COMMONWEALTH OF PUERTO RICO
DEPARTMENT OF TREASURY
SAN JUAN, PUERTO RICO

1st DRAFT

REGULATION TO INCORPORATE ARTICLES 1040.09-1 TO 1040.09-22, TO REGULATION NO. 8049 OF JULY 21, 2011, ALSO KNOWN AS THE "REGULATION OF THE PUERTO RICO INTERNAL REVENUE CODE OF 2011", TO REGULATE SECTION 1040.01 OF THE PUERTO RICO INTERNAL REVENUE CODE OF 2011, AS AMENDED, ISSUED PURSUANT TO SECTION 6051.11 OF SUCH CODE WHICH EMPOWERS THE PUERTO RICO SECRETARY OF TREASURY TO ADOPT THE NECESSARY REGULATIONS TO EXECUTE THE SAME; AND TO REPEAL REGULATION NO. 6246 ISSUED ON DECEMBER 22, 2000.

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DEPARTMENT OF TREASURY

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TITLE: Regulation to incorporate Articles 1040.09-1 to Article 1040.09-22, to Regulation No. 8049 of July 21, 2011, also known as the "Regulations of the Puerto Rico Internal Revenue Code of 2011", to regulate Section 1040.09 of the Puerto Rico Internal Revenue Code of 2011, as amended, issued pursuant to Section 6051.11 of such Code, which authorizes the Secretary of the Treasury to adopt the necessary regulations to execute the same; and to repeal Regulation No. 6246 issued on December 22, 2000.

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Regulation to incorporate Articles 1040.09-1 to Article 1040.09-22, to regulation No. 8049 of July 21, 2011, also known as the "Regulations of the Puerto Rico Internal Revenue Code of 2011", to regulate section 1040.01 of the Puerto Rico Internal Revenue Code of 2011, as amended, issued pursuant to Section 6051.11 of such Code, which authorizes the Secretary of the Treasury to adopt the necessary regulations to execute the same; and to repeal Regulation No. 6246 issued on December 22, 2000.

PREAMBLE

Section 1040.09 of the Puerto Rico Internal Revenue Code of 2011 (hereinafter, the "Code") authorizes the Secretary (hereinafter, the "Secretary") of the Puerto Rico Department of Treasury (hereinafter, the "Department") to distribute, apportion, or allocate gross income and deductions, credits, or allowances between or among two or more organizations, trades, or businesses, whether or not incorporated, whether or not organized in Puerto Rico, and whether or not affiliated, owned or controlled directly or indirectly by the same interests, if the Secretary determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or to clearly reflect the income of any of such organizations, trades, or businesses. Section 1040.09 of the Code also authorizes the Secretary to impute income by reason of interest, dividends, compensation or for any other concept or nature in transactions,

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trades or businesses when it is necessary to avoid tax evasion or to accurately reflect the income of any of such organizations, trades or businesses.

Pursuant to the express power vested in the Secretary of Treasury under Section 1040.09 of the Code, the foregoing regulation aims to provide guidance to organizations with regards to appropriate transfer prices policies from a Puerto Rico tax standpoint. As defined in the "*OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*" (the "OECD Guidelines"), transfer prices are the prices at which an enterprise transfers physical goods and intangible property or provides services to associated enterprises. Establishing aggressive transfer pricing policies which do not properly reflect the economic benefit derived from the transaction in Puerto Rico is considered one kind of tax evasion, particularly if the transaction cross national borders. In summary, this Regulation focus on the application of the arm's length principle to evaluate the transfer pricing policies of associated enterprises and are based considering the OECD Guidelines and the regulations issued under Section 482 of the United States Internal Revenue Code.

The Department adopts the present Regulations in order to establish transfer pricing rules and guidelines among controlled organizations and the necessary procedures for the effective administration of such rules and guidelines.

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Articles 1040.09-1 to 1040.09-22

"Article 1040.09-1.- Definitions.-

For purposes of this Regulation and Section 1040.09 of the Code, the following terms will have the meaning shown below:

a) Code.- The "Code" shall mean the Puerto Rico Internal Revenue Code of 2011, as amended.

b) Comparable Uncontrolled Transaction.- The term "comparable uncontrolled transaction" means a transaction between two independent parties that is comparable to the controlled transaction under examination under any applicable price methodology. It can be either a comparable transaction between one party to the controlled transaction and an independent party ("internal comparable") or between two independent parties, neither of which is a party to the controlled transaction ("external comparable").

c) Control.- The term "control" includes any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted. This term is further defined in Article 1040.09-4 of this Regulation.

d) Controlled Organization or Controlled Taxpayer.- The term "controlled organization" or "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

e) Controlled Transaction or Controlled Transfer.- The terms "controlled transaction" or "controlled transfer" include any transaction or transfer between two or

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more members of the same group or group of controlled organizations. This term is further defined in Article 1040.09-5 of this Regulation.

f) Department.- The “Department” shall mean the Puerto Rico Treasury Department.

g) Group or group of controlled organizations.- The terms "group" and "group of controlled organizations" mean the organizations, trades, or businesses owned or controlled by the same interests. It shall also mean a controlled group of corporations, affiliated group and related parties, as defined by Section 1010.04 and 1010.05 of the Code, respectively, except that, for purposes of Section 1040.09 of the Code, and the regulations issued thereunder, paragraph (b)(2)(D) of Section 1010.04 of the Code will not be applicable. For purposes of Section 1040.09 of the Code, and the regulations issued thereunder, any partnership and any other excluded member under Sections 1010.04 and 1010.05 of the Code shall be considered a part of the group of controlled organizations if the rules stated therein would make the organization part of such controlled group.

h) Intangible.- For purposes of this Regulation, an intangible is an asset that comprises any of the following items and has substantial value independent of the services of any individual, like, for example:

(1) Patents, inventions, formulae, processes, designs, patterns, or know-how;

(2) Copyrights and literary, musical, or artistic compositions;

(3) Trademarks, trade names, or brand names;

(4) Franchises, licenses, or contracts;

(5) Methods, programs, systems, procedures, campaigns, surveys, studies,

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forecasts, estimates, customer lists, or technical data; and

(6) Other similar items. For purposes of this regulation, an item is considered similar to those listed in paragraph (h)(1) through (5) of this Article if it derives its value not from its physical attributes but from its intellectual content or other intangible properties.

i) Organization or Taxpayer.- The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partnership, a trust, an estate, and association, or a corporation (as each is defined or understood in the Code or this Regulation) irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, or whether it is exempt. For purposes of this Regulation, a Branch will be considered a separate entity from its Home Office whether or not one or the other is engaged in trade or business within Puerto Rico.

j) Related parties.- The term “related parties” have the same meaning as stated in Section 1010.05 of the Code except as otherwise stated in this Regulation, except that, any partnership and any other excluded member under Section 1010.05 of the Code shall be considered a related party if the rules stated therein would make the organization a related party.

k) Secretary.- The term “Secretary” means the Secretary of the Puerto Rico Treasury Department.

l) Trade or business.- The terms "trade" or "business" include any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

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m) Transaction.- The term “transaction” shall mean any sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented. A transaction also includes the performance of any services for the benefit of, or on behalf of, another organization.

n) True Taxable Income.- The term "true taxable income" means, in the case of a controlled organization, the taxable income (or, as the case may be, any item or element affecting net income) which would have resulted to the controlled organization, had, it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act), dealt with the other member or members of the group at arm's length, as defined in Article 1040.09-3 of this Regulation. It does not mean the income, the deductions, the credits, the allowances, or the item or element of income, deductions, credits, or allowances, resulting to the controlled organization by reason of the particular contract, transaction, or arrangement, the controlled organization, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement is legally binding upon the persons thereto).

o) Uncontrolled Organization or Uncontrolled Taxpayer.- The term “uncontrolled organization” or “uncontrolled taxpayer” means an organization that is not a controlled organization.

p) Uncontrolled Transaction.- The term “uncontrolled transaction” means a transaction executed between two or more uncontrolled organizations or between organizations that are not members of the same group of controlled corporations.”

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Article 1040.09-2.- Scope, Purpose and Application

(a) Purpose.- The purpose of Section 1040.09 of the Code and this Regulation is to ensure that organizations clearly reflect income attributable to controlled transactions, and to prevent tax evasion with respect to such transactions. The objective of such section is to place a controlled organization on a tax parity with an uncontrolled organization, by determining, according to the standard of an uncontrolled organization, the true taxable income from the property and business of a controlled organization. The interest controlling a group of controlled organizations are assumed to have complete power to cause each controlled organization so as to conduct its affairs in a way that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled organizations. If, however, this has not been done, and the taxable net income is thereby understated in the return, Section 1040.09 the Code authorizes the Secretary to intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting net income, among the controlled organizations constituting the group, he shall determine the true taxable income of each controlled organization. The standard to be applied in every case is that of an uncontrolled organization dealing at arm's length with another uncontrolled organization, as provided by Article 1040.09-3 of this Regulation. Section 1040.09 of the Code grants no right to a controlled organization to apply its provisions at will, nor does it compel the Secretary to apply such provisions.

(b) Scope.-

(1) In General.- This Regulation shall apply to any controlled organization, as

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the term is defined in Article 1040.09-1 of this Regulation.

(2) Exceptions.- With the exception of the Arm's Length Standard set forth in Article 1040.09-3 of this Regulation (which shall be applicable to all transactions conducted between controlled organizations) the procedures and compliance rules set forth in this Regulation shall only be applicable to controlled organizations that are part of a controlled group of corporations in which, at least, one of the organizations comprising such group:

(i) qualify as a Large Taxpayer, as defined in Section 1010.01(a)(35) of the Code; or

(ii) is an entity whose gross sales volume or average assets for the previous taxable tax year ascended to ten million (10,000,000) dollars or more. In order to determine the gross sales volume or average assets under this clause, the aggregate amount of the gross sales volume or the average assets of the whole Group, as this term is defined in Article 1040.09-1(g) of this Regulation, shall be considered.

(c) Advance pricing arrangements.-

(1) Definition.- An "Advance pricing arrangement" is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time.

(2) Administration.- The Secretary may issue a circular letter, administrative determination, informative bulleting, regulation, or any other official document stating the process to request and obtain an advance pricing arrangement and the consequences of such arrangement. No organization may request or obtain an advance pricing arrangement until the Secretary issues the corresponding publication.

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(d) Application.-

(1) In General.- Transactions between one controlled organization and another will be subject to special scrutiny as a mean to assert whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled organization, the intervention of the Secretary is not restricted to the case of improper accounting, to the case of a fraudulent, colorable or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable net income, in whole or in part, of a controlled organization, is other than it would have been had the organization in the conduct of his affairs been an uncontrolled organization dealing at arm's length with another uncontrolled organization.

(2) Documentation.- Subject to the exception of Article 1040.09-2(b)(2), taxpayers subject to this Regulation are required to retain supporting materials like for example, documentation of the efforts undertaken to comply with the arm's length standard (including the information on which the transfer pricing was based, the factors taken into account, and the method selected) for production if the Secretary request such information and documentation when determining the true taxable income of a controlled organization.

(e) Penalties.- If the Secretary makes distributions, apportions, or allocations of gross income and deductions, credits or allowances to reflect the true taxable income of a taxpayer such taxpayer will be subject to the applicable penalties, interest, and addition to taxes as provided for in Subtitle F of the Code.

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(f) Rules of interpretation.- The definitions, words, terms, and phrases, as defined in this article and used in this Regulation shall be used for the purpose of this Regulation and Section 1040.09 of the Code, except when otherwise expressed or if it is clearly derived otherwise from the context. If a matter is not specifically regulated by this Regulation or if it needs further clarification, the Organization for Economic Co-operation and Development's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter, the "OECD Guidelines") and the Regulations issued under Section 482 of the United States Internal Revenue Code may be used for purposes of supplementary non-binding technical guide.

(g) Powers of the Secretary.-

(1) Notwithstanding the provisions of this article, if the Secretary determines that a controlled organization is in violation of Article 1040.09-3 of this Regulation the Secretary could apply, on a case by case basis, at his sole discretion, the procedures and compliance rules set forth in Articles 1040.09-6 to 1040.09-22 of this Regulation to organizations who do not meet the requirements under Article 1040.09-2(b)(2) if a particular transaction is material considering the financial or economic circumstances of the organization.

(2) The Secretary may require by circular letter, administrative determination, informative bulleting, regulation, or any other official document, whether public or private, that a specific taxpayer report, by any means, including a form to be provided by the Secretary, any specific controlled transaction. Also, the Secretary, from time to time, may establish any additional documentation or filling requirements applicable to all taxpayers subject to this Regulation.

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(3) If the taxable income of a controlled taxpayer differs from what it would have been had the taxpayer, in the conduct of its business affairs, been dealing at arm's length with an uncontrolled taxpayer, then the Secretary may distribute, apportion, or allocate gross income and deductions, credits, or allowances to reflect the true taxable income, pursuant to this Article. An adjustment of income by the Secretary made under this article may take the form of an increase or decrease in any relevant amount. The Secretary may make adjustments even if an increase in income of a controlled taxpayer creates or increase a loss to another controlled taxpayer that were participants in a controlled transaction. The Secretary may also make adjustments regardless of whether:

(i) The income ultimately anticipated from a series of transactions has not been or is never realized. For example, if a controlled taxpayer sells a product at less than an arm's length price to a related taxpayer in one taxable year and the second controlled taxpayer resells the product to an unrelated party in the next taxable year, the Secretary may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, even though the second controlled taxpayer had not realized any gross income from the resale of the product in the first year;

(ii) Two controlled taxpayers realize an overall loss that is attributable to a particular controlled transaction;

(iii) The transaction qualifies for nonrecognition of gain or loss under applicable provisions of the Code; or

(iv) the Secretary reasonably believes that the controlled transaction did not meet the arm's length standard.

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(4) Allocating group's income to a member.- The Secretary may distribute, apportion, or allocate gross income and deductions, credits, or allowances of a group's entire income to a single member of the group or to two or more members."

Article 1040.09-3.- Arm's Length Standard

(a) General rule.- In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer.

(b) Arm Length's Standard.- A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result). However, because identical transactions can rarely be located, whether a transaction produces an arm's length result generally will be determined by reference to the results of comparable transactions under comparable circumstancespursuant to the Comparability Analysis Rules of Article 1040.09-8 of this Regulation. Evaluation of whether a controlled transaction produces an arm's length result is made pursuant to a method selected under the Best Method Rule described in Article 1040.09-7 of this Regulation."

Article 1040.09-4.- Control

a) Control.- In order to determine whether or not a taxpayer exercises control over another taxpayer one or more of the following basic elements shall be present:

(1) Common ownership or capital of one organization (as this term is defined in Article 1040.09-1 of this Regulation) by another organization;

(2) Direct or indirect participation in the management or administration of the

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other entity;

(3) Having any decision power over the other entity; or

(4) Having interest over the same property. It shall be considered that two or more organizations have interests over the same property if they hold, directly or indirectly, a legal title, right or share in the same property.

b) Standard of control.- In order to determine whether or not a taxpayer exercises control over another taxpayer the control could be direct or indirect, legally enforceable or not, exercisable or exercised control, implicit or explicit control, and/or constructive control. The mode or form of the exercise shall not be decisive. The decisive factor of control shall be the reality of such control when evaluating a transaction between the controlled taxpayers.

c) Presumption of control.- A presumption of control arises if income or deductions have been arbitrarily shifted."

Article 1040.09-5.- Controlled Transaction

(a) Controlled Transaction.- A controlled transaction shall include, but not limited to, the following transactions amongst controlled taxpayers:

(1) Sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use or sell any property (whether tangible or intangible, real or personal) or money, however such transaction is effected, and whether or not the terms of such transaction are formally documented;

(i) Formal documentation.- When evaluating the formal written agreements between controlled taxpayers, the Secretary shall respect the contractual terms, including the consequent allocation of risks, that are agreed to in writing before the

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transactions are entered into if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties. If the contractual terms are inconsistent with the economic substance of the underlying transaction, the Secretary may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

(ii) Lack of documentation.- In the absence of a written agreement, the Secretary may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights. For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the Secretary may impute a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it.

(2) Performance of any service for the for the benefit of, or on behalf of, another controlled taxpayer, including the payment, by a controlled taxpayer, for the performance of such service by an unrelated third party for the benefit of another controlled taxpayer; or

(3) Any other transaction for any cause or consideration."

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Article 1040.09-6.- Transfer Pricing Methods Principles

(a) In General.- Whenever a controlled taxpayer engages in controlled transactions with another controlled taxpayer they shall apply one of the different transfer pricing methods described in this Regulation for purposes of determining the arm's length amount charged. Each of the methods must be applied in accordance with the Best Method Rule of Article 1040.09-7, the Comparability Analysis Rules of Article 1040.09-8, and the arm's length range of Article 1040.09-9, of this Regulation.

(b) Categorization.- For purposes of this Regulation the comparable uncontrolled price method, the comparable uncontrolled transaction method, the resale price method, and the cost plus method will be categorized as Traditional Transaction Methods. On the other hand, the Transactional Net Margin Method and the Profit Split Method shall be categorized as Transactional Profit Methods.

(c) Purpose.- The purpose of the transfer pricing methods described herein is to establish whether the conditions imposed in the commercial or financial relations between controlled taxpayers are consistent with the arm's length principle. The selection of a transfer pricing method shall always aim to find the most appropriate method for a particular controlled transaction. No one method is suitable in every possible situation. When determining which method shall be used the following factors must be taken into consideration:

(1) The appropriateness of the method considered in view of the nature of the controlled transaction, determined in particular through a functional analysis;

(2) The availability of reliable information (in particular on uncontrolled comparables) needed to apply the selected method and/or other methods;

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(3) The degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate material differences between them. The Comparability Analysis Rules are set forth in Article 1040.09-8, of this Regulation.

(d) Selection of Category of Method Applicable to Transaction.- The method or methods most appropriate to the calculation of arm's length results for controlled transactions must be selected after evaluating all methods, and different methods may be applied to interrelated transactions if such transactions are most reliably evaluated on a separate basis. For example, if services are provided in connection with the transfer of property, it may be appropriate to separately apply the methods applicable to services and property in order to determine an arm's length result.

(e) Determining the Best Method.- Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the results of a controlled transaction are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method. (*See*, Best Method Rule of Article 1040.09-7 of this Regulation). The taxpayer shall justify the application of the chosen method and explain the reason for

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rejecting other available methods. Notwithstanding, the taxpayer shall determine the best method to apply based on the specific circumstances of the controlled transactions.

(1) Comparability.- The relative reliability of a method based on the results of transactions between unrelated parties depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors described in Article 1040.09-8 of this Regulation. As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate is reduced. In addition, if adjustments are made to increase the degree of comparability, the number, magnitude, and reliability of those adjustments will affect the reliability of the results of the analysis. Thus, an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods. An analysis will be relatively less reliable, however, as the uncontrolled transactions become less comparable to the controlled transaction. (*See*, Comparability and reliability considerations throughout this Article and in Article 1040.09-8 of this Regulation.

(2) Data and assumptions.- Whether a method provides the most reliable measure of an arm's length result also depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. Such factors are particularly relevant in evaluating the degree of comparability between the controlled and uncontrolled

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transactions.

(i) Completeness and accuracy of data.- The completeness and accuracy of the data affects the ability to identify and quantify those factors that would affect the result under any particular method. For example, the completeness and accuracy of data will determine the extent to which it is possible to identify differences between the controlled and uncontrolled transactions, and the reliability of adjustments that are made to account for such differences. An analysis will be relatively more reliable as the completeness and accuracy of the data increases.

