

Global Tax Alert

News from EY Americas Tax

Puerto Rico's new transfer pricing study option could allow full deduction of related-party expenses

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Taxpayers may be able to fully deduct related-party expenses in Puerto Rico if they submit a transfer pricing study with their income tax returns.

Background

51% disallowance rule

The Puerto Rico Internal Revenue Code of 2011, as amended, (Code) generally disallows an income tax deduction for 51% of the expenses that a taxpayer incurs from a related person that is not engaged in a trade or business in Puerto Rico. This limitation applies to costs or expenses that are attributable to the conduct of the taxpayer's trade or business in Puerto Rico. Furthermore, payments for the expenses or costs must not be subject to tax or withholding at source in Puerto Rico for the limitation to be applied. The 51% disallowance rule applies the same for a taxpayer operating as a branch with respect to its home office, or any other non-Puerto Rico resident affiliate, as well as to a taxpayer that is not a branch.

For tax years beginning after 31 December 2014 and before 1 January 2019, the Code allowed taxpayers to submit a request to the Puerto Rico Treasury Department (PRTD) for a partial or total waiver from the 51% disallowance.

Act 257-2018

Act 257-2018 amended Section 1033.17(a)(17) of the Code so that the 51% disallowance will not apply, for tax years commencing after 31 December 2018, to taxpayers that submit, along with their income tax return, a transfer pricing study that covers the operations carried out within Puerto Rico. Under this new provision, the transfer pricing study must be prepared in accordance with the requirements established under Internal Revenue Code (IRC) Section 482 of the United States Code and duly reviewed by the Federal Internal Revenue Service.¹

The amendments further provide that the Secretary of the PRTD (Secretary) will establish through regulation or other official publication what constitutes a valid transfer pricing study. Moreover, the Secretary has the power to reject transfer pricing studies if they are deemed noncompliant with the requirements of *Act 257-2018*. As of the date of this Tax Alert, the PRTD has not issued a regulation or official guidance related to the mechanics of using a transfer pricing study to limit the application of the 51% disallowance rule.

Transfer pricing study under IRC Section 482

A transfer pricing study provides a tax authority with an evaluation of the taxpayer's intercompany transactions undertaken during a particular period. Its main goal is to determine whether the related-party transaction pricing complies with the arm's-length principle (i.e., whether it is consistent with the pricing to which unrelated independent parties would agree under similar facts and circumstances).

A transfer pricing study under IRC Section 482 may include a company overview, industry analysis, a functional analysis (functions, risks and assets employed for the intercompany transaction) and an economic analysis. As part of the functional analysis, the taxpayer provides details of the local entity's functions, assets and risks that are necessary to determine the appropriate level of profits of the controlled transactions and entities. The economic analysis includes the taxpayer's disclosure of its transaction volume, the

method used to determine the appropriate pricing and proof that the results are similar to those achieved in comparable transactions between unrelated parties.

Implications

The partial or total waiver from the 51% disallowance that applied before *Act 257-2018* will no longer be an option under the Code for tax years beginning on or after 1 January 2019. Under the new rules, entities that operate within Puerto Rico and have related entities not engaged in a trade or business in Puerto Rico will be able to deduct 100% of the payments made to their home office or other related persons, as long as the taxpayers submit a transfer pricing study analyzing the Puerto Rico operations with their income tax returns. Entities that had a total or partial waiver from the 51% disallowance before the enactment of *Act 257-2018* must have a transfer pricing study if they want to secure full deductibility.

Entities interested in submitting a transfer pricing study with their Puerto Rico income tax returns that currently do not have a study that specifically covers their Puerto Rico operations must consider the time required to have a study completed and available by the income tax return's due date, including the six-month extension period allowed under *Act 257-2018*.

Because no regulations or administrative guidance has been issued by the PRTD at this time, there are unanswered questions and aspects of this new rule that remain unclear. Unofficial statements made by PRTD tax policy officials in public forums have alluded that, in the absence of administrative guidance, a transfer pricing study complying with IRC Section 482 should be sufficient to support full deductibility of related-party expenses under the Code. Nonetheless, this matter should be monitored closely since the PRTD reserves the right to issue an official interpretation on the application of the new transfer pricing option at any time.

Endnote

1. It remains unclear what a review from the Federal Internal Revenue Service entails in this context. According to public statements made by government officials, technical amendments to the Code or administrative guidance from the PRTD is expected to address this requirement.

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