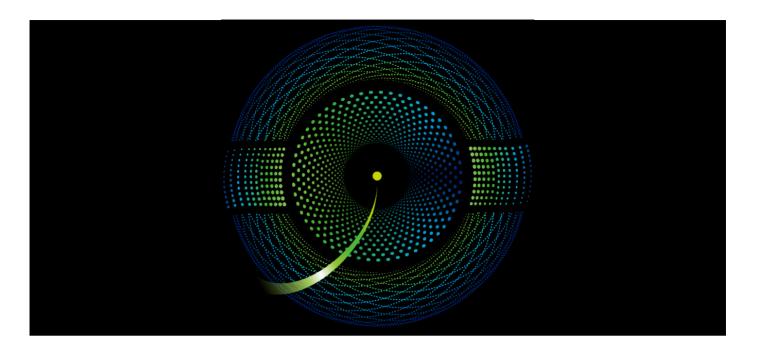
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Tax Newsletter

Timely news and information on national tax issues

Minimum aspects that Salvadorian taxpayers must comply with in financing transactions between related parties

Currently, due to the various implications of COVID-19 being experienced in all industries, many taxpayers have had the need to resort to financing transactions, with their first option being receiving financing from related parties. On the other hand, there are also companies that for other reasons, such as having excess cash flow, have decided to provide financing to related parties in order to pool cash and obtain revenues from interest between companies of the same corporate group.

Due to the above, it is important that Salvadorian taxpayers consider the guidelines established in the local regulations for financing transactions between related parties, as well as the technical transfer pricing considerations applicable to these types of transactions. These are detailed as follows:

1. Presumed income from interest

Article 192-A of the Tax Code of El Salvador (TC) establishes that "for tax purposes, in all contracts for loans of money, regardless of their nature and denomination, it is presumed, unless otherwise established, that interest income is obtained, which is the amount resulting from applying to the total amount of the loan, the average lending interest rate on credits in effect during the monthly tax periods or tax periods of the loan or credit operation." The average rate referred to in this article corresponds to the rate for credits or loans to companies applied by the financial system and published by the Central Reserve Bank of El Salvador (BCR per its Spanish abbreviation).

2. OECD Guidelines

Based on the guidelines of the Organization for Economic Cooperation and Development (OECD), which is the international organization that issues the international transfer pricing guidelines, the Transfer Pricing Guidance on Financial Transactions¹ published in February 2020 establishes that for financing transactions between related parties, it is necessary to consider the same conditions that would be taken into account between independent third parties, as well as the same considerations of creditworthiness, credit risk or risk of default, and economic circumstances, among other factors.

3. Tax withholding for non-domiciled parties

For financing transactions in which Salvadorian taxpayers are borrowing from related companies domiciled abroad, the Salvadorian taxpayer, per Article 158 of the TC, should consider the following tax withholdings for the payment of interest:

- A. The Salvadorian taxpayer is obligated to withhold as definitive payment of the Income Tax 20% of the value of the interest payable.
- B. If the related company or independent third party to which the Salvadorian taxpayer must pay interest in the financing transaction is established, domiciled or resides in a country, state or territory with a preferential tax regime, or of low or zero taxation or is a tax haven, the local company is obligated to withhold 25% as a definitive Income Tax payment.

4. Non-deductible costs and expenses

According to Article 29-A of the Income Tax Law, the interest, commissions, or any other payment for financing transactions performed by the borrower in any of the following cases will not be accepted as expenses deductible from the income obtained:

- A. When in the payment of the interest on financing, the Salvadorian taxpayer has not withheld the Income Tax or the Tax on the Transfer of Movable Goods and the Rendering of Services established in the TC (mentioned in the preceding section).
- B. When the lender is a related party domiciled in the country and it has not declared such sums as taxable income in the same period in which they were earned.
- C. When the agreed upon interest rate for the financing exceeds the average lending interest rate on credits published by the BCR, plus four additional points, and the lender is a related party or a third party domiciled, established or located in a country, state or territory with a preferential tax regime, of low or zero taxation or a tax haven.
- D. When the lender is a related party or a third party that is domiciled, established or located in a country, state or territory with a preferential tax regime, of low or zero taxation or a tax haven and the borrower's debt exceeds the amount resulting from multiplying by three the borrower's total equity.