(ii) Reliability of assumptions.- All methods rely on certain assumptions. The reliability of the results derived from a method depends on the soundness of such assumptions. Some assumptions are relatively reliable. For example, adjustments for differences in payment terms between controlled and uncontrolled transactions may be based on the assumption that at arm's length such differences would lead to price differences that reflect the time value of money. Although selection of the appropriate interest rate to use in making such adjustments involves some judgment, the economic analysis on which the assumption is based is relatively sound. Other assumptions may be less reliable. For example, the residual profit split method may be based on the assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party. Because the costs of developing an intangible may not be related to its market value, the soundness of this assumption will affect the reliability of the results derived from this method."

(iii) Sensitivity of results to deficiencies in data and assumptions.- Deficiencies in the data used or assumptions made may have a greater effect on some methods

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than others. In particular, the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction. For certain other methods, such as the resale price method, the analysis of the extent to which controlled and uncontrolled taxpayers undertake the same or similar functions, employ similar resources, and bear similar risks is particularly important. Finally, under other methods, such as the profit split method, defining the relevant business activity and appropriate allocation of costs, income, and assets may be of particular importance. Therefore, a difference between the controlled and uncontrolled transactions for which an accurate adjustment cannot be made may have a greater effect on the reliability of the results derived under one method than the results derived under another method. For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a comparable uncontrolled price method analysis, while differences in product characteristics will ordinarily have a greater effect on a comparable uncontrolled price method analysis than on a comparable profits method analysis.

(f) Confirmation of results by another method.- If two or more methods produce inconsistent results, the best method rule as described in Article 1040.09-7 of this Regulation will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in evaluating different applications of the same method, the fact that a second

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method (or another application of the first method) produces results that are consistent with one of the competing applications may be taken into account.

(g) Use of more than one method.- The arm's length principle does not require the application of more than one method for a given transaction and a taxpayer is not required to perform arm's length analyses under more than one method, although the taxpayer may choose to initially consider more than one method. However, whenever the Secretary esteems that no one approach is conclusive, the Secretary can allow the evidence of various methods to be used in conjunction. In such cases, an attempt should be made to reach a conclusion consistent with the arm's length principle that is satisfactory from a practical viewpoint, taking into account the facts and circumstances of the case, the mix of evidence available, and the relative reliability of the various methods under consideration.

(h) Preferred Method.-

(1) Traditional Transaction Method.- Whenever a traditional transaction method and a transactional profit method can be applied in an equally reliable manner, the traditional transaction method will be preferable to the transactional profit method. Furthermore, whenever a comparable uncontrolled price method (hereinafter, "CUP") and another transfer pricing method can be applied in an equally reliable manner, the CUP method is to be preferred.

(2) Transactional Profit Method.- A transactional profit method may be more appropriate than a traditional transaction method in cases where one or both or one parties make valuable and unique contributions in relation to the controlled transaction, or where the parties engage in highly integrated activities, or where there is no or limited

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publicly available reliable gross margin information on third parties. A transactional net margin method is unlikely to be reliable if each party to a transaction makes valuable, unique contribution. In such a case, the profit split method will generally be the most appropriate method. However, a one-sided method (traditional transaction method or transactional net margin method) may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one. There are also many cases where a party to a transaction makes contributions that are not unique (for example, the party uses non-unique intangibles such as non-unique business processes or non-unique market knowledge). In such cases, it may be possible to meet the comparability requirements to apply a traditional transaction method or a transactional net margin method because the comparables would also be expected to use a comparable mix of nonunique contributions. The lack of valuable and unique contributions involved in a particular transaction does not automatically imply that the transactional net margin method is the most appropriate method.

(i) Interrelation between tangible and intangible property.- The value of an item of tangible property may be affected by the value of intangible property, such as a trademark affixed to the tangible property (embedded intangible). Ordinarily, the transfer of tangible property with an embedded intangible will not be considered a transfer of such intangible if the controlled purchaser does not acquire any rights to exploit the intangible property other than rights relating to the resale of the tangible property under normal commercial practices. Notwithstanding, the embedded intangible must be

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accounted for in evaluating the comparability of the controlled transaction and uncontrolled comparables. For example, because product comparability has the greatest effect on an application of the comparable uncontrolled price method, trademarked tangible property may be insufficiently comparable to unbranded tangible property to permit a reliable application of the comparable uncontrolled price method. If the transfer of tangible property conveys to the recipient a right to exploit an embedded intangible (other than in connection with the resale of that item of tangible property), it may be necessary to determine the arm's length consideration for such intangible separately from the tangible property, applying methods appropriate to determining the arm's length result for a transfer of intangible property."

Article 1040.09-7.- Best Method Rule.-

(a) In general.- The arm's length result of a controlled transaction must be determined under the method that, under the facts and circumstances, provides the most reliable measure of an arm's length result. Thus, there is no strict priority of methods, and no method will invariably be considered to be more reliable than others. An arm's length result may be determined under any method without establishing the inapplicability of another method, but if another method subsequently is shown to produce a more reliable measure of an arm's length result, such other method must be used. Similarly, if two or more applications of a single method provide inconsistent results, the arm's length result must be determined under the application that, under the facts and circumstances, provides the most reliable measure of an arm's length result.

(b) Determining the best method.- Data based on the results of transactions between unrelated parties provides the most objective basis for determining whether the

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results of a controlled transaction are arm's length. Thus, in determining which of two or more available methods (or applications of a single method) provides the most reliable measure of an arm's length result, the two primary factors to take into account are the degree of comparability between the controlled transaction (or taxpayer) and any uncontrolled comparables, and the quality of the data and assumptions used in the analysis. In addition, in certain circumstances, it also may be relevant to consider whether the results of an analysis are consistent with the results of an analysis under another method. These factors are explained in paragraphs (c), (d) and (e) of this Article.

(c) Comparability.- The relative reliability of a method based on the results of transactions between uncontrolled taxpayers depends on the degree of comparability between the controlled transaction or taxpayers and the uncontrolled comparables, taking into account the factors described in Article 1040.09-8 of this Regulation, and after making adjustments for differences, as described in such Article. As the degree of comparability increases, the number and extent of potential differences that could render the analysis inaccurate is reduced. In addition, if adjustments are made to increase the degree of comparability, the number, magnitude, and reliability of those adjustments will affect the reliability of the results of the analysis. Thus, an analysis under the comparable uncontrolled price method will generally be more reliable than analyses obtained under other methods if the analysis is based on closely comparable uncontrolled transactions, because such an analysis can be expected to achieve a higher degree of comparability and be susceptible to fewer differences than analyses under other methods. An analysis will be relatively less reliable, however, as the

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uncontrolled transactions become less comparable to the controlled transaction.

(d) Data and assumptions.- Whether a method provides the most reliable measure of an arm's length result also depends upon the completeness and accuracy of the underlying data, the reliability of the assumptions, and the sensitivity of the results to possible deficiencies in the data and assumptions. Such factors are particularly relevant in evaluating the degree of comparability between the controlled and uncontrolled transactions. These factors are discussed in paragraphs (d)(1), (2), and (3) of this Article.

(1) Completeness and accuracy of data.- The completeness and accuracy of the data affects the ability to identify and quantify those factors that would affect the result under any particular method. For example, the completeness and accuracy of data will determine the extent to which it is possible to identify differences between the controlled and uncontrolled transactions, and the reliability of adjustments that are made to account for such differences. An analysis will be relatively more reliable as the completeness and accuracy of the data increases.

(2) Reliability of assumptions.- All methods rely on certain assumptions. The reliability of the results derived from a method depends on the soundness of such assumptions. Some assumptions are relatively reliable. For example, adjustments for differences in payment terms between controlled and uncontrolled transactions may be based on the assumption that at arm's length such differences would lead to price differences that reflect the time value of money. Although selection of the appropriate interest rate to use in making such adjustments involves some judgement, the economic analysis on which the assumption is based is relatively sound. Other assumptions may

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be less reliable. For example, the residual profit split method may be based on the assumption that capitalized intangible development expenses reflect the relative value of the intangible property contributed by each party. Because the costs of developing an intangible may not be related to its market value, the soundness of this assumption will affect the reliability of the results derived from this method.

(3) Sensitivity of results to deficiencies in data and assumptions.- Deficiencies in the data used or assumptions made may have a greater effect on some methods than others. In particular, the reliability of some methods is heavily dependent on the similarity of property or services involved in the controlled and uncontrolled transaction. For certain other methods, such as the resale price method, the analysis of the extent to which controlled and uncontrolled taxpayers undertake the same or similar functions, employ similar resources, and bear similar risks is particularly important. Finally, under other methods, such as the profit split method, defining the relevant business activity and appropriate allocation of costs, income, and assets may be of particular importance. Therefore, a difference between the controlled and uncontrolled transactions for which an accurate adjustment cannot be made may have a greater effect on the reliability of the results derived under one method than the results derived under another method. For example, differences in management efficiency may have a greater effect on a comparable profits method analysis than on a comparable uncontrolled price method analysis, while differences in product characteristics will ordinarily have a greater effect on a comparable uncontrolled price method analysis than on a comparable profits method analysis.

(e) Confirmation of results by another method.- If two or more methods

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produce inconsistent results, the best method rule will be applied to select the method that provides the most reliable measure of an arm's length result. If the best method rule does not clearly indicate which method should be selected, an additional factor that may be taken into account in selecting a method is whether any of the competing methods produce results that are consistent with the results obtained from the appropriate application of another method. Further, in evaluating different applications of the same method, the fact that a second method (or another application of the first method) produces results that are consistent with one of the competing applications may be taken into account.

Article 1040.09-8.- Comparability Analysis Rules.-

(a) In general.- Whether a controlled transaction produces an arm's length result is generally evaluated by comparing the results of that transaction to results realized by uncontrolled taxpayers engaged in comparable transactions under comparable circumstances. For this purpose, the comparability of transactions and circumstances must be evaluated considering all factors that could affect prices or profits in arm's length dealings (comparability factors). While a specific comparability factor may be of particular importance in applying a method, each method requires analysis of all of the factors that affect comparability under that method. Such factors include the following:

(1) Functions;

(2) Contractual terms;

(3) Risks;

(4) Economic conditions; and

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(5) Property or services.

(b) Standard of comparability.- A comparable transaction under comparable circumstances can be either a comparable transaction between one party to the controlled transaction and an independent party ("internal comparable") or between two independent parties, neither of which is a party to the controlled transaction ("external comparable"). In order to be considered comparable to a controlled transaction, an uncontrolled transaction need not be identical to the controlled transaction, but must be sufficiently similar that it provides a reliable measure of an arm's length result. If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results. For purposes of this Article, a material difference is one that would materially affect the measure of an arm's length result under the method being applied. If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced. Generally, such adjustments must be made to the results of the uncontrolled comparable and must be based on commercial practices, economic principles, or statistical analyses. The extent and reliability of any adjustments will affect the relative reliability of the analysis. In any event, unadjusted industry average returns themselves cannot establish arm's length results.

(c) Comparability Factors.- The comparability factors enumerated in paragraph (a) of this Article are discussed herein. Each of these factors must be considered in determining the degree of comparability between transactions or

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taxpayers and the extent to which comparability adjustments may be necessary. In addition, in certain cases involving special circumstances, the rules under paragraph (d) of this Article must be considered.

(1) Functional analysis.- Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the functions performed, and associated resources employed, by the taxpayers in each transaction. This comparison is based on a functional analysis that identifies and compares the economically significant activities undertaken, or to be undertaken, by the taxpayers in both controlled and uncontrolled transactions. A functional analysis should also include consideration of the resources that are employed, or to be employed, in conjunction with the activities undertaken, including consideration of the type of assets used, such as plant and equipment, or the use of valuable intangibles. A functional analysis is not a pricing method and does not itself determine the arm's length result for the controlled transaction under review. Functions that may need to be accounted for in determining the comparability of two transactions include:

(i) Research and development;

(ii) Product design and engineering;

(iii) Manufacturing, production and process engineering;

(iv) Product fabrication, extraction, and assembly;

(v) Purchasing and materials management;

(vi) Marketing and distribution functions, including inventory management, warranty administration, and advertising activities;

(vii) Transportation and warehousing; and

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(viii) Managerial, legal, accounting and finance, credit and collection, training, and personnel management services.

(2) Contractual terms.-

(i) In general.- Determining the degree of comparability between the controlled and uncontrolled transactions requires a comparison of the significant contractual terms that could affect the results of the two transactions. These contractual terms to be evaluated may include the following:

(A) The form of consideration charged or paid;

(B) Sales or purchase volume;

(C) The scope and terms of warranties provided;

(D) Rights to updates, revisions or modifications;

(E) The duration of relevant license, contract or other agreements, and termination or renegotiation rights;

(F) Collateral transactions or ongoing business relationships between the buyer and the seller, including arrangements for the provision of ancillary or subsidiary services; and

(G) Extension of credit and payment terms.- If the time for payment of the amount charged in a controlled transaction differs from the time for payment of the amount charged in an uncontrolled transaction, an adjustment to reflect the difference in payment terms should be made if such difference would have a material effect on price. Such comparability adjustment is required even if no interest would be allocated or imputed under Article 1040.09-17 of this Regulation (Loans or advances) or other applicable provisions of the Code.)

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(ii) Identifying contractual terms.-

(A) Written agreement.- The contractual terms, including the consequent allocation of risks, that are agreed to in writing before the transactions are entered into will be respected if such terms are consistent with the economic substance of the underlying transactions. In evaluating economic substance, greatest weight will be given to the actual conduct of the parties, and the respective legal rights of the parties. If the contractual terms are inconsistent with the economic substance of the underlying transaction, the Secretary may disregard such terms and impute terms that are consistent with the economic substance of the transaction.

(B) No written agreement.- In the absence of a written agreement, the Secretary may impute a contractual agreement between the controlled taxpayers consistent with the economic substance of the transaction. In determining the economic substance of the transaction, greatest weight will be given to the actual conduct of the parties and their respective legal rights. (For example, if, without a written agreement, a controlled taxpayer operates at full capacity and regularly sells all of its output to another member of its controlled group, the Secretary may impute a purchasing contract from the course of conduct of the controlled taxpayers, and determine that the producer bears little risk that the buyer will fail to purchase its full output. Further, if an established industry convention or usage of trade assigns a risk or resolves an issue, that convention or usage will be followed if the conduct of the taxpayers is consistent with it.)

(3) Risk.-

(i) Comparability.- Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant risks

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that could affect the prices that would be charged or paid, or the profit that would be earned, in the two transactions. Relevant risks to consider include:

(A) Market risks, including fluctuations in cost, demand, pricing, and inventory levels;

(B) Risks associated with the success or failure of research and development activities;

(C) Financial risks, including fluctuations in foreign currency rates of exchange and interest rates;

(D) Credit and collection risks;

(E) Product liability risks; and

(F) General business risks related to the ownership of property, plant, and equipment.

(ii) Identification of taxpayer that bears risk.- In general, the determination of which controlled taxpayer bears a particular risk will be made in accordance with the provisions of (c)(2)(ii) of this Article. Thus, the allocation of risks specified or implied by the taxpayer's contractual terms will generally be respected if it is consistent with the economic substance of the transaction. An allocation of risk between controlled taxpayers after the outcome of such risk is known or reasonably knowable lacks economic substance. In considering the economic substance of the transaction, the following facts will be considered:

(A) Whether the pattern of the controlled taxpayer's conduct over time is consistent with the purported allocation of risk between the controlled taxpayers; or where the pattern is changed, whether the relevant contractual arrangements have

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been modified accordingly;

(B) Whether a controlled taxpayer has the financial capacity to fund losses that might be expected to occur as the result of the assumption of a risk, or whether, at arm's length, another party to the controlled transaction would ultimately suffer the consequences of such losses; and

(C) The extent to which each controlled taxpayer exercises managerial or operational control over the business activities that directly influence the amount of income or loss realized. In arm's length dealings, parties ordinarily bear a greater share of those risks over which they have relatively more control.

(iii) Documentation.- For purposes of determining comparability under the risk factor, a taxpayer's nominal assumption of risk may be disregarded unless documentation reflecting the allocation of risks was executed before the results of such risks were known or reasonably knowable.

(4) Economic conditions.- Determining the degree of comparability between controlled and uncontrolled transactions requires a comparison of the significant economic conditions that could affect the prices that would be charged or paid, or the profit that would be earned in each of the transactions. These economic conditions may include the following:

(i) Similarity of geographic markets;

(ii) The relative size of each market, and the extent of the overall economic development in each market;

(iii) The level of the market (for example, wholesale, retail, etc.);

(iv) The relevant market shares for the products, properties, or services

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transferred or provided;

(v) The location-specific costs of the factors of production and distribution;

(vi) The extent of competition in each market with regard to the property or services under review;

(vii) The economic condition of the particular industry, including whether the market is in contraction or expansion; and

(viii) The alternatives realistically available to the buyer and seller.

(5) Property or services.- Evaluating the degree of comparability between controlled and uncontrolled transactions requires a comparison of the property or services transferred in the transactions. This comparison may include any intangible property that is embedded in tangible property or services being transferred (embedded intangibles). The relevance of product comparability in evaluating the relative reliability of the results will depend on the method applied.

(d) Special circumstances.-

(1) Market share strategy.- In certain circumstances, taxpayers may adopt strategies to enter new markets or to increase a product's share of an existing market (market share strategy). Such a strategy would be reflected by temporarily increased market development expenses or resale prices that are temporarily lower than the prices charged for comparable products in the same market. Whether or not the strategy is reflected in the transfer price depends on which party to the controlled transaction bears the costs of the pricing strategy. In any case, the effect of a market share strategy on a controlled transaction will be taken into account only if it can be

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shown that an uncontrolled taxpayer engaged in a comparable strategy under comparable circumstances for a comparable period of time, and the taxpayer provides documentation that substantiates the following:

(i) The costs incurred to implement the market share strategy are borne by the controlled taxpayer that would obtain the future profits that result from the strategy, and there is a reasonable likelihood that the strategy will result in future profits that reflect an appropriate return in relation to the costs incurred to implement it;

(ii) The market share strategy is pursued only for a period of time that is reasonable, taking into consideration the industry and product in question; and

(iii) The market share strategy, the related costs and expected returns, and any agreement between the controlled taxpayers to share the related costs, were established before the strategy was implemented.

(2) Different geographic markets.-

(i) In general.- Uncontrolled comparables ordinarily should be derived from the geographic market in which the controlled taxpayer operates, because there may be significant differences in economic conditions in different markets. If information from the same market is not available, an uncontrolled comparable derived from a different geographic market may be considered if adjustments are made to account for differences between the two markets. If information permitting adjustments for such differences is not available, then information derived from uncontrolled comparables in the most similar market for which reliable data is available may be used, but the extent of such differences may affect the reliability of the method for purposes of the best method rule. For this purpose, a geographic market is any geographic area in which the

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economic conditions for the relevant product or service are substantially the same, and may include multiple countries, depending on the economic conditions.

(ii) Location Savings.- If an uncontrolled taxpayer operates in a different geographic market than the controlled taxpayer, adjustments may be necessary to account for significant differences in costs attributable to the geographic markets. These adjustments must be based on the effect such differences would have on the consideration charged or paid in the controlled transaction given the relative competitive positions of buyers and sellers in each market. Thus, for example, the fact that the total costs of operating in a controlled manufacturer's geographic market are less than the total costs of operating in other markets ordinarily justifies higher profits to the manufacturer only if the cost differences would increase the profits of comparable uncontrolled manufacturers operating at arm's length, given the competitive positions of buyers and sellers in that market.

