the search for comparables by consulting various sources of information in public databases and applying an

objective selection process. It is common to find a series of limitations in the different databases, since they present information for the general public and not necessarily for transfer pricing purposes.

3. In practice, basing the comparability analysis on a single commercial database could lead to doubts regarding the reliability of the analysis, due to the quality of accurate information that can be obtained.
4. To refine the search for externally comparable information, it is necessary to use other types of publicly available information. This refinement in the search for information in the databases with other sources of information seeks to prioritize quality over the standard criteria and is valid for the taxpayer, consultants, and Tax Administration.
5. Another common mistake in the use of information from commercial databases is related to the review of the financial information. Commercial databases do not always contain sufficiently detailed information to justify the transfer pricing method selected or detailed information for making accounting reclassifications according to the accounting framework of the tested party. This process implies a detailed review of the financial statements of the external comparables (using other sources of public information) that is not normally performed by the taxpayers or is incorrectly performed by the external consultants. The above would result in mistaken conclusions and risks of modification of the results by the Tax Authority.
6. The rejection of comparable companies may be entirely justified if they do not satisfy the comparability criteria for the tested transactions. However, one of the main errors in this respect is the lack of appropriate documentation of this process. In general terms, the taxpayer and/or

consultants should document the process for the selection or rejection of comparables in order to demonstrate to the tax authorities that these results comply with the specific requirements, according to the transfer pricing method applied.

7. Another common mistake is the “non-exclusion” of companies located in a preferential tax regime or tax haven, as part of the companies selected as comparables. According to article 199-D of the Tax Code, the transactions performed with parties domiciled, established or located in countries, states or territories with preferential tax regimes, of low or zero taxation or tax havens, do not constitute transactions between independent parties.

5. Application of adjustments of capital accounts (economic adjustments) without proper justification

For Transfer Pricing purposes, being comparable means that none of the possibly existing differences between the situations being compared can significantly influence the condition being examined, or that sufficiently accurate adjustments can be made to eliminate the effect of such differences.

A common mistake in this step is the application of economic adjustments (accounting adjustments, capital adjustments, etc.) without proper justification and/or documentation; that is, there is no reasonable business criterion that seeks to improve the comparability.

The fact that these adjustments are made in practice does not mean that they should mandatorily or routinely be made. On the contrary, it is advisable to test whether the proposed adjustment improves comparability (as with any adjustment).

In principle, if the relevant conditions of the related party transaction (for example, the price or the margin) is within the arm’s length range, it would not be necessary to make adjustments.

Adjustments are not always justified. For example, an adjustment made to “accounts receivable” would not be especially useful when there are substantial differences in the accounting criteria that cannot be resolved.

Similarly, sometimes sophisticated adjustments are made in order to create the false impression that the result of the search for comparables is “scientific,” reliable and precise.

6. Performance of global analyses versus segmented transactions

In this respect, it is necessary to indicate that it would be inappropriate to apply a profit-based method (for example, TNMM) at the level of the whole company if it performs different related party transactions that cannot be compared on an aggregate basis with those of an independent company. In principle, the income, costs and expenses not related to the tested transaction should be excluded when they significantly affect the comparability of the transactions.

Therefore, in order to determine the net benefit that the taxpayer obtains from a related party transaction, it is necessary to have a certain degree of segmentation of the financial information.

Likewise, upon analyzing the transactions between independent companies, those benefits attributable to transactions that are not similar to the related party transactions being tested, should be excluded from the comparison. Finally, the result of the transactions (of the independent companies) should not be distorted by the related party transactions of that company.

Another common mistake is the inclusion of elements not related to the ordinary operation or business activity, such as income and expenses from financial interest and income taxes. In general terms, those exceptional and extraordinary items of a non-recurring nature should also be excluded from the calculation of the net benefit. This last point requires a specific review of these items, based on the circumstances analyzed.

7. Inconsistencies between report F-982 and the Transfer Pricing Study

According to local regulations, report F-982 should be submitted no later than within the first three months following the end of the fiscal year (Article 124-A of the Tax Code). Prior to submitting this report, the taxpayer should have the final version of the Transfer Pricing

Study, in order to report the correct information in report F-982.

However, in practice, it is common to find inconsistencies between the final version of the Transfer Pricing Study and report F-982, which may be due to various reasons, for example the filing date of the audited financial results.

Based on the above, it is important to make sure that the results from both reports are consistent, since any difference would be questioned by the tax authorities and there would be the risk that this discrepancy could be interpreted as a filing of report F-982 without compliance with the minimum specifications required by law (Art. 124 I of the Tax Code).

Final comments

Oversight actions are not just limited to the verification of compliance with the formal obligations (filing of report F-982 and preparation of the Transfer Pricing Study), since reviews are also focused on the verification of the technical framework used. Any mistakes such as those previously mentioned, would lead to questioning of the taxpayer and, in the worst case, a reconsideration of the conclusions obtained, resulting in greater tax due for companies.

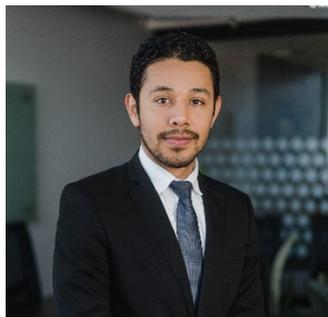
Due to the above, it is important for taxpayers (together with their consultants) to these aspects in order to ensure proper with the Transfer Pricing regime and reduce any type of tax contingency.



Federico Paz
Tax Partner
fepaz@deloitte.com



Mario Coyoy
Transfer Pricing Partner
mcoyoy@deloitte.com



Wilmer García
Transfer Pricing Manager
wsgarcia@deloitte.com
www.deloitte.com/sv

Tax Calendar

December 2020

The updated 2020 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
2020 Obligations Calendar

Descargar Calendario
de Obligaciones 2020



December 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)

December 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)

December 24 - 31

Christmas and New Year's holidays

Contacts

Federico Paz

Tax Partner

fepaz@deloitte.com

Ghendrex Garcia

Tax and BPS Partner

ggarciaq@deloitte.com

Mario Coyoy

Transfer Pricing Partner

mcoyoy@deloitte.com

Cosette Fuentes

Legal Services Manager

cg.fuentes@deloitte.com

Henry Aguirre

BPS Manager

haguirre@deloitte.com

Alvaro Miranda

Transfer Pricing Manager

ajmiranda@deloitte.com

Wilmer Garcia

Transfer Pricing Manager

wsgarcia@deloitte.com

Jhonny Flores

Tax Consulting Manager

jflores@deloitte.com

Daysi Acosta

Tax Compliance Manager

daacosta@deloitte.com

Mantente informado.
Descubre Deloitte tax@hand

Descarga la APP



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