5. Income obtained in El Salvador

According to Article 16 of the Income Tax Law, the income that is non-taxable, exempt, or not subject to tax obtained by Salvadorian taxpayers in another country is considered as taxable income in El Salvador and must pay the corresponding tax. Similarly, if the income transactions of Salvadorian taxpayers

¹ Transfer Pricing Guidance on Financial Transactions

obtained abroad are considered as taxable, they will not be taxable in El Salvador.

Based on the guidelines detailed above, it is important that when Salvadorian taxpayers serve as lenders in transactions with related parties, they must take as a reference the rates used in financing carried out with independent financial institutions or according to the average interest rates published by the BCR, because for transfer pricing purposes, it is presumed that such transactions would be thus agreed upon between independent third parties in similar conditions.

In addition, Article 62-A of the TC indicates that for tax purposes, the taxpayers that enter into transactions with related parties are obligated to determine the prices of the considerations using market values.

Therefore, it is important that the taxpayers entering into these types of transactions <u>as lenders</u> with related parties verify the following key points:

- 1. That all financing transactions have an interest rate. This is due to the fact that at no time will the Tax Administration allow for a Salvadorian taxpayer, as a lender, to enter into financing transactions without agreeing upon an interest rate. Otherwise, according to article 62-A, the Tax Administration, in the exercise of its authority, may determine the corresponding market prices and make the respective tax adjustments.
- 2. That all interest rates for financing transactions are agreed upon at market values. This is due to the fact that if the interest rate does not meet this criteria, the Tax Administration could make the corresponding adjustments, taking as a reference the rates for credits or loans published by the BCR, and apply the corresponding penalties and fines to the taxpayer.

Furthermore, it is important that all Salvadorian taxpayers entering into financing transactions as

<u>borrowers</u> consider the following key points when agreeing upon such transactions:

- Calculation of withholdings: The taxpayer should consider that for all financing transactions recognized with foreign parties, the corresponding withholdings must be made.
- 2. **Deductibility of costs and expenses.** The taxpayer should verify compliance with all of the criteria for deducting costs and expenses resulting from financing transactions.

Evidence of the above is the fact that on 23 August 2021, the Tax Administration issued through the Court of Appeals for Internal Revenue and Customs (TAIIA per its Spanish acronym) ruling R1704012.TM, which resulted in a tax adjustment for a Salvadorian taxpayer involved in financing transactions with related parties due to a lack of compliance with the criteria described above. In this case, the taxpayer, acting as a lender, did not agree upon an interest rate for financing transactions with related parties, and the Tax Administration concluded that a 0% interest rate was below the market value determined, according to the calculations made per Article 192-A of the TC. This resulted in an Income Tax adjustment payable by the Salvadorian taxpayer, plus a fine for the violation indicated in Article 253 of this code, classified as Unintentional Evasion in the audited period.

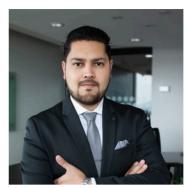
Final comments:

Although many local companies, due to different circumstances, both economic and strategic, choose to enter into financing transactions with related parties as their first choice, instead of conducting similar transactions with independent financial institutions, it is important to consider the key factors mentioned above for both lenders and borrowers in order to avoid any risk of questioning and/or adjustment by the Salvadorian Tax Administration.

Likewise, it is recommended as a good practice for transfer pricing, that Salvadorian taxpayers document

² Ruling R1704012.TM — Court of Appeals for Internal Revenue and Customs

all financing transaction between related parties through contracts that establish the purpose of the financing, the amount, the interest rate and the parties involved. This is important because this documentation will support the transfer pricing report and the financing transactions analyzed.



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Tax Calendar December 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.



Download the 2021 Obligations Calendar



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 to December 31

Christmas and New Year's holidays

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