(e) Transactions ordinarily not accepted as comparables.- Transactions ordinarily will not constitute reliable measures of an arm's length result for purposes of this Article if:

(1) They are not made in the ordinary course of business; or

(2) One of the principal purposes of the uncontrolled transaction was to establish an arm's length result with respect to the controlled transaction.

Article 1040.09-9.- Arm’s Length Range.-

(a) In General.- In some cases, application of a pricing method will produce a single figure (e.g. price or margin) that is the most reliable to establish whether the conditions of a transaction are arm's length. In other cases, application of the most

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appropriate method or methods may produce a number of figures all of which are relatively equally reliable. In these cases, differences in the figures that comprise the range may be caused by the fact that in general the application of the arm's length principle only produces an approximation of conditions that would have been established between uncontrolled taxpayers. A range of figures may also result when more than one method is applied to evaluate a controlled transaction. For example, two methods that attain similar degrees of comparability may be used to evaluate the arm's length character of a controlled transaction. Each method may produce an outcome or a range of outcomes that differs from the other because of differences in the nature of the methods and the data, relevant to the application of a particular method, used. Nevertheless, each separate range potentially could be used to define an acceptable range of arm's length figures. A taxpayer will not be subject to adjustment if its results fall within such range (arm's length range).

(b) Determination of arm's length range.-

(1) Single method.- The arm's length range is ordinarily determined by applying a single pricing method selected under the best method rule to two or more uncontrolled transactions of similar comparability and reliability.

(2) Selection of comparables.- Uncontrolled comparables must be selected based upon the comparability criteria relevant to the method applied and must be sufficiently similar to the controlled transaction that they provide a reliable measure of an arm's length result. If material differences exist between the controlled and uncontrolled transactions, adjustments must be made to the results of the uncontrolled transaction if the effect of such differences on price or profits can be ascertained with

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sufficient accuracy to improve the reliability of the results in accordance with the Standard of Comparability described in Article 1040.09-8 of this Regulation. The arm's length range will be derived only from those uncontrolled comparables that have, or through adjustments can be brought to, a similar level of comparability and reliability, and uncontrolled comparables that have a significantly lower level of comparability and reliability will not be used in establishing the arm's length range.

(3) Comparables included in arm's length range.-

(i) Full range.- The arm's length range will consist of the results of all of the uncontrolled comparables that meet the following conditions:

(A) The information on the controlled transaction and the uncontrolled comparables is sufficiently complete that it is most probable that all material differences have been identified;

(B) The material differences identified have reasonably ascertainable effect on price or profit; and

(C) Adjustment is made to eliminate the effect of each such difference.

(ii) Adjustment of range to increase reliability.- If the conditions necessary to determine the full range of results, the arm's length range shall be derived from the results of all the uncontrolled comparables, selected pursuant to paragraph (b)(2) of this Article, that achieve a similar level of comparability and reliability. In such cases the reliability of the analysis must be increased, where it is possible to do so, by adjusting the range through application of a valid statistical method to the results of all of the uncontrolled comparables so selected. The reliability of the analysis is increased when statistical methods are used to establish a range of results in which the limits of the

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range will be determined such that there is a 75 percent probability of a result falling above the lower end of the range and a 75 percent probability of a result falling below the upper end of the range. The interquartile range ordinarily provides an acceptable measure of this range; however a different statistical method may be applied if it provides a more reliable measure. If the taxpayer does not select the interquartile range such taxpayer must justify the use of any other measure and a valid justification for the rejection of the interquartile range must be provided.

(4) Interquartile range.-

(i) In General.- For purposes of this Article, the interquartile range is the range from the 25th to the 75th percentile of the results derived from the uncontrolled comparables. For this purpose, the 25th percentile is the lowest result derived from an uncontrolled comparable such that at least 25 percent of the results are at or below the value of that result. However, if exactly 25 percent of the results are at or below a result, then the 25th percentile is equal to the average of that result and the next higher result derived from the uncontrolled comparables. The 75th percentile is determined analogously.

(ii) Application.- Whenever the interquartile range is applied, a minimum number of comparable uncontrolled transaction must be included in the analysis so that the interquartile range can be construed. For purposes of this Regulations a minimum of two (2) comparable uncontrolled transaction must be analyzed when applying the interquartile range.

(c) Adjustment if taxpayer's results are outside arm's length range.- If the results of a controlled transaction fall outside the arm's length range, the Secretary may

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make allocations that adjust the controlled taxpayer's result to any point within the arm's length range. If the interquartile range is used to determine the arm's length range, such adjustment will ordinarily be to the median of all the results. The median is the 50th percentile of the results, which is determined in a manner analogous to that described in paragraph (b)(4) of this Article. In other cases, an adjustment normally will be made to the arithmetic mean of all the results.

(d) Arm's length range not prerequisite to allocation-. The rules of this Article do not require that the Secretary establish an arm's length range prior to making an allocation under Section 1040.09 of the Code. For example, the Secretary may properly propose an allocation on the basis of a single comparable uncontrolled price if the comparable uncontrolled price method has been properly applied. However, if the taxpayer subsequently demonstrates that the results claimed on its income tax return are within the range established by additional equally reliable comparable uncontrolled prices in a manner consistent with the requirements set forth in paragraph (b)(3) of this Article, then no allocation will be made.

Article 1040.09-10.- Analyzed Party

(a) Tested Party.-

(1) In General.- Except as otherwise stated throughout this Regulation, when applying a cost plus, resale price or transactional net margin method, it is necessary to choose the party to the transaction for which a financial indicator (mark-up on costs, gross margin, or net profit indicator) is tested. The choice of the tested party should be consistent with the functional analysis of the transaction. In every other case, as a general rule, the tested party is the one to which a transfer pricing method can be

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applied in the most reliable manner and for which the most reliable comparables can be found taking into account the Comparability Analysis Rules described in Article 1040.09-8 of this Regulation and the Best Method Rule of Article 1040.09-7 of this Regulation. In most cases, the tested party will be the one that has the less complex functional analysis.

(2) Local Party.- For purposes of this Regulation, the taxpayer shall not select the local party by default to be the tested party. Instead, when choosing which taxpayer in a controlled transaction shall be analyzed for purposes of applying the transfer pricing method, an appropriate analysis of comparability and reliability should be deployed when issuing such selection consistent with the above stated in paragraph (a)(1) of this Article.

(b) Aggregation of Transactions.- In order to arrive at the most precise approximation of arm's length conditions, the arm's length principle should be applied on a transaction-by-transaction basis. However, there are often situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately on a separate basis. Therefore, aggregate transactions may be used to analyze whether or not such transactions are with the arm's length standard.

(c) Multiple Years.-

(1) In general.- The results of a controlled transaction ordinarily will be compared with the results of uncontrolled comparables occurring in the taxable year under review. However data relating to the uncontrolled comparables or the controlled taxpayer for one or more years before or after the year under review may be considered if they add value to the transfer pricing analysis. If data relating to uncontrolled

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comparables from multiple years is used, data relating to the controlled taxpayer for the same years ordinarily must be considered. However, if such data is not available, reliable data from other years, as adjusted pursuant to the Standard of Comparability set forth in Article 1040.09-8 of this Regulation may be used.

(2) Circumstances warranting consideration of multiple year data.- The extent to which it is appropriate to consider multiple year data depends on the method being applied and the issue being addressed. Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data are available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible property being examined.

(3) Comparable effect over comparable period.- Data from multiple years may be considered to determine whether the same economic conditions that caused the controlled taxpayer's results had a comparable effect over a comparable period of time on the uncontrolled comparables that establish the arm's length range. For example, given that uncontrolled taxpayers enter into transactions with the ultimate expectation of earning a profit, persistent losses among controlled taxpayers may be an indication of non-arm's length dealings. Thus, if a controlled taxpayer that realizes a loss with respect to a controlled transaction seeks to demonstrate that the loss is within the arm's length range, the Secretary may take into account data from taxable years other than the taxable year of the transaction to determine whether the loss was attributable to arm's length dealings.

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(4) Application of methods using multiple year averages.- If a comparison of a controlled taxpayer's average result over a multiple year period with the average results of uncontrolled comparables over the same period would reduce the effect of short-term variations that may be unrelated to transfer pricing, it may be appropriate to establish a range derived from the average results of uncontrolled comparables over a multiple year period to determine if an adjustment should be made. In such a case the Secretary may make an adjustment if the controlled taxpayer's average result for the multiple year period is not within such range. Such a range must be determined in accordance with Article 1040.09-9 of this Regulation. An adjustment in such a case ordinarily will be equal to the difference, if any, between the controlled taxpayer's result for the taxable year and the mid-point of the uncontrolled comparables' results for that year. If the interquartile range is used to determine the range of average results for the multiple year period, such adjustment will ordinarily be made to the median of all the results of the uncontrolled comparables for the taxable year. In other cases, the adjustment normally will be made to the arithmetic mean of all the results of the uncontrolled comparables for the taxable year. However, an adjustment will be made only to the extent that it would move the controlled taxpayer's multiple year average closer to the arm's length range for the multiple year period or to any point within such range.

Article 1040.09-11.- Comparable Uncontrolled Price Method (CUP method) & Comparable Uncontrolled Transaction Method (CUT Method)

(a) Comparable Uncontrolled Price Method.-

(1) In General.- The comparable uncontrolled price (hereinafter, “CUP Method”) consists on comparing the price charged for tangible property or services

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transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. If there is any difference between the two prices, there will be a presumption that the conditions of the commercial and financial relations of the related taxpayers are not arm's length, and that the price in the uncontrolled transaction may need to be substituted for the price in the controlled transaction.

(2) Comparable Conditions.-

(i) Required Conditions.- An uncontrolled transaction is comparable to a controlled transaction (comparable uncontrolled transaction) for purposes of the CUP method if one of two conditions is met:

(A) None of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or

(B) Reasonably accurate adjustments can be made to eliminate the material effects of such differences. Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP method is preferable over all other methods.

(ii) Adjustment of Data.- In considering whether controlled and uncontrolled transactions are comparable, the Secretary shall regard the effect on price of broader business functions other than just product comparability. Where differences exist between the controlled and uncontrolled transactions or between the parties undertaking those transactions, it may be difficult to determine reasonably accurate

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adjustments to eliminate the effect on price. The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. The taxpayer shall make every effort to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.

(3) CUP Method Application.-

(i) In general.- The CUP method evaluates whether the amount charged in a controlled transaction is arm's length by reference to the amount charged in a comparable uncontrolled transaction.

(ii) Comparability and reliability considerations.-

(A) Best Method Rule.- Whether results derived from applications of the CUP method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in Article 1040.09-7 of this Regulation. The application of these factors under the CUP Method is discussed in this clause (ii).

(B) Comparability.-

(I) In general.- The degree of comparability between controlled and uncontrolled transactions is determined by applying the Comparability Analysis Rules set forth in Article 1040.09-8 of this Regulation. Although all of the factors described in the aforementioned Article must be considered, similarity of products generally will have the greatest effect on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the

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amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the CUP method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences with the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the CUP method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material product differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

(II) Adjustments for differences between controlled and uncontrolled transactions.- If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the provisions of Article 1040.09-8 of this Regulation. When making such adjustments, the following factors may be particularly relevant to the CUP Method:

i. Quality of the product;

ii. Contractual terms, (for example, scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

iii. Level of the market (i.e., wholesale, retail, etc.);

iv. Geographic market in which the transaction takes place;

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v. Date of the transaction;

vi. Intangible property associated with the sale;

vii. Foreign currency risks; and

viii. Alternatives realistically available to the buyer and seller.

(iii) Data and assumptions.- The reliability of the results derived from the CUP method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method in accordance with the Best method rule.

(4) Arm's length range.- *See*, Article 1040.09-9 of this Regulation.

(5) Indirect evidence of comparable uncontrolled transactions.

(j) In general.- A CUP may be derived from data from public exchanges or quotation media, but only if the following requirements are met:

(A) The data is widely and routinely used in the ordinary course of business in the industry to negotiate prices for uncontrolled sales;

(B) The data derived from public exchanges or quotation media is used to set prices in the controlled transaction in the same way it is used by uncontrolled taxpayers in the industry; and

(C) The amount charged in the controlled transaction is adjusted to reflect differences in product quality and quantity, contractual terms, transportation costs, market conditions, risks borne, and other factors that affect the price that would be agreed to by uncontrolled taxpayers.

(ii) Exception.- Use of data from public exchanges or quotation media may not be appropriate under extraordinary market conditions, like war, outbreaks or political

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turmoil.

(6) Examples.-

(i) Corporation A, a U.S. corporation not engaged in trade or business in Puerto Rico ("ETB-PR"), sells the same consumer product to both, Corporation B (a controlled taxpayer) and Corporation C, an uncontrolled taxpayer, both ETB-PR. The circumstances surrounding the transactions between the controlled and uncontrolled taxpayers are substantially the same, except that the controlled sales price is a delivered price and the uncontrolled sales are made f.o.b. Corporation A's factory. No other material difference has been identified between the controlled and uncontrolled transactions. Differences in the contractual terms of transportation and insurance generally have a definite and reasonably ascertainable effect on price, and adjustments shall be made to the results of the uncontrolled transaction to account for such differences pursuant to Article 1040.09-8 of this Regulation. Because Corporation A sells in both the controlled and uncontrolled transactions, it is likely that all material differences between the two transactions have been identified. In addition, because the comparable uncontrolled price method is applied to an uncontrolled comparable with no product differences, and there are only minor contractual differences that have a definite and reasonably ascertainable effect on price, the results of this application of the comparable uncontrolled price method will provide the most direct and reliable measure of an arm's length result. The facts are the same as the above example, except that Corporation A affixes its valuable trademark to the property sold in the controlled transactions, but does not affix its trademark to the property sold in the uncontrolled transactions. If the effect on price of the trademark is material and cannot be reliably

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estimated, there would be material product differences for which reliable adjustments cannot be made. Therefore, the CUP method is unlikely to provide a reliable measure of the arm's length result and should not be applied under such circumstances.

(b) Comparable Uncontrolled Transaction Method.-

(1) In general.- The Comparable Uncontrolled Transaction Method (hereinafter, the “CUT Method”) evaluates whether the amount charged for a controlled transfer of intangible property was arm's length by reference to the amount charged in a comparable uncontrolled transaction. The amount determined under this method may be adjusted as required Periodic Adjustments set forth in Article 1040.09-20(c) of this Regulation.

(2) Comparability and reliability considerations.- Whether results derived from applications of this method are the most reliable measure of an arm's length result is determined using the factors described under the best method rule in Article 1040.09-7 of this Regulation. The application of these factors under the CUT method shall be made in accordance to the following considerations:

(i) Reliability.- If an uncontrolled transaction involves the transfer of the same intangible under the same, or substantially the same, circumstances as the controlled transaction, the results derived from applying the comparable uncontrolled transaction method will generally be the most direct and reliable measure of the arm's length result for the controlled transfer of an intangible. Circumstances between the controlled and uncontrolled transactions will be considered substantially the same if there are at most only minor differences that have a definite and reasonably ascertainable effect on the amount charged and for which appropriate adjustments are made. If such uncontrolled

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transactions cannot be identified, uncontrolled transactions that involve the transfer of comparable intangibles under comparable circumstances may be used to apply this method, but the reliability of the analysis will be reduced.

(ii) Comparability.- The degree of comparability between controlled and uncontrolled transactions is determined by applying the Comparability Analysis Rules in Article 1040.09-8 of this Regulation. Although all of the factors described in Article 1040.09-8, of this Regulation must be considered, specific factors may be particularly relevant to this method. In particular, the application of this method requires that the controlled and uncontrolled transactions involve either the same intangible property or comparable intangible property, as defined below in paragraph (b)(2)(ii)(A)(I) of this Article. In addition, because differences in contractual terms, or the economic conditions in which transactions take place, could materially affect the amount charged, comparability under this method also depends on similarity with respect to these factors, or adjustments to account for material differences in such circumstances.

(A) Factors to be considered in determining comparability.-

(I) Comparable intangible property.- In order for the intangible property involved in an uncontrolled transaction to be considered comparable to the intangible property involved in the controlled transaction, both intangibles must:

(a) Be used in connection with similar products or processes within the same general industry or market; and

(b) Have similar profit potential.- The profit potential of an intangible is most reliable when measured by directly calculating the net present value of the benefits to be realized (based on prospective profits to be realized or costs to be saved) through

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the use or subsequent transfer of the intangible, considering the capital investment and start-up expenses required, the risks to be assumed, and other relevant considerations. The need to reliably measure profit potential increases in relation to both the total amount of potential profits and the potential rate of return on investment necessary to exploit the intangible. If the information necessary to directly calculate net present value of the benefits to be realized is unavailable, and the need to reliably measure profit potential is reduced because the potential profits are relatively small in terms of total amount and rate of return, comparison of profit potential may be based upon the factors referred to in the next sub-sub clause (II) of this paragraph (Comparable Circumstances). Finally, the reliability of a measure of profit potential is affected by the extent to which the profit attributable to the intangible can be isolated from the profit attributable to other factors, such as functions performed and other resources employed.

(II) Comparable circumstances.- In evaluating the comparability of the circumstances of the controlled and uncontrolled transactions, although all of the factors described in Article 1040.09-8, of this Regulation, specific factors that may be particularly relevant to this method include the following:

(a) The terms of the transfer, including the exploitation rights granted in the intangible, the exclusive or nonexclusive character of any rights granted, any restrictions on use, or any limitations on the geographic area in which the rights may be exploited;

(b) The stage of development of the intangible (including, where appropriate, necessary governmental approvals, authorizations, or licenses) in the market in which the intangible is to be used;

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(c) Rights to receive updates, revisions, or modifications of the intangible;

(d) The uniqueness of the property and the period for which it remains unique, including the degree and duration of protection afforded to the property under the laws of the relevant countries;

(e) The duration of the license, contract, or other agreement, and any termination or renegotiation rights;

(f) Any economic and product liability risks to be assumed by the transferee;

(g) The existence and extent of any collateral transactions or ongoing business relationships between the transferee and transferor; and

(h) The functions to be performed by the transferor and transferee, including any ancillary or subsidiary services.

(iii) Data and assumptions.- The reliability of the results derived from the CUT method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method under the Best method rule.

(iv) Arm's length range.- *See*, Article 1040.09-9 of this Regulation for the determination of an arm's length range.

(3) Example.-

(i) Corporation X, a U.S. pharmaceutical company, develops a new drug "D" for the treatment of the disease ZK. Corporation X is the owner of the patent and has the permits for the manufacture and marketing of drug D in the United States and in various foreign countries. Corporation X licenses its subsidiary in Puerto Rico, Corporation PR, to produce and sell drug D in Puerto Rico. At the same time, it licenses an unrelated taxpayer, Corporation VI, to produce and sell drug D in the U.S. Virgin

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Islands. Puerto Rico and the Virgin Islands are relatively similar countries in incidence of ZK on a per capita basis. Consequently, drug D is expected to sell in similar quantities and at similar prices in both countries. In addition, costs of producing and marketing drug D in each country are expected to be approximately the same. Corporation X and Corporation PR establish terms for the license of drug D that are identical in every material respect, including royalty rate, to the terms established between Corporation X and Corporation VI. In this case the Secretary determines that the royalty rate established in the Corporation PR license agreement is a reliable measure of the arm's length royalty rate for the Corporation VI license agreement.

Article 1040.09-12.- Resale price method.-

(a) In General.- The resale price method evaluates the price at which a product that has been purchased from a controlled taxpayer is resold to an uncontrolled taxpayer. This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties, sales tax, etc.), as an arm's length price for the original transfer of property between the controlled taxpayers.

