



Puerto Rico Treasury Department's Evolving Attitude Towards Transfer Pricing Issues

By: Juan Zaragoza-Gómez

In our Special Bulletins from February and March 2019, we discussed several new provisions introduced by Act 257-2018 (commonly referred to as the "PR 2018 Tax Reform"). In this issue we will highlight those related to transfer pricing matters.

Background

Historically, the PRTD has had a hands-off approach towards transfer pricing issues. This approach, which runs opposite to the one of most tax authorities around the world, was nothing more than a reflection of Puerto Rico's economy and of the nature of the largest taxpayers for decades.

For a long time, Puerto Rico's economy was mainly manufacturing industry based, and most of those players were United States companies with manufacturing facilities in the Island. These companies were attracted by a combination of local and federal tax breaks that minimized their tax burden. In fact, there was an implicit incentive to shift income to Puerto Rico to take advantage of the reduced tax burden.

Particularly since 1997, Puerto Rico has seen its manufacturing jobs being reduced from approximately 164,000 to 74,000 in 2017. At the same time, there has been significant growth in the retail sector, particularly among foreign companies. Due to the nature of the

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operations of these companies, they are taxed most of the time at regular tax rates, thus triggering an incentive to minimize the net income from the local operations.

The transfer pricing provisions of the Puerto Rico Internal Revenue Code of 2011, as amended (“the Code”) and the related regulations, even though originated from the 1954 US Internal Revenue Code, have not evolved significantly and they just provided some general guidelines regarding this area.

Recent developments

As part of recent tax legislation, the PR 2018 Tax Reform amended Sections 1033.17(a)(16) and (17) of the Code, which disallow certain type of expenses, as discussed below, to provide for the granting of a waiver upon the submission of a transfer pricing study to be included with the taxpayer’s yearly income tax return (the “Transfer Pricing Study”). As a general rule, these subsections require a disallowance of 51% of the payments made to nonresident related parties, or a Home Office in the case of a branch, for expenses related to the Puerto Rico trade or business which are not subject to income tax withholding under the Code.

Pursuant to the above-mentioned amendment, the following rules will apply to the Transfer Pricing Study:

- Applicable to taxable years beginning after December 31, 2018;
- Must include an analysis of the Puerto Rico operations in conformity with Section 482 of the US 1986 Internal Revenue Code, as amended (the “US Code”);
- Must have been “properly reviewed” by the US Internal Revenue Service (“IRS”); and
- In the case of passthrough entities (partnerships, special partnerships and corporations of individuals), if none of the entities has operations in the United States the Transfer Pricing

Study may be prepared under the rules established by the Organization for Economic Co-operation and Development (“OECD”).

Unanswered questions

As can be seen, these new guidelines provided under the Code, are vague and leave many unanswered questions. At this stage, and considering the absence of any guidance issued by the PRTD as of this date, formal guidance should be issued clarifying at least the following issues:

1. Will the Transfer Pricing Study be required on an annual basis or its effectiveness will go beyond one taxable year?
2. What will be the extent of the Puerto Rico operations required to be covered under the Transfer Pricing Study? Will the Transfer Pricing Study be limited to the expenses charged by the foreign entity or will it include all operations?
3. What is the meaning of “properly reviewed” by the IRS? Specially, since we are not aware, other than the advanced pricing agreements¹, of any type of review or approval process provided by the IRS?
4. Can the Transfer Pricing Study for any taxable year be made using as reference the intercompany charges for the immediately preceding taxable year?
5. Will the exception to allow the Transfer Pricing Study to be made under the OECD rules be extended to corporations or eliminated completely in order to be consistent?

ATBA comments

Some of the unanswered questions above may be addressed through legislation while others will be handled administratively.

There are talks of possible legislation to amend the Code and we expect it to include language to eliminate or clarify the requirement for the Transfer Pricing Study to be properly reviewed by the IRS and to provide a consistent rule regarding the possible use of OECD rules in certain Transfer Pricing Studies. Furthermore, we expect guidance to be issued by the PRTD before the end of calendar 2019 answering at least some of the questions mentioned above, including the period or periods covered under a Transfer Pricing Study. We will keep you posted of any developments in this area. At ATBA we

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From November 2014 to December 2016 Juan served as Secretary of the Treasury for the Government of Puerto Rico. During such period he also served as a member in several government boards such as the Government Development Bank, Teachers Retirement System, Puerto Rico Industrial Development Company, among others.

Among other professional experiences Juan adds to his resume being Partner in Charge of Arthur Andersen’s San Juan Tax Practice, President of the Puerto Rico Certified Public Accountants Society and Assistant Secretary for Internal Revenue at the Puerto Rico Treasury Department. Over the years he has also participated in several advisory municipal and state committees regarding Tax Reforms, Sales and Use Tax and Municipal Revenue Collection among other tax topics.

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Note

¹ An advanced pricing agreement (“APA”) is a pre-arrangement done between a taxpayer and a tax authority on a specific or appropriate methodology for certain transactions, usually among related parties, over a determined period of time.

Continues on Page 3

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