Tax Newsletter

Timely news and information on national tax issues

Transfer Pricing considerations related to intragroup financial transactions

Financial transactions between independent parties are based on various commercial considerations, and normally both parties seek to maximize their profitability. However, members of an MNE Group[1] have the flexibility and discretion to decide upon the conditions that will apply to the financial transactions performed between companies within such group. As result, in this intragroup situation, the tax consequences of the Transfer Pricing policies applicable to these types of transactions should be taken into account, considering their structure and nature.

In different MNE Groups, financial transactions play an important role in their commercial transactions, with these services typically playing a supporting role in the companies' value chain.

In general terms, financial transactions between related parties, as with any other intragroup service transaction, will be subject to compliance with the arm's length principle. Consequently, the first consideration for these transactions requires an accurate delineation of its economic substance (real transaction), including the justification of its purpose in the context of the business of the MNE Group.

[1] For purposes of this document, the Multinational Enterprise Group in question are those not normally engaged in financial intermediation, that is, non-banking, non-insurance or other similar companies.

In an intragroup context, the most common financial transactions include intercompany loans, cash pooling, treasury and financial derivative services such as foreign currency transactions, options on shares, forward contracts and other hybrids. In this document, greater reference is made to "*intragroup loans*" since it is one of the most common transactions between related companies; however, similar considerations may apply to other types of financial transactions.

1. Characterization

One of the most relevant aspects in the financial transactions is the determination of their actual economic circumstance or characterization. The alignment of this characterization should consider the current focus of the Transfer Pricing regulations and of the criteria of the tax authorities, applicable to similar transactions.

Based on the above, the taxpayer could characterize the transaction as a loan, but the economic facts and circumstances, additional information and behavior between the related parties could lead to a different conclusion.

The relevant evidence in the characterization could, for example, include an analysis of the debt capacity of the borrower, purpose of the investment, commercial strategy and security offered (credit risk). In such cases, it is possible that for Transfer Pricing purposes, the transaction is partly treated as a loan and partly as something other than a loan, for example, as a capital contribution.

Following is a general list of the significant economic characteristics of a financial transaction that should be considered when evaluating these transactions for Transfer Pricing purposes:

- Contractual terms;
- Functional analysis;
- Risk analysis between the parties;
- Determination of the financial characteristics of the product or service;
- Economic circumstances;
- Business strategies;

2. Consideration of solvencies and risks

For purposes of aligning the real financial transaction and, consequently, being able to properly select comparable to use in the Transfer Pricing analysis, an analysis of creditworthiness is relevant. In the case of intragroup loans, this analysis implies, among others, the consideration of the loan security (that is, the guarantees the borrower can offer) and consideration of the future cash flows for paying interest and repaying the principal amount of the debt. One way of assessing debt capacity is to look at the credit rating of the debtor, which reflects the credit risk for the creditor extending debt to the counterparty.

The credit rating expresses the probability of default, and thus, the risk to the potential lender. Credit risk can be measured by assigning a rating (that is, credit rating) to the debtor or to a specific instrument issued by the debtor. In some cases, these ratings may be derived from independent commercial credit rating agencies (Risk Rating Agencies). In other cases, some companies have also developed in-house commercial tools that can be used for credit rating purposes; however, this last methodology should include qualitative and quantitative factors.

In addition to the above, it could also be relevant to consider the risk of an entity that operates in a particularly risky country (that is, the risk deriving from a country's business environment, including the legal environment, levels of corruption, and socioeconomic variables), to the extent that this is not already reflected in the credit rating of that entity (debtor).

3. Selection of the Transfer Pricing method

With respect to financial transactions between related parties, the most commonly used method is the Comparable Uncontrolled Price Method ("CUP").

CUP can be used when there are comparable transactions between one party of the intragroup loan transaction and an independent party ("internal comparable") or between two independent parties, neither of which is part of the intragroup loan transaction ("external comparable").

In a loan transaction between related parties, CUP can be applied, with the selection of financial instruments and/or loan transactions agreed upon between independent parties.