(b) Value of functions performed.- The resale price method measures the value of functions performed, and is ordinarily used in cases involving the purchase and resale of tangible property in which the reseller has not added substantial value to the

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tangible goods by physically altering the goods before resale. For this purpose, packaging, repackaging, labelling, or minor assembly do not ordinarily constitute physical alteration. Further, the resale price method is not ordinarily used in cases where the controlled taxpayer uses its intangible property to add substantial value to the tangible goods.

(c) Margins.- The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions ("internal comparable"). Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide ("external comparable"). Where the reseller is carrying on a general brokerage business, the resale price margin may be related to a brokerage fee, which is usually calculated as a percentage of the sales price of the product sold. The determination of the resale price margin in such a case should take into account whether the broker is acting as an agent or a principal.

(d) Comparable Conditions.- An uncontrolled transaction is comparable to a controlled transaction (comparable uncontrolled transaction) for purposes of the resale price method if one of two conditions is met:

(1) None of the differences (if any) between the transactions being compared or between the taxpayers undertaking those transactions could materially affect the resale price margin in the open market; or,

(2) Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

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(e) Determination of arm's length price when using the resale price method.-

(1) In general.- The resale price method measures an arm's length price by subtracting the appropriate gross profit from the applicable resale price for the property involved in the controlled transaction under review.

(2) Applicable resale price.- The applicable resale price is equal to either the resale price of the particular item of property involved or the price at which contemporaneous resales of the same property are made. If the property purchased in the controlled sale is resold to one or more controlled taxpayer in a series of controlled sales before being resold in an uncontrolled sale, the applicable resale price is the price at which the property is resold to an uncontrolled taxpayer, or the price at which contemporaneous resales of the same property are made. In such case, the determination of the appropriate gross profit will take into account the functions of all members of the group participating in the series of controlled sales and final uncontrolled resales, as well as any other relevant factors (Factors for determining comparability) described in Article 1040.09-8 of this Regulation.

(3) Appropriate gross profit.- The appropriate gross profit is computed by multiplying the applicable resale price by the gross profit margin (expressed as a percentage of total revenue derived from sales) earned in comparable uncontrolled transactions.

(f) Arm's length range. *See*, Article 1040.09-9 of this Regulation.

(g) Comparability and reliability considerations.-

(1) In general.- Whether results derived from applications of this method are the most reliable measure of the arm's length result must be determined using the

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factors described under the best method rule. The application of these factors under the resale price method shall be made in accordance to the following considerations:

(i) Reliability.-

(A) Material Differences.- When the resale price margin used is that of an uncontrolled taxpayer in a comparable transaction, the reliability of the resale price method may be affected if there are material differences in the ways the controlled taxpayer and uncontrolled taxpayers carry out their businesses. Such differences could include those that affect the level of costs taken into account (e.g. the differences could include the effect of management efficiency on levels and ranges of inventory maintenance), which may well have an impact on the profitability of an enterprise but which may not necessarily affect the price at which it buys or sells its goods or services in the open market. The Secretary may consider these types of characteristics when determining whether an uncontrolled transaction is comparable for purposes of applying the resale price method.

(B) Comparability of Functions.- The resale price method also depends on comparability of functions performed (taking into account assets used and risks assumed). It may become less reliable when there are differences between the controlled and uncontrolled transactions and the parties to the transactions, and those differences have a material effect on the attribute being used to measure arm's length conditions, in this case the resale price margin realized. Where there are material differences that affect the gross margins earned in the controlled and uncontrolled transactions (for example, in the nature of the functions performed by the parties to the transactions), adjustments should be made to account for such differences. The extent

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and reliability of those adjustments will affect the relative reliability of the analysis under the resale price method in any particular case.

(ii) Comparability.-

(A) Functional comparability.- The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of Article 1040.09-8 of this Regulation. A reseller's gross profit provides compensation for the performance of resale functions related to the product or products under review, including an operating profit in return for the reseller's investment of capital and the assumption of risks. Therefore, although all of the factors described in Article 1040.09-8 of this Regulation must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, appropriate gross profit margins should be derived from comparable uncontrolled purchases and resales of the reseller involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of comparable uncontrolled transactions involving the same reseller, an appropriate gross profit margin may be derived from comparable uncontrolled transactions of other resellers.

(B) Activities of the reseller.- The amount of the resale price margin will be influenced by the level of activities performed by the reseller. This level of activities can range widely from the case where the reseller performs only minimal services as a forwarding agent to the case where the reseller takes on the full risk of ownership

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together with the full responsibility for and the risks involved in advertising, marketing, distributing and guaranteeing the goods, financing stocks, and other connected services. If the reseller in the controlled transaction does not carry on a substantial commercial activity but only transfers the goods to a third party, the resale price margin could, in light of the functions performed, be a small one. The resale price margin could be higher where it can be demonstrated that the reseller has some special expertise in the marketing of such goods, in effect bears special risks, or contributes substantially to the creation or maintenance of intangible property associated with the product. (For example, the resale price margin may be affected if the reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks or trade names) which are owned by a controlled taxpayer.) However, the level of activity performed by the reseller, whether minimal or substantial, would need to be well supported by relevant evidence. This would include justification for marketing expenditures that might be considered unreasonably high; for example, when part or most of the promotional expenditure was clearly incurred as a service performed in favor of the legal owner of the trademark. In such a case the cost plus method described in Article 1040.09-13 of this Regulation may well supplement the resale price method. Where the reseller is clearly carrying on a substantial commercial activity in addition to the resale activity itself, then a reasonably substantial resale price margin might be expected. If the reseller in its activities employs valuable and possibly unique assets (for example, intangible property of the reseller, such as its marketing organization), the Secretary may decide not to evaluate the arm's length conditions in the controlled transaction using an unadjusted resale price margin derived from

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uncontrolled transactions in which the uncontrolled reseller does not employ similar assets considering the fact that if the reseller possesses valuable marketing intangibles, the resale price margin in the uncontrolled transaction may underestimate the profit to which the reseller in the controlled transaction is entitled, unless the comparable uncontrolled transaction involves the same reseller or a reseller with similarly valuable marketing intangibles. In a case where there is a chain of distribution of goods through an intermediate company, the Secretary may look not only at the resale price of goods that have been purchased from the intermediate company but also at the price that such company pays to its own supplier and the functions that the intermediate company undertakes. If it cannot be demonstrated that the intermediate company either bears a real risk or performs an economic function in the chain that has increased the value of the goods, then any element in the price that is claimed to be attributable to the activities of the intermediate company would reasonably be attributed elsewhere in the controlled group, because uncontrolled taxpayer would not normally have allowed such a company to share in the profits of the transaction. The resale price margin should also be expected to vary according to whether the reseller has the exclusive right to resell the goods. Arrangements of this kind are found in transactions between uncontrolled taxpayer and may influence the margin. Thus, this type of exclusive right will be taken into account by the Secretary in any comparison. The value to be attributed to such an exclusive right will depend to some extent upon its geographical scope and the existence and relative competitiveness of possible substitute goods. The arrangement may be valuable to both the supplier and the reseller in an arm's length transaction. For instance, it may stimulate the reseller to greater efforts to sell the supplier’s particular

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line of goods. On the other hand, such an arrangement may provide the reseller with a kind of monopoly with the result that the reseller possibly can realize a substantial turn over without great effort. Accordingly, the effect of this factor upon the appropriate resale price margin will be examined by the Secretary.

(C) Sales agent.- If the controlled taxpayer is comparable to a sales agent that does not take title to goods or otherwise assume risks with respect to ownership of such goods, the commission earned by such sales agent, expressed as a percentage of the uncontrolled sales price of the goods involved, may be used as the comparable gross profit margin.

(D) Other comparability factors.- Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. For example, distributors of a wide variety of consumer durables might perform comparable distribution functions without regard to the specific durable goods distributed. Substantial differences in the products may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve the distribution of products of the same general type. Furthermore, significant differences in the value of the distributed goods due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a

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start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(iii) Data and assumptions.-

(A) In general.- The reliability of the results derived from the resale price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method under the Best method rule.

(B) Consistency in accounting.- The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit margin affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit margin, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the uncontrolled comparable should be consistent in the reporting of items (such as discounts, returns and allowances, rebates, transportation costs, insurance, and packaging) between cost of goods sold and operating expenses.

(h) Adjustments for differences between controlled and uncontrolled transactions.- If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit margin, adjustments should be made to the gross profit margin earned with respect to the uncontrolled transaction according to the Comparability Analysis Rules of Article 1040.09-8 . For this purpose, consideration of operating expenses associated with functions performed and risks assumed may be

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necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include:

(1) Inventory levels and turnover rates, and corresponding risks, including any price protection programs offered by the manufacturer;

(2) Contractual terms (for example, scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms);

(3) Sales, marketing, advertising programs and services, (including promotional programs, rebates, and co-op advertising);

(4) The level of the market (for example, wholesale, retail, etc.); and

(5) Foreign currency risks.

(i) Examples. The provisions of this Article are explained in the following examples:

(1) Corporation "S", a Puerto Rico corporation that is ETB-PR and is a distributor and wholly owned subsidiary of Corporation "P", a non-Puerto Rico corporation that is not ETB-PR. The Secretary is auditing the Puerto Rico income tax return of Corporation "S" to determine if the income that it reported from its sales should be adjusted or not pursuant to Section 1040.09 of the Code. For such purposes, the Secretary determined that the resale price method is the appropriate method of establishing whether the purchase price of the merchandise that it resells is adequate. Corporation "P" sells generic consumer goods to Corporation S that in turn resells it to

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uncontrolled taxpayers. The purchase price of the generic consumer goods from Corporation “P”, is ninety (90) dollars per item, and the reselling price by Corporation “S” to an uncontrolled taxpayer is one hundred (100) dollars. There are no changes in the beginning and ending inventory of Corporation “S” for the year under review. Information regarding an uncontrolled comparable sale is sufficiently complete to conclude that all material differences between the controlled and uncontrolled transactions have been identified and properly adjusted (for example, the operating expenses incurred by Corporation “S” in the sales to uncontrolled taxpayers). Therefore, the only factor that differentiates the sale of the articles by Corporation S and by an uncontrolled taxpayer is the purchase price of the merchandise that each of them sells. The Secretary has concluded that the appropriate gross profit margin of such sales, industry wise, is 20%. Accordingly, if the applicable resale price of the property involved in the controlled sale is $100 and the appropriate gross profit margin is 20%, then an arm's length result of the controlled sale should be a purchase price of eight (80) dollars ($100 minus $20 (20% × $100)). Since in the return being audited the profit margin of Corporation “S” is ten (10) percent ($100 minus ninety (90) dollars (cost of goods sold), the Secretary has basis under Section 1040.09 of the Code to adjust the purchase price from ninety (90) dollars to eighty (80) dollars so that the resulting gross profit margin is twenty (20) percent (the industry’s margin) instead of ten (10) percent (the resulting margin reflected in the income tax return of Corporation “S”).

Article 1040.09-13.- Cost plus method.-

(a) In General.- The cost plus method evaluates the costs incurred by the supplier of property (or services) in a controlled transaction for tangible property

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transferred or services provided to an controlled taxpayer that acts as a purchaser. An appropriate cost plus mark up is then added to this cost to make an appropriate profit in light of the functions performed and the market conditions. What is arrived at after adding the cost plus mark up to the above costs may be regarded as an arm's length price of the original controlled transaction. This method probably is most useful where semi finished goods are sold between controlled taxpayers, where controlled taxpayers have concluded joint facility agreements or long-term buy-and-supply arrangements, or where the controlled transaction is the provision of services.

(b) Cost plus mark up.- The cost plus mark up of the supplier in the controlled transaction should ideally be established by reference to the cost plus mark up that the same supplier earns in comparable uncontrolled transactions ("internal comparable"). In addition, the cost plus mark up that would have been earned in comparable transactions by an independent enterprise may serve as a guide ("external comparable").

(c) Comparable Conditions.- An uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the cost plus method if one of two conditions is met:

(1) None of the differences (if any) between the transactions being compared or between the taxpayers undertaking those transactions materially affect the cost plus mark up in the open market; or

(2) Reasonably accurate adjustments can be made to eliminate the material effects of such differences.

(d) Determination of arm's length price when using the cost plus method.-

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(1) In general.- The cost plus method measures an arm's length price by adding the appropriate gross profit to the controlled taxpayer's costs of producing the property involved in the controlled transaction.

(2) Appropriate gross profit.- The appropriate gross profit is computed by multiplying the controlled taxpayer's cost of producing the transferred property by the gross profit markup, expressed as a percentage of cost, earned in comparable uncontrolled transactions.

(3) Purchasing agent.- If a controlled taxpayer is comparable to a purchasing agent that does not take title to property or otherwise assume risks with respect to ownership of such goods, the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may be used as the appropriate gross profit markup.

(4) Arm's length range.- *See*, Article 1040.09-9 of this Regulation.

(e) Comparability and reliability considerations.-

(1) In general.- Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in Article 1040.09-7 of this Regulation .

(2) Comparability.-

(A) Functional comparability.- The degree of comparability between controlled and uncontrolled transactions is determined by applying the Comparability Analysis Rules set forth in Article 1040.09-8 of this Regulation. A producer's gross profit provides compensation for the performance of the production functions related to the product or products under review, including an operating profit for the producer's

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investment of capital and assumption of risks. Therefore, although all of the factors described in Article 1040.09-8 of this Regulation must be considered, comparability under this method is particularly dependent on similarity of functions performed, risks borne, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross profit markup should be derived from comparable uncontrolled transactions of the taxpayer involved in the controlled sale, because similar characteristics are more likely to be found among sales of property by the same producer than among sales by other producers. In the absence of such sales, an appropriate gross profit markup may be derived from comparable uncontrolled sales of other producers whether or not such producers are members of the same controlled group.

(B) Comparability of markup.- The taxpayer shall apply a comparable mark up to the comparable cost basis. For instance, if the supplier to which reference is made in applying the cost plus method in carrying out its activities employs leased business assets, the cost basis might not be comparable without adjustment if the supplier in the controlled transaction owns its business assets. The cost plus method relies upon a comparison of the mark up on costs achieved in a controlled transaction and the mark up on costs achieved in one or more comparable uncontrolled transactions. Therefore, differences between the controlled and uncontrolled transactions that have an effect on the size of the mark up shall be analyzed by the Secretary to determine what adjustments should be made, if any, to the uncontrolled transactions' respective mark up. For this purpose, the taxpayer shall consider differences in the level and types of expenses – operating expenses and nonoperating expenses including financing

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expenditures – associated with functions performed and risks assumed by the parties or transactions being compared. Consideration of these differences may indicate the following:

(I) If expenses reflect a functional difference (taking into account assets used and risks assumed) which has not been taken into account in applying the method, an adjustment to the cost plus markup may be required.

(II) If the expenses reflect additional functions that are distinct from the activities tested by the method, separate compensation for those functions may need to be determined. Such functions may for example amount to the provision of services for which an appropriate reward may be determined. Similarly, expenses that are the result of capital structures reflecting non-arm's length arrangements may require separate adjustment.

(III) If differences in the expenses of the parties being compared merely reflect efficiencies or inefficiencies of the enterprises, as would normally be the case for supervisory, general, and administrative expenses, then no adjustment to the gross margin shall be made.

In any of the above circumstances the taxpayer may supplement the cost plus and resale price methods by considering the results obtained from applying other methods.

(C) Other comparability factors.- Comparability under this method is less dependent on close physical similarity between the products transferred than under the comparable uncontrolled price method. Substantial differences in the products may, however, indicate significant functional differences between the controlled and

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uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions involve the production of goods within the same product categories. Furthermore, significant differences in the value of the products due, for example, to the value of a trademark, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross profit may be adversely affected by factors that have less effect on prices. For example, gross profit may be affected by a variety of other factors, including cost structures (as reflected, for example, in the age of plant and equipment), business experience (such as whether the business is in a start-up phase or is mature), or management efficiency (as indicated, for example, by expanding or contracting sales or executive compensation over time). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(3) Data and assumptions.-

(i) In general. The reliability of the results derived from the cost plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. *See*, Best Method Rule.

(ii) Consistency in accounting.- The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross profit markup affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the gross profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, the controlled transaction and the comparable uncontrolled transaction should be consistent in the reporting of

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costs between cost of goods sold and operating expenses. The term cost of producing includes the cost of acquiring property that is held for resale.

(f) Adjustments for differences between controlled and uncontrolled transactions.- If there are material differences between the controlled and uncontrolled transactions that would affect the gross profit markup, adjustments should be made to the gross profit markup earned in the comparable uncontrolled transaction according to the Standard of Comparability set forth in Article 1040.09-8 of this Regulation. For this purpose, consideration of the operating expenses associated with the functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in operating expenses. If there are differences in functions performed, however, the effect on gross profit of such differences is not necessarily equal to the differences in the amount of related operating expenses. Specific examples of the factors that may be particularly relevant to this method include:

(1) The complexity of manufacturing or assembly;

(2) Manufacturing, production, and process engineering;

(3) Procurement, purchasing, and inventory control activities;

(4) Testing functions;

(5) Selling, general, and administrative expenses;

(6) Foreign currency risks; and

(7) Contractual terms (for example, the scope and terms of warranties provided, sales or purchase volume, credit terms, transport terms).

(g) The provisions of this Article are explained in the following example:

(1) Corporation “S”, a Puerto Rico corporation that is ETB-PR and a wholly

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owned subsidiary of Corporation “P”, a non-Puerto Rico corporation that is not ETB-PR. The Secretary is auditing the Puerto Rico income tax return of Corporation “S” to determine if the income that it reported from its operations in Puerto Rico should be adjusted or not pursuant to Section 1040.09 of the Code. For such purposes, the Secretary determined that the cost-plus method is the appropriate method for establishing whether certain payments made by Corporation “S” to its parent for services that it performed in connection with the operations that Corporation “S” carries out in Puerto Rico is adequate. Corporation “P” is in charge of storing in its servers located in the United States all the electronic data of all of its subsidiaries. Corporation “P” charges a fee for such data storage services, which consists of its storage costs plus a twenty five (25) percent mark-up. In the taxable year being audited, Corporation “P” charged a total of twelve thousand five hundred (12,500) dollars, including the mark-up. Information regarding an uncontrolled comparable service fee is sufficiently complete to conclude that all material differences between the controlled and uncontrolled transactions have been identified and properly adjusted. Therefore, the only factor that differentiates the fee paid by Corporation S and by an uncontrolled taxpayer is the mark-up charged for the services that each performs. The Secretary has concluded that the appropriate mark-up for such services, industry wise, is twenty (20) percent. Accordingly, if the applicable mark-up of the services performed in the controlled transaction is twenty (20) percent, then an arm's length result of the controlled service fee should be twelve thousand (12,000) dollars, a cost of ten thousand (10,000) dollars plus two thousand (2,000) dollars (representing the mark-up). Since in the return being audited the mark-up paid by Corporation “S” is twenty five (25)

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percent, the Secretary has basis under Section 1040.09 of the Code to adjust the amount of fees paid from twelve thousand five hundred (12,500) dollars to twelve thousand (12,000) dollars so that the resulting mark-up is twenty (20) percent (the industry's mark-up) instead of twenty five (25) percent (the resulting mark-up reflected in the income tax return of Corporation "S").

Article 1040.09-14.- Profit split method.-

(a) In general.- The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The combined operating profit or loss must be derived from the most narrowly identifiable business activity of the controlled taxpayers for which data is available that includes the controlled transactions (relevant business activity).

(b) Appropriate share of profits and losses.- The relative value of each controlled taxpayer's contribution to the success of the relevant business activity must be determined in a manner that reflects the functions performed, risks assumed, and resources employed by each participant in the relevant business activity, consistent with the Comparability Analysis Rules set forth in Article 1040.09-8 of this Regulation. Such an allocation is intended to correspond to the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers engaged in the relevant business activity. The profit allocated to any particular member of a controlled group is not necessarily limited to the total operating profit of the group from the relevant business activity. For

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example, in a given year, one member of the group may earn a profit while another member incurs a loss. In addition, it may not be assumed that the combined operating profit or loss from the relevant business activity should be shared equally, or in any other arbitrary proportion. The specific method of allocation must be determined under paragraph (c) of this Article.

(c) Application of the profit split method.-

(1) In general.- The allocation of profit or loss under the profit split method must be made in accordance with one of the following allocation methods-

(i) The comparable profit split, described in paragraph (c)(2) of this Article; or

(ii) The residual profit split, described in paragraph (c)(3) of this Article.

(2) Comparable profit split.-

(i) In general.- A comparable profit split is derived from the combined operating profit of uncontrolled taxpayers whose transactions and activities are similar to those of the controlled taxpayers in the relevant business activity. Under this method, each uncontrolled taxpayer's percentage of the combined operating profit or loss is used to allocate the combined operating profit or loss of the relevant business activity. The Secretary shall evaluate whether the allocation of profit or losses was established considering the arm’s length standard.

(ii) Comparability and reliability considerations.-

(A) In general.- Whether results derived from application of this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule.

(B) Comparability.-

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(I) In general.- The degree of comparability between the controlled and uncontrolled taxpayers is determined by applying the Comparability Analysis Rules set forth in Article 1040.09-8 of this Regulation. The comparable profit split compares the division of operating profits among the controlled taxpayers to the division of operating profits among uncontrolled taxpayers engaged in similar activities under similar circumstances. In addition, because the contractual terms of the relationship among the participants in the relevant business activity will be a principal determinant of the allocation of functions and risks among them, comparability under this method also depends particularly on the degree of similarity of the contractual terms of the controlled and uncontrolled taxpayers. Finally, the comparable profit split may not be used if the combined operating profit (as a percentage of the combined assets) of the uncontrolled comparables varies significantly from that earned by the controlled taxpayers.

(II) Data and assumptions.- The reliability of the results derived from the comparable profit split is affected by the quality of the data and assumptions used to apply this method. Therefore, the following factors must be considered:

(a) The reliability of the allocation of costs, income, and assets between the relevant business activity and the participants' other activities will affect the accuracy of the determination of combined operating profit and its allocation among the participants. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets. Similarly, the reliability of the results derived from the

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application of this method is affected by the extent to which it is possible to apply the method to the parties' financial data that is related solely to the controlled transactions. For example, if the relevant business activity is the assembly of components purchased from both controlled and uncontrolled suppliers, it may not be possible to apply the method solely to financial data related to the controlled transactions. In such a case, the reliability of the results derived from the application of this method will be reduced; and

(b) The degree of consistency between the controlled and uncontrolled taxpayers in accounting practices that materially affect the items that determine the amount and allocation of operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect operating profit, the ability to make reliable adjustments for such differences would affect the reliability of the results. Further, accounting consistency among the participants in the controlled transaction is required to ensure that the items determining the amount and allocation of operating profit are measured on a consistent basis.

(III) Other factors affecting reliability.- The comparable profit split relies exclusively on external market benchmarks. As the degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the comparable profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data and assumptions are significantly more reliable with

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respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

(iii) Adjustments for differences between the controlled and uncontrolled taxpayers.- If there are differences between the controlled and uncontrolled taxpayers that would materially affect the division of operating profit, adjustments must be made according to the Standard of comparability set forth in Article 1040.09-8 of this Regulation.

(3) Residual profit split.-

(i) In general.- Under this allocation method, the combined operating profit or loss from the relevant business activity is allocated between the controlled taxpayers following the two-step process set forth in paragraphs (c)(3)(i)(A) and (B) of this Article.

(A) Allocation of income to routine contributions.- During the first step, the operating income to each party to the controlled transactions is allocated to provide a market return for its routine contributions to the relevant business activity. Routine contributions are contributions of the same or a similar kind to those made by uncontrolled taxpayers involved in similar business activities for which it is possible to identify market returns. Routine contributions ordinarily include contributions of tangible property, services and intangible property that are generally owned by uncontrolled taxpayers engaged in similar activities. A functional analysis is required to identify these contributions according to the functions performed, risks assumed, and resources employed by each of the controlled taxpayers. Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities.

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(B) Allocation of residual profit.-

(I) Nonroutine contributions generally.- The allocation of income to the controlled taxpayer's routine contributions will not reflect profits attributable to each controlled taxpayer's contributions to the relevant business activity that are not routine (nonroutine contributions). A nonroutine contribution is a contribution that is not accounted for as a routine contribution. Thus, in cases where such nonroutine contributions are present, there normally will be an unallocated residual profit after the allocation of income described in paragraph (c)(3)(i)(A) of this Article. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of their nonroutine contributions to the relevant business activity. The relative value of the nonroutine contributions of each taxpayer should be measured in a manner that most reliably reflects each nonroutine contribution made to the controlled transaction and each controlled taxpayer's role in the nonroutine contributions. If the nonroutine contribution by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the nonroutine contribution must be made among all the business activities in which it is used.

(II) Nonroutine contributions of intangible property.- In many cases, nonroutine contributions of a taxpayer to the relevant business activity may be contributions of intangible property. For purposes of paragraph (c)(3)(i)(B)(I) of this Article, the relative value of nonroutine intangible property contributed by taxpayers may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of nonroutine intangible property

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contributions may be estimated by the capitalized cost of developing the intangible property and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible property. Finally, if the intangible property development expenditures of the parties are relatively constant over time and the useful life of the intangible property contributed by all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of nonroutine intangible property contributions.

(ii) Comparability and reliability considerations.-

(A) In general.- Whether results derived from this method are the most reliable measure of the arm's length result is determined using the factors described under the best method rule. Thus, comparability and the quality of data and assumptions must be considered in determining whether this method provides the most reliable measure of an arm's length result.

(B) Comparability.- The first step of the residual profit split relies on market benchmarks of profitability. Thus, the comparability considerations that are relevant for the first step of the residual profit split are those that are relevant for the methods that are used to determine market returns for the routine contributions. The second step of the residual profit split, however, may not rely so directly on market benchmarks. Thus, the reliability of the results under this method is reduced to the extent that the allocation of profits in the second step does not rely on market benchmarks.

(C) Data and assumptions.- The reliability of the results derived from the residual profit split is affected by the quality of the data and assumptions used to apply this method. In particular, the following factors must be considered:

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(I) The reliability of the allocation of costs, income, and assets;

(II) Accounting consistency;

(III) The reliability of the data used and the assumptions made in valuing the intangible property contributed by the participants. In particular, if capitalized costs of development are used to estimate the value of intangible property, the reliability of the results is reduced relative to the reliability of other methods that do not require such an estimate, for the following reasons. First, in any given case, the costs of developing the intangible may not be related to its market value. Second, the calculation of the capitalized costs of development may require the allocation of indirect costs between the relevant business activity and the controlled taxpayer's other activities, which may affect the reliability of the analysis. Finally, the calculation of costs may require assumptions regarding the useful life of the intangible property.

(D) Other factors affecting reliability.- The first step of the residual profit split relies exclusively on external market benchmarks. The degree of comparability between the controlled and uncontrolled transactions increases, the relative weight accorded the analysis under this method will increase. In addition, to the extent the allocation of profits in the second step is not based on external market benchmarks, the reliability of the analysis will be decreased in relation to an analysis under a method that relies on market benchmarks. Finally, the reliability of the analysis under this method may be enhanced by the fact that all parties to the controlled transaction are evaluated under the residual profit split. However, the reliability of the results of an analysis based on information from all parties to a transaction is affected by the reliability of the data and the assumptions pertaining to each party to the controlled transaction. Thus, if the data

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and assumptions are significantly more reliable with respect to one of the parties than with respect to the others, a different method, focusing solely on the results of that party, may yield more reliable results.

Article 1040.09-15.- Transactional Net Margin Method

(a) In general.- The Transactional Net Margin Method (hereinafter, the "TNMM") examines the net profit margin relative to an appropriate base (for example, cost, sales, assets) that a taxpayer realizes from a controlled transaction (or aggregate transactions). This means in particular that the net profit indicator of the taxpayer from the controlled transaction (or transactions that are appropriate to aggregate should ideally be established by reference to the net profit indicator that the same taxpayer earns in comparable uncontrolled transactions (internal comparables). Where this is not possible, the net margin that would have been earned in comparable transactions by an independent enterprise (external comparables) may serve as a guide. A functional analysis of the controlled and uncontrolled transactions is required to determine whether the transactions are comparable and what adjustments may be necessary to obtain reliable results. In cases where the net profit margin is weighed to costs or sales, the TNMM compares the net profit margin arising from controlled and uncontrolled transactions (after relevant operating expenses have been deducted) instead of comparing a gross profit on resale or gross mark up on costs. Most often, the net profit indicator that is tested in a TNMM related to the net profit margin before interest, extraordinary items and income taxes. A TNMM is unlikely to be reliable if each party to a transaction makes valuable, unique contributions. In such a case, a profit split method (as described in Article 1040.09-14 of this Regulation) will generally be the most

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appropriate method. However, the TNMM may be applicable in cases where one of the parties makes all the unique contributions involved in the controlled transaction, while the other party does not make any unique contribution. In such a case, the tested party should be the less complex one. Notwithstanding, the lack of valuable and unique contributions involved in a particular transaction does not automatically imply that the transactional net margin method is the most appropriate method.

(b) Determination of arm's length result.-

(1) In general.- Under the TNMM, the determination of an arm's length result is based on the amount of net profit margins that the tested party would have earned in controlled transactions if its net profit indicator were equal to that of an uncontrolled comparable. The comparable net profit margins is calculated by determining the net profit indicator for an uncontrolled comparable, and applying the net profit indicator to the transactions being tested. Under the TNMM, the transactions being tested may be aggregated with similar transactions whenever appropriate.

(2) Tested party.-

(i) In general.- For purposes of this Article, the tested party will be the participant in the controlled transaction whose net profit margin attributable to the controlled transactions can be verified using the most reliable data and requiring the fewest and most reliable adjustments, and for which reliable data regarding uncontrolled comparables can be located. Consequently, in most cases the tested party will be the least complex of the controlled taxpayers and will not own valuable intangible property or unique assets that distinguish it from potential uncontrolled comparables. In determining the arm’s length standard, the tested party's reported net profit margins

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shall be compared to the comparable net profit margins derived from the net profit indicator of uncontrolled comparables in order to determine whether the reported net profit margins represents an arm's length result.

(c) Net Profit Indicator.-

(1) Selection of the net profit indicator.- When applying the TNMM the selection of the most appropriate net profit indicator should take account of the respective strengths and weaknesses of the various possible indicators; the appropriateness of the indicator considered in view of the nature of the controlled transaction, determined in particular through a functional analysis; the availability of reliable information (in particular on uncontrolled comparables) needed to apply the transactional net margin method based on that indicator; and the degree of comparability between controlled and uncontrolled transactions, including the reliability of comparability adjustments that may be needed to eliminate differences between them, when applying the transactional net margin method based on that indicator.

(2) Determination of the net profit.-

(i) In General.- The following items shall be taken into account in the determination of the net profit indicator for the application of the TNMM:

(A) Items that are direct directly or indirectly related to the controlled transaction at hand; and

(B) Items that are of an operating nature.

(ii) Segmentation of the taxpayer's financial data.- An appropriate level of segmentation of the taxpayer's financial data is needed when determining or testing the net profit it earns from a controlled transaction. Therefore, it would be inappropriate to

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apply the transactional net margin method on a company-wide basis if the company engages in a variety of different controlled transactions that cannot be appropriately compared on an aggregate basis with those of an independent enterprise.

(iii) Exclusion of data.- Costs and revenues that are not related to the controlled transaction under review should be excluded where they materially affect comparability with uncontrolled transactions. Non-operating items such as interest income and expenses and income taxes should be excluded from the determination of the net profit indicator. Exceptional and extraordinary items of a non-recurring nature should generally also be excluded. This however is not always the case as there may be situations where it would be appropriate to include them, depending on the circumstances of the case and on the functions being undertaken and risks being borne by the tested party. Even where exceptional and extraordinary items are not taken into account in the determination of the net profit indicator, it may be useful to review them because they can provide valuable information for the purpose of comparability analysis (for instance by reflecting that the tested party bears a given risk). In those cases where there is a correlation between the credit terms and the sales prices, it could be appropriate to reflect interest income in respect of short-term working capital within the calculation of the net profit indicator and/or to proceed with a working capital adjustment

(3) Net Profit Indicators.-

(i) Net profit weighted to sales.- A net profit indicator of net profit divided by sales is frequently used to determine the arm's length price of purchases from an controlled taxpayer for resale to uncontrolled taxpayers. In such cases, the sales figure at the denominator should be the re-sales of items purchased in the controlled

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transaction under review. Sales revenue that is derived from uncontrolled activities (purchase from uncontrolled taxpayersfor re-sale to unrelated taxpayers) should not be included in the determination or testing of the remuneration for controlled transactions, unless the uncontrolled transactions are such that they do not materially affect the comparison; and/or the controlled and uncontrolled transactions are so closely linked that they cannot be evaluated adequately on a separate basis.

(ii) Net profit weighted to costs.- Cost-based indicators should only be used in those cases where costs are a relevant indicator of the value of the functions performed, assets used and risks assumed by the tested party. In addition, the determination of what costs should be included in the cost base should derive from a careful review of the facts and circumstances of the case. Where the net profit indicator is weighted against costs, only those costs that directly or indirectly relate to the controlled transaction under review should be taken into account. Accordingly, an appropriate level of segmentation of a taxpayer's accounts is needed in order to exclude from the denominator costs that relate to other activities or transactions and materially affect comparability with uncontrolled transactions. Moreover, in most cases only those costs which are of an operating nature should be included in the denominator. In applying a cost-based TNMM, fully loaded costs are often used, including all the direct and indirect costs attributable to the activity or transaction, together with an appropriate allocation in respect of the overheads of the business. Depending on the facts and circumstances of the case, actual costs, as well as standard or budgeted costs, may be appropriate to use as the cost base. Using actual costs may raise an issue because the tested party may have no incentive to carefully monitor the costs. In arrangements

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between uncontrolled taxpayers, it is not rare that a cost savings objective is factored into the remuneration method. It can also happen in manufacturing arrangements between independent parties that prices are set on the basis of standard costs, and that any decrease or increase in actual costs compared to standard costs is attributed to the manufacturer. Where they reflect the arrangements that would be taken between independent parties, similar mechanisms could be taken into account in the application of the cost-based TNMM.

(iii) Net profit weighted to assets.-

(A) Returns on assets.- Returns on assets (or on capital) can be an appropriate base in cases where assets (rather than costs or sales) are a better indicator of the value added by the tested party, (e.g. in certain asset intensive activities and in capital-intensive financial activities.) Where the indicator is a net profit weighted to assets, operating assets only should be used. Operating assets include tangible operating fixed assets, including land and buildings, plant and equipment, operating intangible assets used in the business, such as patents and know-how, and working capital assets such as inventory and trade receivables (less trade payables). Investments and cash balances are generally not operating assets outside the financial industry sector.

(B) Valuation of assets.- The choice between book value, adjusted book value, market value and other possibly available options should be made with a view to finding the most reliable measure, taking account of the size and complexity of the transaction and of the costs and burden involved.

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(iv) Other net profit indicators.- Other net profit indicators may be appropriate depending on the facts and circumstances of the transactions. For instance, depending on the industry and on the controlled transaction under review, it may be useful to look at other denominators where independent data may exist, such as: floor area of retail points, weight of products transported, number of employees, time, distance, etc. While there is no reason to rule out the use of such bases where they provide a reasonable indication of the value added by the tested party to the controlled transaction, they should only be used where it is possible to obtain reliable comparable information to support the application of the method with such a net profit indicator.

(4) Berry ratios.-

(i) In General.- A berry ratio is a ratio of the gross profit to the operating expenses. Interest and extraneous income are generally excluded from the gross profit determination; depreciation and amortization may or may not be included in the operating expenses, depending in particular on the possible uncertainties they can create in relation to valuation and comparability.

(ii) Factors.- In order for a Berry ratio to be appropriate to test the remuneration of a controlled transaction the following factors must be considered:

(A) The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is proportional to the operating expenses;

(B) The value of the functions performed in the controlled transaction (taking account of assets used and risks assumed) is not materially affected by the value of the products distributed, *(*for example*,* it is not proportional to sales, and

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(C) The taxpayer does not perform, in the controlled transactions, any other significant function (for example, manufacturing function) that should be remunerated using another method or financial indicator.

(d) Comparability and reliability considerations.-

(1) In general.- Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule.

(2) Comparability.- The degree of comparability between an uncontrolled taxpayer and the tested party is determined by applying the Comparability Analysis Rules. The TNMM compares the net profit margin of the tested party, measured by the net profit indicator, to the net profit margins of uncontrolled taxpayers in similar circumstances. As with all methods that rely on external market benchmarks, the greater the degree of comparability between the tested party and the uncontrolled taxpayer, the more reliable will be the results derived from the application of this method. The determination of the degree of comparability between the tested party and the uncontrolled taxpayer depends upon all the relevant facts and circumstances, including the relevant lines of business, the product or service markets involved, the asset composition employed (including the nature and quantity of tangible assets, intangible assets and working capital), the size and scope of operations, and the stage in a business or product cycle.

(3) Functional, risk and resource comparability.- A net profit margin represents a return for the investment of resources and assumption of risks. Therefore, although all of the factors described in Article 1040.09-8(c) of this Regulation must be

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considered, comparability under the TNMM is particularly dependent on resources employed and risks assumed. Moreover, because resources and risks usually are directly related to functions performed, it is also important to consider functions performed in determining the degree of comparability between the tested party and an uncontrolled taxpayer. The degree of functional comparability required to obtain a reliable result under the TNMM, however, is generally less than that required under the resale price or cost plus methods. For example, because differences in functions performed often are reflected in operating expenses, taxpayers performing different functions may have very different gross profit margins but earn similar levels of operating profit.

(4) Adjustments for the differences between the tested party and the uncontrolled taxpayers.- If there are differences between the tested party and an uncontrolled comparable that would materially affect the profits determined under the relevant net profit indicator, adjustments should be made according to the Comparability Analysis Rules of Article 1040.09-8. In some cases, the assets of an uncontrolled comparable may need to be adjusted to achieve greater comparability between the tested party and the uncontrolled comparable. In such cases, the uncontrolled comparable's operating income attributable to those assets must also be adjusted before computing a net profit indicator in order to reflect the income and expense attributable to the adjusted assets. In certain cases it may also be appropriate to adjust the net profit of the tested party and comparable parties. For example, where there are material differences in accounts payable among the comparable parties and the tested

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party, it will generally be appropriate to adjust the net profit margin of each party by increasing it to reflect an imputed interest charge on each party's accounts payable.

(e) Data and assumptions.-

(1) In general.- The reliability of the results derived from the TNMM is affected by the quality of the data and assumptions used to apply this method.