In regard to the application of this Transfer Pricing method, the basic determination of the cost of the debt (price) of these transactions can be based on the consideration of the following items:

a) For certain loan transactions, (for example, loans between entities domiciled in the country), internal transactions performed by the taxpayer, quotes with local banks or financial information of the Central Reserve Bank can be evaluated.

b) For transactions in which the debtor is located in a different country than the creditor, an alternative for the analysis of the arm's length principle in the cost of the debt may include the consideration of the following items:

    I. Risk-Free Rate (for example, LIBOR rate);
    II. Yield or margin (basis points according to the financial or debt instrument);
    III. Spread or credit risk of the debtor;
    IV. Country risk (in the event it is not included in the credit risk);

The selection of comparable (financial instruments), in general terms will depend on the characteristics of the transaction (see section 1 "Characterization"), that is, its functional analysis. The application of adjustments in the determination of the price (cost of the debt), will also depend on the risks assumed between the parties and the economic risks of the transaction.

In other types of financial transactions, for example, cash pooling, it is possible that the functions performed do not add value; therefore, a remuneration at cost may be considered. In other cases, the application of a Cost Plus Method (CPM) or a Transactional Net Margin Method (TNMM) may be required if the functions performed add value and require the determination of an arm's length remuneration (*Mark Up*).

4. Tax Considerations

According to local laws, among the main tax aspects to be considered by taxpayers in financial transactions, with respect to income tax matters, are the following:

Law	Scope of Application
Art. 16 of the LISR [2]	Interest income and its possible consideration of taxable income in El Salvador
Art. 158 CT [3]	Withholdings on non-domiciled parties
Art. 158-A of the CT	Withholdings on parties located in some preferential tax regimes (tax havens)
Art. 74-A of the LISR	Withholdings for the granting of loans, mutual agreement or advances or any other way of financing
Art. 29 numeral 10 of the LISR	Deductibility of interest, general rules
Art. 29-A numeral 14) letter b) of the LISR	Non-deductibility of interest, commissions and any other payment of financial transactions, evaluating their declaration as taxable income
Art. 29-A numeral 14) letter c) of the LISR	Non-deductibility of interest, analyzing the average lending rate active plus four percentage points
Art. 29-A numeral 14) letter d) of the LISR	Non-deductibility of payments made, analyzing the level of indebtedness of the credit transactions of the borrowing taxpayer

[2] Income Tax Law

[3] Tax Code

5. Final Comments

For the types of financial transactions mentioned above, within our local Transfer Pricing regulations, the tax authorities have not established the application of an explicit methodology for performing an analysis. Therefore, each type of transaction of this nature should be evaluated individually so that the taxpayer can ensure compliance with the arm's length principle and Art. 62-A of the Tax Code.

Undoubtedly, business strategies and the corporate decisions of the various MNE Groups and their capital structures are of great relevance for the analysis of these transactions for Transfer Pricing purposes.

The determination of the price in each case will depend to a great extent on the functional analysis and risks assumed between the parties, as well as on the public information that is available for similar transactions.

We suggest that our clients and friends perform the analysis mentioned above, which will allow them to characterize the transaction and document it in order to support their position in the event of a future review by the tax authorities.

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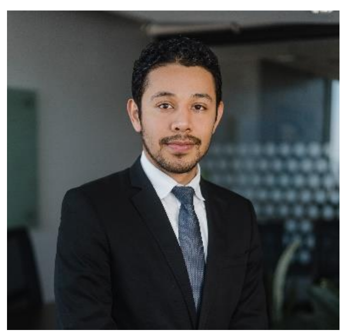

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Tax Calendar May 2021

The updated 2021 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 2021 Obligations Calendar

May 17

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)

May 24

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)

May 31

Other Obligations

- Appoint Tax Auditor per the Tax Code and International Services Law for the 2021 fiscal year.
- Tax opinion and report per the Tax Code for the 2020 fiscal year, general type; Tax opinion and report for dissolution and liquidation and transformation process (F-455)
- Semi-annual opinion on compliance with the obligations contained in the International Services Law corresponding to the second half of the 2020 fiscal year (F-455)

May 10

Mother’s Day

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