(2) Consistency in accounting.- The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect operating profit affects the reliability of the result. Thus, for example, if differences in inventory and other cost accounting practices would materially affect the net profit margin, the ability to make reliable adjustments for such differences would affect the reliability of the results.

(3) Allocations between the tested transactions and other activities.- The reliability of the allocation of costs, income, and assets between the tested transactions and other activities of the tested party or an uncontrolled comparable will affect the reliability of the determination of net profit margin and profit level indicators. If it is not possible to allocate costs, income, and assets directly based on factual relationships, a reasonable allocation formula may be used. To the extent that direct allocations are not made, the reliability of the results derived from the application of this method is reduced relative to the results of a method that requires fewer allocations of costs, income, and assets.

Article 1040.09-16.- Unspecified Method

(a) In General.- Methods not otherwise identified in this Regulation may be used to evaluate whether the amount charged in a controlled transaction is arm's length.

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Any method used under this Article must be applied in accordance with the Comparability Analysis Rules, the Arm Length's Standard, and Best Method Rules described throughout this Regulation. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled price method compares a controlled transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled transaction. Therefore, in establishing whether a controlled transaction achieved an arm's length result, an unspecified method should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction. As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. Therefore, in accordance with the Comparability Analysis Rules of Article 1040.09-8 of this Regulation, to the extent that a method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(b) Limits on use of unspecified method.- If an unspecified method is selected, their selection should be supported by an explanation of why the methods recognized through this Regulation were regarded as less appropriate or non-workable

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in the circumstances of the case and of the reason why the selected other method was regarded as providing a better solution.

Article 1040.09-17.- Determination of taxable income in specific situations: Loans or advances.-

(a) Interest on bona fide indebtedness.- Where one member of a group of controlled taxpayers makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group and either charges no interest, or charges interest at a rate which is not equal to an arm's length rate of interest with respect to such loan or advance, the Secretary may make appropriate allocations to reflect an arm's length rate of interest charged on the principal amount of a bona fide indebtedness between members of a group of controlled taxpayers. For purposes of this paragraph, bona fide indebtedness shall mean:

(1) Loans or advances of money or other consideration (whether or not evidenced by a written instrument); and

(2) Indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

(b) Exceptions.- For purposes of this Article a bona fide indebtedness shall exclude:

(1) Payments with respect to all or a portion of such alleged indebtedness where in fact all or a portion of an alleged indebtedness is a contribution to the capital of a corporation or a distribution by a corporation with respect to its shares;

(2) Payments with respect to an alleged purchase-money debt instrument

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given in consideration for an alleged sale of property between two controlled entities where in fact the transaction constitutes a lease of the property;

(c) Period for which interest shall be charged.- Except as otherwise provided in paragraphs (d) of this Article, the period for which interest shall be charged with respect to a bona fide indebtedness between controlled entities begins on the day after the day the indebtedness arises and ends on the day the indebtedness is satisfied (whether by payment, offset, cancellation, or otherwise).

(d) Exception to period for which interest shall be charged.- The following exceptions for not charging interest within the period specified in paragraph (c) of this Article shall apply to indebtedness arising in the ordinary course of business from sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit as described in paragraph (a)(2) of this Article and that are not evidenced by a written instrument requiring the payment of interest. Such amounts are hereinafter referred to as intercompany trade receivables. In general, an intercompany trade receivable arises at the time economic performance occurs with respect to the underlying transaction between controlled taxpayers except on the following cases:

(1) Exception for certain intercompany transactions in the ordinary course of business.- Interest is not required to be charged on an intercompany trade receivable until the first day of the third calendar month following the month in which the intercompany trade receivable arises, regardless of whether or not the transaction for which the trace receivable arose was conducted outside of Puerto Rico by the debtor member.

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(2) Exception for regular trade practice of creditor member or others in creditor's industry.- If the creditor member or unrelated persons in the creditor member's industry, as a regular trade practice, allow unrelated parties a longer period without charging interest than the ones described in paragraph(d)(1) of this Article with respect to transactions which are similar to transactions that give rise to intercompany trade receivables, such longer interest-free period shall be allowed with respect to a comparable amount of intercompany trade receivables.

(3) Exception for property purchased for resale in a foreign country.-

(i) General rule.- If in the ordinary course of business one member of the group (related purchaser) purchases property from another member of the group (related seller) for resale to unrelated persons located outside of Puerto Rico, the related purchaser and the related seller may use as the interest-free period for the intercompany trade receivables arising during the related seller's taxable year from the purchase of such property within the same product group an interest-free period equal the sum of:

(A) The number of days in the related purchaser's average collection period (as defined in paragraph (d)(4)(ii) of this Article) for sales of property within the same product group sold in the ordinary course of business to unrelated persons located in the same foreign country; plus

(B) Ten (10) calendar days.

(ii) Average collection period.- An average collection period for purposes of paragraph (d) will be determined using the following steps:

(A) Step 1.- Determine total sales (less returns and allowances) by the related

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purchaser in the product group to unrelated persons located in the same foreign country during the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(B) Step 2.- Determine the related purchaser's average month-end accounts receivable balance with respect to sales described in Step 1 for the related purchaser's last taxable year ending on or before the first day of the related seller's taxable year in which the intercompany trade receivable arises.

(C) Step 3.- Compute a receivables turnover rate by dividing the total sales amount described in Step 1 by the average receivables balance described in Step 2.

(D) Step 4.- Divide the receivables turnover rate determined in Step 3 into three hundred and sixty five (365), and round the result to the nearest whole number to determine the number of days in the average collection period.

(iii) Average collection period in sales with multiple countries.- If the related purchaser makes sales in more than one foreign country, or sells property in more than one product group in any foreign country, separate computations of an average collection period, by product group within each country, are required.

(e) Limits and prohibitions of interest-free period.- The interest-free period under paragraph (d) shall not exceed one hundred and eighty three (183) days and shall not apply to intercompany trade receivables attributable to property which is manufactured, produced, or constructed by the related purchaser.

(f) Preference.-

(1) General Rule.- When determining the period of time for which an amount owed by one member of the group to another member is outstanding, payments or

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other credits to an account are considered to be applied against the earliest amount outstanding, that is, payments or credits are applied against amounts in a first-in, first-out (FIFO) order. Thus, tracing payments to individual intercompany trade receivables is generally not required in order to determine whether a particular intercompany trade receivable has been paid within the applicable interest-free period determined under paragraph (d) of this Article.

(2) Exception.- Notwithstanding the first-in, first-out payment application rule, the taxpayer may apply payments or credits against amounts owed in some other order on its books in accordance with an agreement or understanding of the related parties if the taxpayer can demonstrate that either it or others in its industry, as a regular trade practice, enter into such agreements or understandings in the case of similar balances with unrelated parties.

(g) Arm's length interest rate.-

(1) In general.- For purposes of Section 1040.09 of the Code and this Article, an arm's length rate of interest shall be a rate of interest which was charged, or would have been charged, at the time the indebtedness arose, in independent transactions with or between uncontrolled taxpayers under similar circumstances. All relevant factors shall be considered, including the principal amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans between unrelated parties.

(2) Exception; Funds obtained at situs of borrower.- If the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower, the arm's length rate for any taxable year shall be equal to the rate actually paid by the

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lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate.

(h) Examples.-

(1) The following example illustrates the rules set forth in Article 1040.09-17(b)(1) of this Regulation.

(i) An individual, A, transfers $20,000 to a corporation controlled by A. Such transfer was not evidenced by any agreement or note, thus no interest rate was provided with respect to such transfer. Upon audit, the Secretary re-characterized the transaction as a contribution to the capital of the corporation. Accordingly, under Article 1040.09-17(b)(1) of this Regulation, Article 1040.09.-17(a) of this Regulation does not apply to the transaction because there is no bona fide indebtedness, and, therefore, the Secretary cannot impute interest income to A therefrom.

(2) The following example illustrates the rules set forth in Article 1040.09-17(a) and (g) of this Regulation.

(i) B, an individual, is a controlling shareholder of Z. B makes a term loan of $15,000 to Z without charging an interest rate over the principal in order to avoid increasing his taxable income for the current tax year. Under Section 1040.09 of the Code and paragraph (a) and (g) of this Article, the Secretary can determine the rate of interest that should be charged on this $15,000 loan under the factors described in paragraph (g) of this Article and after making such determination, the Secretary may impute an interest rate that should have been charged by B and adjust B's true taxable income.

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Article 1040.09-18.- Determination of taxable income in specific situations: Controlled Services Transaction

(a) In General.- Controlled Services Transaction.-

(1) Scope.- A controlled services transaction includes any activity (as defined by paragraph (a)(3) of this Article) by one member of a group of controlled taxpayers (the renderer) that results in a benefit (as defined in paragraph (a)(4) of this Article) to one or more other members of the controlled group (the recipient(s)).The arm's length amount charged in a controlled services transaction must be determined under one of the methods provided for in through paragraph (b) through (h) of this Article. Each method must be applied in accordance with the Best Method Rule of Article 1040.09-7, the Comparability Analysis Rules of Article 1040.09-8, and the arm's length range of Article 1040.09-9 of this Regulation, except as those provisions are modified in this Article.

(2) Disaggregation of transactions.- A controlled services transaction may be analyzed as two separate transactions for purposes of determining the arm's length consideration, if that analysis is the most reliable means of determining the arm's length consideration for the controlled services transaction in accordance with the Best Method Rule.

(3) Activity.- For purposes of this Article and activity shall include the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances. An activity also includes making available to the recipient any property or other

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resources of the renderer.

(4) Benefit.-

(i) In general.- An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the same activity or a similar activity. A benefit may result to the owner of intangible property if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible property.

(ii) Indirect or remote benefit. An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit from that activity is so indirect or remote that the recipient would not be willing to pay, on either a fixed or contingent-payment basis, an uncontrolled party to perform a similar activity, and would not be willing to perform such activity for itself for this purpose. The determination whether the benefit from an activity is indirect or remote is based on the nature of the activity and the situation of the recipient, taking into consideration all facts and circumstances.

(iii) Duplicative activities.- If an activity performed by a controlled taxpayer duplicates an activity that is performed, or that reasonably may be anticipated to be

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performed, by another controlled taxpayer on or for its own account, the activity is generally not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient.

(iv) Shareholder activities.- An activity is not considered to provide a benefit if the sole effect of that activity is either to protect the renderer's capital investment in the recipient or in other members of the controlled group, or to facilitate compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, or both. Activities in the nature of day-to-day management generally do not relate to protection of the renderer's capital investment. Based on analysis of the facts and circumstances, activities in connection with a corporate reorganization may be considered to provide a benefit to one or more controlled taxpayers.

(v) Passive association.- A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

(b) Services cost method.-

(1) In general.- The services cost method evaluates whether the amount charged for certain services is arm's length by reference to the total services costs with no markup. If the Secretary determines that the total services costs is not at arm’s length, the Secretary may make allocations to adjust the amount charged for such services to the properly determined amount of such total services costs.

(2) Total Services Cost.- For purposes of this Article, total services costs shall

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mean all costs of rendering the services for which the total services costs are being determined. Total services costs include all costs in cash or in kind (including stock-based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated the services. In general, costs for this purpose should comprise provision for all resources expended, used, or made available to achieve the specific objective for which the service is rendered. Reference to generally accepted accounting principles may provide a useful starting point but will not necessarily be conclusive regarding inclusion of costs in total services costs. Total services costs do not include interest expense, foreign income taxes, or Puerto Rico income taxes.

(3) Allocation of costs.- In any case where the renderer's activity that results in a benefit for one recipient in a controlled services transaction also generates a benefit for one or more other members of a controlled group (including the benefit, if any, to the renderer), and the amount charged under this Article in the controlled services transaction is determined under a method that makes reference to costs, costs must be allocated among the portions of the activity performed for the benefit of the first mentioned recipient and such other members of the controlled group. The principles here described must also be used whenever it is appropriate to allocate and apportion any class of costs (for example, overhead costs) in order to determine the total services costs of rendering the services. In no event will an allocation of costs based on a generalized or non-specific benefit be appropriate.

(4) Appropriate method of allocation and apportionment.-

(i) Reasonable method standard.- Any reasonable method may be used to

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allocate and apportion costs under this Article. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent. The costs incurred by supporting departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments' costs by applying reasonable departmental overhead rates. Allocations and apportionments of costs must be made on the basis of the full cost, as opposed to the incremental cost.

(ii) Use of general practices.- The practices used by the taxpayer to apportion costs in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the Secretary.

(5) Eligibility for the services cost method.- To apply the services cost method to a service in accordance with the rules of this paragraph (b), all of the following requirements must be satisfied with respect to the service:

(i) The service is a covered service which consists of controlled service transaction or a group of controlled service transactions that meet the definition of specified covered services. For purposes of this paragraph (b) a specified covered services shall have the following meaning:

(A) Specified covered services.- Specified covered services are controlled services transactions that the Secretary specifies by regulation, circular letter,

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administrative determination or any other form of official publication. Services will be included in such official publication based upon the Secretary's determination that the specified covered services are support services common among taxpayers across industry sectors and generally do not involve a significant median comparable markup on total services costs. The Secretary may add to, subtract from, or otherwise revise the specified covered services described in any official publication by subsequent official publications. Until the Department issues the official publication herein referenced, the taxpayer shall not considered Article 1040.09.-18(b)(5)(i) for purposes of determining the eligibility of the services that shall be covered under the services cost method.

(ii) The service is not an excluded activity.- An excluded activity includes the following:

(A) Manufacturing;

(B) Production;

(C) Extraction, exploration, or processing of natural resources;

(D) Construction;

(E) Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement;

(F) Research, development, or experimentation;

(G) Engineering or scientific;

(H) Financial transactions, including guarantees;

(I) Insurance or reinsurance.

(iii) The service is not precluded from constituting a covered service by the business judgment rule.- A service is precluded from constituting a covered service by

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the business judgment rule if the taxpayer reasonably concludes in its business judgment that the service does not contribute significantly to key competitive advantages, core capabilities, or fundamental risks of success or failure in one or more trades or businesses of the controlled group when considering all the facts and circumstances.

(iv) Adequate books and records are maintained subject to the following requirements:

(A) Permanent books of account and records are maintained for as long as the costs with respect to the covered services are incurred by the renderer;

(B) Such books and records must include a statement evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for such services. Such books and records must be adequate to permit verification by the Secretary of the total services costs incurred by the renderer, including a description of the services in question, identification of the renderer and the recipient of such services, and sufficient documentation to allow verification of the methods used to allocate and apportion such costs to the services in question.

(6) Shared services arrangement.-

(i) In general.- If the services cost method is used to evaluate the amount charged for covered services, and such services are rendered in consideration of a shared services arrangement, then the arm's length charge to each participant for such services will be the portion of the total costs of the services otherwise determined under the services cost method of this paragraph (b) that is properly allocated to such participant pursuant to the arrangement.

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(ii) Requirements for shared services arrangement.- A shared services arrangement must meet the requirements described herein in order to be considered under the services cost method:

(A) Eligibility requirements.- To be eligible for treatment under this paragraph (b)(6), a shared services arrangement must:

(I) Include two or more participants;

(II) Include as participants all controlled taxpayers that reasonably anticipate a benefit from one or more covered services specified in the shared services arrangement; and

(III) Be structured in such manner that each covered service (or each reasonable aggregation of services) confers a benefit on at least one participant in the shared services arrangement.

(B) Allocation.-

(I) In General.- The costs for covered services must be allocated among the participants based on their respective shares of the reasonably anticipated benefits (as defined in paragraph (a)(4) of this Article) from those services, without regard to whether the anticipated benefits are in fact realized. The allocation of costs must provide the most reliable measure of the participants' respective shares of the reasonably anticipated benefits under the principles of the best method rule. The allocation must be applied on a consistent basis for all participants and services. The allocation to each participant in each taxable year must reasonably reflect that participant's respective share of reasonably anticipated benefits for such taxable year.

(II) Aggregation.- Two or more covered services may be aggregated in a

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reasonable manner taking into account all the facts and circumstances, including whether the relative magnitude of reasonably anticipated benefits of the participants sharing the costs of such aggregated services may be reasonably reflected by the allocation basis employed pursuant to paragraph (b)(6)(iii)(B)(I) of this Article.

(III) Coordination With Cost Contribution Arrangement.- To the extent that an allocation is made to a participant in a shared services arrangement that is also a participant in a Cost Contribution Arrangement, such amount with respect to covered services should be first allocated pursuant to the shared services arrangement under this paragraph (b)(6). Costs allocated pursuant to a shared services arrangement may (if applicable) be further allocated between the intangible property development activity under a Cost Contribution Arrangement and other activities of the participant.

(C) Documentation.- The taxpayer must maintain sufficient documentation to establish that the requirements of this paragraph (b)(6) of this Article are satisfied which shall include:

(I) A statement evidencing the taxpayer's intention to apply the services cost method to evaluate the arm's length charge for covered services pursuant to a shared services arrangement;

(II) A list of the participants and the renderer or renderers of covered services under the shared services arrangement;

(IV) A description of the basis of allocation to all participants, consistent with the participants' respective shares of reasonably anticipated benefits; and

(V) A description of any aggregation of covered services for purposes of the shared services arrangement.

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(7) Example.- The provisions of this Article are illustrated in the following example:

(I) Corporations A, B, and C, each a controlled taxpayer, own and operate hospitals in Puerto Rico. Each owns an electronic database of medical information gathered by doctors and nurses during interviews and treatment of its patients. All three databases are maintained and updated by Corporation A's administrative support employees who perform data entry activities by entering medical information from the paper records of Corporations A, B, and C into their respective databases. Assume that these services relating to data entry are specified covered services within the meaning of paragraph (b)(5)(i)(A) of this Article. Under the facts and circumstances of the business of the controlled taxpayers, the taxpayer could reasonably conclude that these services do not contribute significantly to the controlled group's key competitive advantages, core capabilities, or fundamental risks of success or failure in the group's business. If these services meet the other requirements of this paragraph (b)(5), Corporation A will be eligible to charge these services to Corporation B and Corporation C in accordance with the services cost method. When applying the aforementioned method, the total services costs must be at arm’s length by reference the total services costs that an uncontrolled taxpayer would have incurred in an uncontrolled transaction.

(c) Comparable uncontrolled services price method.-

(1) In general.- The comparable uncontrolled services price method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the amount charged in a comparable uncontrolled services transaction.

(2) Comparability and reliability considerations.-

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(i) In general.- Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule.

(ii) Comparability.-

(A) In general.- The degree of comparability between controlled and uncontrolled transactions is determined by applying the Comparability Analysis Rules as described in Article 1040.09-8. Although all of the factors described in such Article must be considered, similarity of the services rendered, and of the intangible property (if any) used in performing the services, generally will have the greatest effects on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled services price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences from the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled services price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure

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of an arm's length result.

(B) Adjustments for differences between controlled and uncontrolled transactions.- If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the Standard of Comparability set forth in the Comparability Analysis Rules of Article 1040.09-8 of this Regulation. Specific examples of factors that may be particularly relevant to application of this method include the following:

(I) Quality of the services rendered;

(II) Contractual terms (for example, scope and terms of warranties or guarantees regarding the services, volume, credit and payment terms, allocation of risks, including any contingent-payment terms and whether costs were incurred without a provision for current reimbursement);

(III) Intangible property (if any) used in rendering the services;

(IV) Geographic market in which the services are rendered or received;

(V) Risks borne (for example, costs incurred to render the services, without provision for current reimbursement);

(VI) Duration or quantitative measure of services rendered;

(VII) Collateral transactions or ongoing business relationships between the renderer and the recipient, including arrangement for the provision of tangible property in connection with the services; and

(VIII) Alternatives realistically available to the renderer and the recipient.

(iii) Data and assumptions.- The reliability of the results derived from the

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comparable uncontrolled services price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method.

(iv) Arm's length range. *See*, Article 1040.09-9 of this Regulation.

(v) Indirect evidence of the price of a comparable uncontrolled services transaction.

(A) In general.- The price of a comparable uncontrolled services transaction may be derived based on indirect measures of the price charged in comparable uncontrolled services transactions if:

(I) The data is widely and routinely used in the ordinary course of business in the particular industry or market segment for purposes of determining prices actually charged in comparable uncontrolled services transactions;

(II) The data is used to set prices in the controlled services transaction in the same way they are used to set prices in uncontrolled services transactions of the controlled taxpayer, or in the same way they are used by uncontrolled taxpayers to set prices in uncontrolled services transactions; and

(III) The amount charged in the controlled services transaction may be reliably adjusted to reflect differences in quality of the services, contractual terms, market conditions, risks borne (including contingent-payment terms), duration or quantitative measure of services rendered, and other factors that may affect the price to which uncontrolled taxpayers would agree.

(d) Gross services margin method.-

(1) In general. The gross services margin method evaluates whether the

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amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with an uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer (e.g. subcontractor). This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method may also be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer and another member of the controlled group actually performs a portion of the services provided.

(2) Determination of arm's length price.-

(i) In general.- The gross services margin method evaluates whether the price charged or amount retained by a controlled taxpayer in the controlled services transaction in connection with the relevant uncontrolled transaction is arm's length by determining the appropriate gross profit of the controlled taxpayer.

(ii) Relevant uncontrolled transaction.- The relevant uncontrolled transaction is a transaction between a member of the controlled group and an uncontrolled taxpayer as to which the controlled taxpayer performs agent services or an intermediary function.

(iii) Applicable uncontrolled price.- The applicable uncontrolled price is the price paid or received by the uncontrolled taxpayer in the relevant uncontrolled transaction.

(iv) Appropriate gross services profit.- The appropriate gross services profit is computed by multiplying the applicable uncontrolled price by the gross services profit

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margin in comparable uncontrolled transactions. The determination of the appropriate gross services profit will take into account any functions performed by other members of the controlled group, as well as any other relevant factors for determining comparability described in Article 1040.09.-8 of this Regulation. The comparable gross services profit margin may be determined by reference to the commission in an uncontrolled transaction, where that commission is stated as a percentage of the price charged in the uncontrolled transaction.

(v) Arm's length range. *See*, Article 1040.09-9 of this Regulation.

(3) Comparability and reliability considerations.-

(i) In general.- Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule described in Article 1040.09.-7 of this Regulation. The application of these factors under the gross services margin method is discussed in paragraphs (d)(3)(ii) and (iii) of this Article.

(ii) Comparability.-

(A) Functional comparability.- The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of the Comparability Analysis Rules of Article 1040.09-8 of this Regulation. A gross services profit provides compensation for services or functions that bear a relationship to the relevant uncontrolled transaction, including an operating profit in return for the investment of capital and the assumption of risks by the controlled taxpayer performing the services or functions under review. Therefore, although all of the factors described in the Comparability Analysis Rules of Article 1040.09-8 of this

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Regulation must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangible property (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit margin should be derived from comparable uncontrolled transactions by the controlled taxpayer under review, because similar characteristics are more likely found among different transactions by the same controlled taxpayer than among transactions by other parties (internal comparable). In the absence of comparable uncontrolled transactions involving the same controlled taxpayer, an appropriate gross services profit margin may be derived from transactions of uncontrolled taxpayers involving comparable services or functions with respect to similarly related transactions (external comparable).

(B) Other comparability factors.- Comparability under this method is not dependent on close similarity of the relevant uncontrolled transaction to the related transactions involved in the uncontrolled comparables. However, substantial differences in the nature of the relevant uncontrolled transaction and the relevant transactions involved in the uncontrolled comparables, such as differences in the type of property transferred or service provided in the relevant uncontrolled transaction, may indicate significant differences in the services or functions performed by the controlled and uncontrolled taxpayers with respect to their respective relevant transactions. Thus, it ordinarily would be expected that the services or functions performed in the controlled and uncontrolled transactions would be with respect to relevant transactions involving the transfer of property within the same product categories or the provision of services

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of the same general type (for example, information-technology systems design). Furthermore, significant differences in the intangible property (if any) used by the controlled taxpayer in the controlled services transaction as distinct from the uncontrolled comparables may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) Adjustments for differences between controlled and uncontrolled transactions.- If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit margin, adjustments should be made to the gross services profit margin, according to the comparability provisions the Comparability Analysis Rules of Article 1040.09-8 of this Regulation. For this purpose, consideration of the total services costs associated with functions performed and risks assumed may be necessary because differences in functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related costs. Specific examples of factors that may be particularly relevant to this method include:

(I) Contractual terms (for example, scope and terms of warranties or

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guarantees regarding the services or function, volume, credit and payment terms, and allocation of risks, including any contingent-payment terms);

(II) Intangible property (if any) used in performing the services or function;

(III) Geographic market in which the services or function are performed or in which the relevant uncontrolled transaction takes place; and

(IV) Risks borne.

(D) Buy-sell distributor.- If a controlled taxpayer that performs an agent service or intermediary function is comparable to a distributor that takes title to goods and resells them, the gross profit margin earned by such distributor on uncontrolled sales, stated as a percentage of the price for the goods, may be used as the comparable gross services profit margin.

(iii) Data and assumptions.-

(A) In general.- The reliability of the results derived from the gross services margin method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method.

(B) Consistency in accounting.- The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit margin affects the reliability of the results under this method.

(4) Example.- The provisions of this paragraph (d) are illustrated in the following example.

(i) Company A and Company B are members of a controlled group. Company A is a U.S. corporation not ETB-PR that manufactures industrial equipment.

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Company B is a Puerto Rico corporation that acts as a commission agent for Company A by arranging for Company A to make direct sales of the equipment it manufactures to unrelated purchasers in the Puerto Rico market. Company B does not take title to the equipment but instead receives from Company A commissions that are determined as a specified percentage of the sales price for the equipment that is charged by Company A to the unrelated purchaser. Company B also arranges for direct sales of similar equipment by unrelated manufacturers to unrelated purchasers in the Puerto Rico market. Company B charges these unrelated manufacturers a commission fee of seven (7) percent of the sales price charged by the unrelated manufacturers to the unrelated Puerto Rico purchasers for the equipment. Information regarding the comparable agent services provided by Company B to unrelated manufacturers is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjustments for such differences have been made. For purposes of this example, the comparable gross services profit margin is seven (7) percent of the price charged in the relevant transactions involved in the uncontrolled comparables. In such case, the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to seven (7) percent of the applicable uncontrolled price charged by Company A in sales of equipment in the relevant uncontrolled transactions. Upon audit, the Secretary determined that Corporation B was, in effect charging a three (3) percent commission fee to Corporation A for its services, thus reducing the income that it reported in its Puerto Rico income tax return. Following the gross services margin method described above, the Secretary increased the amount that Corporation B should

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have charged to Corporations A for the agent services that it performed to a seven (7) percent thus increasing its taxable income.

(e) Cost of services plus method.-

(1) In general.- The cost of services plus method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross services profit markup realized in comparable uncontrolled transactions. The cost of services plus method is ordinarily used in cases where the controlled service renderer provides the same or similar services to both controlled and uncontrolled parties.

(2) Determination of arm's length price.-

(i) In general.- The cost of services plus method measures an arm's length price by adding the appropriate gross services profit to the controlled taxpayer's comparable transactional costs.

(ii) Appropriate gross services profit.- The appropriate gross services profit is computed by multiplying the controlled taxpayer's comparable transactional costs by the gross services profit markup, expressed as a percentage of the comparable transactional costs earned in comparable uncontrolled transactions.

(iii) Comparable transactional costs.- Comparable transactional costs consist of the costs of providing the services under review that are taken into account as the basis for determining the gross services profit markup in comparable uncontrolled transactions. Depending on the facts and circumstances, such costs typically include all compensation attributable to employees directly involved in the performance of such services, materials and supplies consumed or made available in rendering such

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services, and may include as well other costs of rendering the services. Comparable transactional costs must be determined on a basis that will facilitate comparison with the comparable uncontrolled transactions. For that reason, comparable transactional costs may not necessarily equal total services costs, as defined in paragraph (b)(2) of this Article, and in appropriate cases may be a subset of total services costs. Generally accepted accounting principles may provide useful guidance but will not conclusively establish the appropriate comparable transactional costs for purposes of this method.

(iv) Arm's length range.- *See*, Article 1040.09-9 of this Regulation.

(3) Comparability and reliability considerations.-

(i) In general.- Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule.

(ii) Comparability.-

(A) Functional comparability.- The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of the Comparability Analysis Rules set forth in Article 1040.09-8 of this Regulation. A service renderer's gross services profit provides compensation for performing services related to the controlled services transaction under review, including an operating profit for the service renderer's investment of capital and assumptions of risks. Therefore, although all of the factors described in the Comparability Analysis Rules of Article 1040.09-8 of this Regulation must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangible property (if any) used in providing the services or functions, and contractual

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terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit markup should be derived from comparable uncontrolled transactions of the same taxpayer participating in the controlled services transaction because similar characteristics are more likely to be found among services provided by the same service provider than among services provided by other service providers. In the absence of such services transactions, an appropriate gross services profit markup may be derived from comparable uncontrolled services transactions of other service providers. If the appropriate gross services profit markup is derived from comparable uncontrolled services transactions of other service providers, in evaluating comparability the controlled taxpayer must consider the results under this method expressed as a markup on total services costs of the controlled taxpayer, because differences in functions performed may be reflected in differences in service costs other than those included in comparable transactional costs.

(B) Other comparability factors.- Comparability under this method is less dependent on close similarity between the services provided than under the comparable uncontrolled services price method. Substantial differences in the services may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve services of the same general type (for example, information-technology systems design). Furthermore, if a significant amount of the controlled taxpayer's comparable transactional costs consists of service costs incurred in a tax accounting period other than the tax accounting period under review, the reliability of the analysis would be reduced. In addition, significant differences in the

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value of the services rendered, due for example to the use of valuable intangible property, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency-related factors (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) Adjustments for differences between the controlled and uncontrolled transactions. If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit markup, adjustments should be made to the gross services profit markup earned in the comparable uncontrolled transaction according to the standard of comparability described in Article 1040.09-8 of this Regulation. For this purpose, consideration of the comparable transactional costs associated with the functions performed and risks assumed may be necessary, because differences in the functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related comparable transactional costs. Specific examples of the factors that may be particularly relevant to this method include:

(I) The complexity of the services;

(II) The duration or quantitative measure of services;

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(III) Contractual terms (for example, scope and terms of warranties or guarantees provided, volume, credit and payment terms, allocation of risks, including any contingent-payment terms);

(IV) Economic circumstances; and

(V) Risks borne.

(iii) Data and assumptions.-

(A) In general.- The reliability of the results derived from the cost of services plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method.

(B) Consistency in accounting.- The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit markup affects the reliability of the results under this method. Thus, for example, if differences in cost accounting practices would materially affect the gross services profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results obtained under this method. Further, reliability under this method depends on the extent to which the controlled and uncontrolled transactions reflect consistent reporting of comparable transactional costs. For purposes of this paragraph (e)(3)(iii)(B), the term comparable transactional costs includes the cost of acquiring tangible property that is transferred (or used) with the services, to the extent that the arm's length price of the tangible property is not separately evaluated as a controlled transaction under another provision.

(f) Transactional net margin method.- *See*, Article 1040.09-15 of this Regulation.

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(g) Profit split method.- *See*, Article 1040.09-14 of this Regulation.

(h) Unspecified methods. *See*, Article 1040.09-16 of this Regulation.

(i) Contingent-payment contractual terms for services.-

(1) In general.- In the case of a contingent-payment arrangement, the arm's length result for the controlled services transaction generally would not require payment by the recipient to the renderer in the tax accounting period in which the service is rendered if the specified contingency does not occur in that period. If the specified contingency occurs in a tax accounting period subsequent to the period in which the service is rendered, the arm's length result for the controlled services transaction generally would require payment by the recipient to the renderer on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer in performing the activities in the absence of a provision that unconditionally obligates the recipient to pay for the activities performed in the tax accounting period in which the service is rendered.

(2) Contingent-payment arrangement.- For purposes of this paragraph (i), an arrangement will be treated as a contingent-payment arrangement if it meets all of the requirements in this paragraph (i)(2)(i) of this Article and is consistent with the economic substance and conduct requirement in paragraph (i)(2)(ii) of this Article.

(i) General requirements.-

(A) Written contract.- The arrangement is set forth in a written contract entered into prior to, or contemporaneous with, the start of the activity or group of activities constituting the controlled services transaction.

(B) Specified contingency.- The contract states that payment for a controlled

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services transaction is contingent (in whole or in part) upon the happening of a future benefit (as defined in paragraph (a)(4) of this Article) for the recipient directly related to the activity or group of activities. For purposes of the preceding sentence, whether the future benefit is directly related to the activity or group of activities is evaluated based on all the facts and circumstances.

(C) Basis for payment.- The contract provides for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer.

(ii) Economic substance and conduct.- The arrangement, including the contingency and the basis for payment, is consistent with the economic substance of the controlled transaction and the conduct of the controlled parties.

(3) Secretary's authority to impute contingent-payment terms.- The Secretary may impute contingent-payment contractual terms in a controlled services transaction if the economic substance of the transaction is consistent with the existence of such terms.

(4) Evaluation of arm's length charge.- Whether the amount charged in a contingent-payment arrangement is arm's length will be evaluated in accordance with this the principles set forth in Article 1040.09-3 of this Regulation.

(j) Coordination with transfer pricing rules for other transactions.-

(1) Services transactions that include other types of transactions.- A transaction structured as a controlled services transaction may include other elements for which a separate category or categories of methods are provided, such as a loan or advance, a rental, or a transfer of tangible or intangible property. Whether such an

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integrated transaction is evaluated as a controlled services transaction under this Article or whether one or more elements should be evaluated separately under other Articles of this Regulation depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, an integrated transaction of this type may be evaluated under this Article and its separate elements need not be evaluated separately, provided that each component of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length result in the controlled transaction.

(2) Services transactions that affect a transfer of intangible property.- A transaction structured as a controlled services transaction may in certain cases include an element that constitutes the transfer of intangible property or may result in a transfer, in whole or in part, of intangible property. Notwithstanding paragraph (j)(1) of this Article, if such element relating to intangible property is material to the evaluation, the arm's length result for the element of the transaction that involves intangible property must be corroborated or determined by an analysis under the applicable methods described in Article 1040.09-20 of this Regulation.

(3) Coordination with rules governing Cost Contribution Arrangement.- In the case of a Cost Contribution Arrangement, consideration of the provisions set forth in Article 1040.09-7 of this Regulation is relevant in determining the best method under this Article, as appropriately adjusted in light of the differences in the facts and circumstances between such arrangement and a cost sharing arrangement.

(4) Other types of transactions that include controlled services transactions.- A transaction structured other than as a controlled services transaction may include one

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or more elements for which separate pricing methods are provided in this Article. Whether such an integrated transaction is evaluated under another Article of this Regulation or whether one or more elements should be evaluated separately under this Article depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, a single method may be applied to such an integrated transaction, and the separate services component of the transaction need not be separately analyzed under this Article, provided that the controlled services may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length results in the controlled transaction.

Article 1040.09-19.- Determination of taxable income in specific situations: Use of tangible property.-

(a) In General.- Where possession, use, or occupancy of tangible property owned or leased by one member of a group of controlled taxpayers (referred to in this paragraph as the owner) is transferred by lease or other arrangement to another member of such group (referred to in this paragraph as the user) without charge or at a charge which is not equal to an arm's length rental charge (as defined in paragraph (b)(1) of this Article) the Secretary may make appropriate allocations to properly reflect such arm's length charge. Where possession, use, or occupancy of only a portion of such property is transferred, the determination of the arm's length charge and the allocation shall be made with reference to the portion transferred.

(b) Arm's length charge.-

(1) In General.- For purposes of this paragraph, an arm's length rental charge

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shall be the amount of rent which was charged, or would have been charged for the use of the same or similar property, during the time it was in use, in independent transactions with or between unrelated parties under similar circumstances considering the period and location of the use, the owner's investment in the property or rent paid for the property, expenses of maintaining the property, the type of property involved, its condition, and all other relevant facts.

(2) Subleases.-Except as provided in paragraph (b)(1) of this Article, where possession, use, or occupancy of tangible property, which is leased by the owner (lessee) from an unrelated party is transferred by sublease or other arrangement to the user, an arm's length rental charge shall be considered to be equal to all the deductions claimed by the owner (lessee) which are attributable to the property for the period such property is used by the user. Where only a portion of such property was transferred, any allocations shall be made with reference to the portion transferred. The deductions to be considered include the rent paid or accrued by the owner (lessee) during the period of use and all other deductions directly and indirectly connected with the property paid or accrued by the owner (lessee) during such period. Such deductions include deductions for maintenance and repair, utilities, management and other similar deductions.

(3) Exception.- The provisions of paragraph (b)(2) of this Article shall not apply if either the taxpayer establishes a more appropriate rental charge under the general rule set forth in paragraph (b)(1) of this Article or during the taxable year, the owner (lessee) or the user was regularly engaged in the trade or business of renting property of the sane general type as the property in question to unrelated persons.

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Article 1040.09-20.- Determination of taxable income in specific situations: Transfer or use of intangible property.

(a) In general.- Except in the case of a Cost Contribution Agreement, where intangible property or an interest therein is transferred, sold, assigned, loaned, or otherwise made available in any manner by one member of a group of controlled entities (referred to in this paragraph as the transferor) to another member of the group (referred to in this paragraph as the transferee) for other than an arm's length consideration, the Secretary may make appropriate allocations to reflect an arm's length consideration for such property or its use.

(b) Form of consideration.- If a transferee of an intangible pays nominal or no consideration and the transferor has retained a substantial interest in the property, the arm's length consideration shall be in the form of a royalty, unless a different form is demonstrably more appropriate.

(c) Periodic Adjustments.-

(1) In General.- If an intangible is transferred under an arrangement that covers more than one year, the consideration charged in each taxable year may be adjusted to ensure that it is commensurate with the income attributable to the intangible. Adjustments made pursuant to this paragraph (c)(1) shall be consistent with the arm's length standard and the applicable provisions of this Regulation. In determining whether to make such adjustments in the taxable year under examination, the Secretary may consider all relevant facts and circumstances throughout the period the intangible is used. The determination in an earlier year that the amount charged for an intangible was an arm's length amount will not preclude the Secretary in a subsequent taxable

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year from making an adjustment to the amount charged for the intangible in the subsequent year. A periodic adjustment under the commensurate with income requirement of Section 1040.09 of the Code may be made in a subsequent taxable year without regard to whether the taxable year of the original transfer remains open for statute of limitation purposes.

(2) Exceptions.-

(i) Transactions involving the same intangible.- If the same intangible was transferred to an uncontrolled taxpayer under substantially the same circumstances as those of the controlled transaction; this transaction serves as the basis for the application of the comparable uncontrolled transaction method in the first taxable year in which substantial periodic consideration was required to be paid; and the amount paid in that year was an arm's length amount, then no allocation in a subsequent year will be made under paragraph (b) of this Article for a controlled transfer of intangible property.

(ii) Transactions involving comparable intangible.- If the arm's length result is derived from the application of the comparable uncontrolled transaction method based on the transfer of a comparable intangible under comparable circumstances to those of the controlled transaction, no allocation will be made under paragraph (b) of this Article if each of the following facts is established:

(A) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, such consideration was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid under the agreement, and such agreement remained in effect for the taxable year under

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review;

(B) There is a written agreement setting forth the terms of the comparable uncontrolled transaction relied upon to establish the arm's length consideration (uncontrolled agreement), which contains no provisions that would permit any change to the amount of consideration, a renegotiation, or a termination of the agreement, in circumstances comparable to those of the controlled transaction in the taxable year under review (or that contains provisions permitting only specified, non-contingent, periodic changes to the amount of consideration);

(C) The controlled agreement is substantially similar to the uncontrolled agreement, with respect to the time period for which it is effective;

(D) The controlled agreement limits use of the intangible to a specified field or purpose in a manner that is consistent with industry practice and any such limitation in the uncontrolled agreement;

(E) There were no substantial changes in the functions performed by the controlled transferee after the controlled agreement was executed, except changes required by events that were not foreseeable; and

(F) The aggregate profits actually earned or the aggregate cost savings actually realized by the controlled taxpayer from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the comparability of the uncontrolled agreement was established under paragraph (b) of Article 1040.09-11 (Comparable Uncontrolled Price Method (CUP method) and the Comparable Uncontrolled Transaction Method (CUT Method) of this Regulation.

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(iii) Methods other than comparable uncontrolled transaction.- If the arm's length amount was determined under any method other than the comparable uncontrolled transaction method, no allocation will be made under paragraph (c)(1) of this Article if each of the following facts is established:

(A) The controlled taxpayers entered into a written agreement (controlled agreement) that provided for an amount of consideration with respect to each taxable year subject to such agreement, and such agreement remained in effect for the taxable year under review;

(B) The consideration called for in the controlled agreement was an arm's length amount for the first taxable year in which substantial periodic consideration was required to be paid, and relevant supporting documentation was prepared contemporaneously with the execution of the controlled agreement;

(C) There have been no substantial changes in the functions performed by the transferee since the controlled agreement was executed, except changes required by events that were not foreseeable; and

(D) The total profits actually earned or the total cost savings realized by the controlled transferee from the exploitation of the intangible in the year under examination, and all past years, are not less than 80% nor more than 120% of the prospective profits or cost savings that were foreseeable when the controlled agreement was entered into.

(d) Allocations.-

(1) Transfer of property.- In the absence of a bona fide Cost Contribution Arrangement, where one member of a group of related entities undertakes the

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development of intangible property as a developer, no allocation with respect to such development activity shall be made under the rules of this paragraph or any other paragraph of this Article until such time as any property developed, or any interest therein, is or is deemed to be transferred, sold, assigned, loaned, or otherwise made available in any manner by the developer to a related entity in a transfer subject to the rules of this paragraph. Where a member of the group other than the developer acquires an interest in the property developed by virtue of obtaining a patent or copyright, or by any other means, the developer shall be deemed to have transferred such interest in such property to the acquiring member in a transaction subject to the rules of this paragraph. For example, if one member of a group (the developer) undertakes to develop a new patentable product and the costs of development are incurred by that entity over a period of three (3) years, no allocation with respect to that entity's activity shall be made during such period. The amount of any allocation that may be appropriate at the expiration of such development period when, for example, the patent on the product is transferred, or deemed transferred, to a related entity for other than an arm's length consideration, shall be determined in accordance with the rules of this paragraph.

(2) Value of the Assistance.- Where one member of a group renders assistance in the form of loans, services, or the use of tangible or intangible property to a developer in connection with an attempt to develop intangible property, the amount of any allocation that may be appropriate with respect to such assistance shall be determined in accordance with the rules of the appropriate paragraph or paragraphs of this Article. Thus, where one entity allows a related entity, which is the developer, to use

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tangible property, such as laboratory equipment, in connection with the development of intangible property, the amount of any allocation that may be appropriate with respect to such use shall be determined in accordance with the rules of subparagraph (3) of this Article. In the event that the Secretary does not exercise his discretion to make allocations with respect to the assistance rendered to the developer, the value of the assistance shall be allowed as a set-off against any allocation that the Secretary may make under this paragraph as a result of the transfer of the intangible property to the entity rendering the assistance.

(3) Determination of developer.- The determination as to which member of a group of related entities is a developer and which members of the group are rendering assistance to the developer in connection with its development activities shall be based upon all the facts and circumstances of the individual case. Of all the facts and circumstances to be taken into account in making this determination, greatest weight shall be given to the relative amounts of all the direct and indirect costs of development and the corresponding risks of development borne by the various members of the group, and the relative values of the use of any intangible property of members of the group which is made available without adequate consideration for use in connection with the development activity, which property is likely to contribute to a substantial extent in the production of intangible property. For this purpose, the risk to be borne with respect to development activity is the possibility that such activity will not result in the production of intangible property or that the intangible property produced will not be of sufficient value to allow for the recovery of the costs of developing it. A member will not be considered to have borne the costs and corresponding risks of development unless

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such member is committed to bearing such costs in advance of, or contemporaneously with, their incurrence and without regard to the success of the project. Other factors that may be relevant in determining which member of the group is the developer include the location of the development activity, the capabilities of the various members to carry on the project independently, and the degree of control over the project exercised by the various members.

(e) Arm's length consideration.-

(1) In General.- An arm's length consideration shall be in a form which is consistent with the form which would be adopted in transactions between unrelated parties under the same circumstances. To the extent appropriate, an arm's length consideration may take any one or more of the following forms: (1) Royalties based on the transferee's output, sales, profits, or any other measure; (2) lump-sum payments; or (3) any other form, including reciprocal licensing rights, which might reasonably have been adopted by unrelated parties under the circumstances, provided that the parties can establish that such form was adopted pursuant to an arrangement which in fact existed between them. However, where the transferee pays nominal or no consideration for the property or interest therein and where the transferor has retained a substantial interest in the property, an allocation shall be presumed not to take the form of a lump-sum payment.

(2) Standard for arm’s length.- In determining the amount of an arm's length consideration, the standard to be applied is the amount that would have been paid by an unrelated party for the same intangible property under the same circumstances. Where there have been transfers by the transferor to unrelated parties involving the

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same or similar intangible property under the same or similar circumstances the amount of the consideration for such transfers shall generally be the best indication of an arm's length consideration.

(3) Factors in the absence of unrelated taxpayer.- Where a sufficiently similar transaction involving an unrelated taxpayer cannot be found, the following factors, to the extent appropriate (depending upon the type of intangible property and the form of the transfer), may be considered in arriving at the amount of the arm's length consideration:

(i) The prevailing rates in the same industry or for similar property;

(ii) The offers of competing transferors or the bids of competing transferees;

(iii) The terms of the transfer, including limitations on the geographic area covered and the exclusive or nonexclusive character of any rights granted;

(iv) The uniqueness of the property and the period for which it is likely to remain unique;

(v) The degree and duration of protection afforded to the property under the laws of the relevant countries;

(vi) Value of services rendered by the transferor to the transferee in connection with the transfer;

(vii) Prospective profits to be realized or costs to be saved by the transferee through its use or subsequent transfer of the property;

(viii) The capital investment and starting up expenses required of the transferee;

(ix) The availability of substitutes for the property transferred;

(x) The arm's length rates and prices paid by unrelated parties where the

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property is resold or sublicensed to such parties;

(xi) The costs incurred by the transferor in developing the property; and

(xii) Any other fact or circumstance which unrelated parties would have been likely to consider in determining the amount of an arm's length consideration for the property.

Article 1040.09-21.- Determination of taxable income in specific situations: Sales of tangible property.-

(a) Sales of Tangible Property.-

(1) In General.- Where one member of a group of controlled entities ("seller") sells or otherwise disposes of tangible property to another member of such group ("buyer") at other than an arm's length price ("controlled sale"), the Secretary may make appropriate allocations between the seller and the buyer to reflect an arm's length price for such sale or disposition. An arm's length price is the price that an unrelated party would have paid under the same circumstances for the property involved in the controlled sale. Since unrelated parties normally sell products at a profit, an arm's length price normally involves a profit to the seller.

(2) Application of Transfer Pricing Methods.-

(i) In General.- The arm's length amount charged in the sale of tangible property must be determined under one of the methods provided for in through paragraph (b) through (d) of this Article. However, each method should be considered in the order of preference described in the following clause (ii).

(ii) Preferred method.- If there are comparable uncontrolled sales, the comparable uncontrolled price method must be utilized because it is the method likely to

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result in the most accurate estimate of an arm's-length price (for the reason that it is based upon the price actually paid by unrelated parties for the same or similar products). If there are no comparable uncontrolled sales, then the resale price method must be utilized if the standards for its application are met because it is the method likely to result in the next most accurate estimate in such instances (for the reason that, in such instances, the arm's-length price determined under such method is based more directly upon actual arm's-length transactions than is the cost plus method). A typical situation where the resale price method may be required is where a manufacturer sells products to a related distributor which, without further processing, resells the products in uncontrolled transactions. If all the standards for the mandatory application of the resale price method are not satisfied, then, either that method or the cost-plus method may be used, depending upon which method is more feasible and is likely to result in a more accurate estimate of an arm's-length price. A typical situation where the cost-plus method may be appropriate is where a manufacturer sells products to a related entity which performs substantial manufacturing, assembly, or other processing of the product or adds significant value by reason of its utilization of its intangible property prior to resale in uncontrolled transactions. Where the standards for applying one of the three methods of pricing described above are met, such method must, for the purposes of this Article, be utilized unless the taxpayer can establish that, considering all the facts and circumstances, some method of pricing other than those described in this paragraph is more appropriate.

(3) Pricing of product lines.- The methods of determining arm's length prices described in paragraph (a)(2) of this Article are stated in terms of their application to

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individual sales of property. However, because of the possibility that a taxpayer may make controlled sales of many different products, or many separate sales of the same product, it may be impractical to analyze every sale for the purposes of determining the arm's length price. It is therefore permissible to determine or verify arm's length prices by applying the appropriate methods of pricing to product lines or other groupings where it is impractical to ascertain an arm's length price for each product or sale. In addition, the Secretary may determine or verify the arm's length price of all sales to a related entity by employing reasonable statistical sampling techniques.

(b) Comparable uncontrolled price method.-

(1) Arm's Length Price.- Under the CUP method of pricing, the arm's length price of a controlled sale is equal to the price paid in comparable uncontrolled sales, adjusted as provided in subparagraph (2) of this paragraph.

(2) Uncontrolled sales.- Uncontrolled sales are sales in which the seller and the buyer are not members of the same controlled group. These include (a) sales made to a member of the controlled group to an unrelated party, (b) sales made to a member of the controlled group by an unrelated party, and (c) sales made in which the parties are not members of the controlled group and are not related to each other. However, uncontrolled sales do not include sales at unrealistic prices, as for example where a member makes uncontrolled sales in small quantities at a price designed to justify a non-arm's length price on a large volume of controlled sales. Uncontrolled sales are considered comparable to controlled sales if the physical property and circumstances involved in the uncontrolled sales are identical to the physical property and circumstances involved in the controlled sales, or if such properties and circumstances

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are so nearly identical that any differences either have no effect on price, or such differences can be reflected by a reasonable number of adjustments to the price of uncontrolled sales. For this purpose, differences can be reflected by adjusting prices only where such differences have a definite and reasonably ascertainable effect on price. If the differences can be reflected by such adjustment, then the price of the uncontrolled sale as adjusted constitutes the comparable uncontrolled sale price. Some of the differences which may affect the price of property are differences in the quality of the product, terms of sale, intangible property associated with the sale, time of sale, and the level of the market and the geographic market in which the sale takes place. Whether and to what extent differences in the various properties and circumstances affect price, and whether differences render sales noncomparable, depends upon the particular circumstances and property involved. Where there are two or more comparable uncontrolled sales susceptible of adjustment, the comparable uncontrolled sale or sales requiring the fewest and simplest adjustments should generally be selected. Thus, for example, if a taxpayer makes comparable uncontrolled sales of a particular product which differ from the controlled sale only with respect to the terms of delivery, and makes other comparable uncontrolled sales of the product which differ from the controlled sale with respect to both terms of delivery and terms of payment, the comparable uncontrolled sales differing only with respect to terms of delivery should be selected as the comparable uncontrolled sale.

(3) Price Reduction.- One of the circumstances which may affect the price of property is the fact that the seller may desire to make sales at less than a normal profit for the primary purpose of establishing or maintaining a market for his products. Thus, a

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seller may be willing to reduce the price of a product, for a time, in order to introduce his product into an area or in order to meet competition. However, controlled sales may be priced in such a manner only if such price would have been charged in an uncontrolled sale under comparable circumstances. Such fact may be demonstrated by showing that the buyer in the controlled sale made corresponding reductions in the resale price to uncontrolled purchasers, or that such buyer engaged in substantially greater sales promotion activities with respect to the product involved in the controlled sale than with respect to other products. For example: X, a manufacturer of medical equipment, sells such equipment to its subsidiary, Y, for resale. In its existing markets X's medical equipment sell to independent retailers at $500 per unit, and X sells them to wholesalers at $400 per unit. Y also sells X's medical equipment to independent retailers at $500 per unit. X's medical equipment is not known in the market in which Y is operating. In order to engage competitively in the new market Y incurs selling and advertising costs substantially higher than those incurred for its sales of other products. Under these circumstances X may sell to Y, for a time, at less than $400 to take into account the increased selling and advertising activities of Y in penetrating and establishing the new market. This may be done even though it may result in a transfer price from X to Y which is below X's full costs of manufacturing the product.

(c) Resale price method.-

(1) In General.- Under the Resale Price Method, the arm's length price of a controlled sale is equal to the applicable resale price reduced by an appropriate markup, and adjusted as provided in subparagraph (4). An appropriate markup is computed by multiplying the applicable resale price by the appropriate markup

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percentage as defined in subparagraph (6).

(2) Use of resale price method.- The resale price method must be used to compute an arm's length price of a controlled sale if all the following circumstances exist:

(i) There are no comparable uncontrolled sales;

(ii) An applicable resale price is available with respect to resales made within a reasonable time before or after the time of the controlled sale;

(iii) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by physically altering the product before resale. For this purpose packaging, repacking, labeling, or minor assembly of property does not constitute physical alteration;

(iv) The buyer (reseller) has not added more than an insubstantial amount to the value of the property by the use of intangible property.

(3) Exception.- Notwithstanding the fact that one or both of the requirements of paragraphs (1) and (2) may not be met, the resale price method may be used if such method is more feasible and is likely to result in a more accurate determination of an arm's length price than the use of the cost plus method. Thus, even though one of the requirements of such subdivision is not satisfied, the resale price method may nevertheless be more appropriate than the cost plus method because computations and evaluations required under the former method may be fewer and easier to make than under the latter method. In general, the resale price method is more appropriate when the functions performed by the seller are more extensive and more difficult to evaluate than the functions performed by the buyer (reseller).

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(4) Applicable resale price.- The applicable resale price shall mean the price at which it is anticipated that property purchased in the controlled sale will be resold by the buyer in an uncontrolled sale. The applicable resale price will generally be equal to either the price at which current resales of the same property are being made or the resale price of the particular item of property involved.

(5) Resale of property.- Where the property purchased in the controlled sale is resold in another controlled sale, the applicable resale price is the price at which such property is finally resold in an uncontrolled sale, providing that the series of sales as a whole meets all the requirements of subparagraph (2) or that the resale price method is used pursuant to subparagraph (3) of this paragraph. In such case, the determination of the appropriate markup percentage shall take into account the function or functions performed by all members of the group participating in the series of sales and resales.

(6) Appropriate markup percentage.- The appropriate markup percentage is equal to the percentage of gross profit (expressed as a percentage of sales) earned by the buyer (reseller) or another party on the resale of property which is both purchased and resold in an uncontrolled transaction, which resale is most similar to the applicable resale of the property involved in the controlled sale. The following are the most important characteristics to be considered in determining the similarity of resales:

(i) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances;

(ii) The functions performed by the reseller with respect to the property. For example: packaging, labeling, delivering, maintenance of inventory, minor assembly, advertising, selling at wholesale, selling at retail, billing, maintenance of accounts

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receivable, and servicing;

(iii) The effect on price of any intangible property utilized by the reseller in connection with the property resold. For example: patents, trademarks, trade names; and

(iv) The geographic market in which the functions are performed by the reseller (In general, the similarity to be sought relates to the probable effect upon the markup percentage of any differences in such characteristics between the uncontrolled purchases and resales on the one hand and the controlled purchases and resales on the other hand. Thus, close physical similarity of the property involved in the sales compared is not required under the resale price method since a lack of close physical similarity is not necessarily indicative of dissimilar markup percentages.)

(7) Markup Percentages.- Whenever possible, markup percentages should be derived from uncontrolled purchases and resales of the buyer (reseller) involved in the controlled sale, because similar characteristics are more likely to be found among different resales of property made by the same reseller than among sales made by other resellers. In the absence of resales by the same buyer (reseller) which meet the standards of subparagraph (6) of this paragraph, evidence of an appropriate markup percentage may be derived from resales by other resellers selling in the same or a similar market in which the controlled buyer (reseller) is selling, providing such resellers perform comparable functions. Where the function performed by the reseller is similar to the function performed by a sales agent which does not take title, such sales agent will be considered a reseller for the purpose of determining an appropriate markup percentage under this subparagraph and the commission earned by such sales agent,

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expressed as a percentage of the sales price of the goods, may constitute the appropriate markup percentage. In calculating the markup percentage earned on uncontrolled purchases and resales, and in applying such percentage to the applicable resale price to determine the appropriate markup, the same elements which enter into the computation of the sales price and the costs of goods sold of the property involved in the comparable uncontrolled purchases and resales should enter into such computation in the case of the property involved in the controlled purchases and resales. Thus, if freight-in and packaging expense are elements of the cost of goods sold in comparable uncontrolled purchases, then such elements should also be taken into account in computing the cost of goods sold of the controlled purchase. Similarly, if the comparable markup percentage is based upon net sales (after reduction for returns and allowances) of uncontrolled resellers, such percentage must be applied to net sales of the buyer (reseller).

(8) Arm's Length Price Appropriate Adjustment.- In determining an arm's length price appropriate adjustment must be made to reflect any material differences between the uncontrolled purchases and resales used as the basis for the calculation of the appropriate markup percentage and the resale of property involved in the controlled sale. The differences referred to in this subdivision are those differences in functions or circumstances which have a definite and reasonably ascertainable effect on price.

(d) Cost plus method.-

(1) Arm’s Length.- Under cost plus method the arm's length price of a controlled sale of property shall be computed by adding to the cost of producing such property (as computed in subparagraph (2) of this paragraph), an amount which is equal

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to such cost multiplied by the appropriate gross profit percentage (as computed in subparagraph (3) of this paragraph), plus or minus any adjustments as provided in subparagraph (5) of this paragraph.

(2) Costs.- The cost of producing the property involved in the controlled sale, and the costs which enter into the computation of the appropriate gross profit percentage shall be computed in a consistent manner in accordance for allocating or apportioning costs, which neither favors nor burdens controlled sales in comparison with uncontrolled sales. Thus, if the costs used in computing the appropriate gross profit percentage are comprised of the full cost of goods sold, including direct and indirect costs, then the cost of producing the property involved in the controlled sales must be comprised of the full cost of goods sold, including direct and indirect costs. On the other hand, if the costs used in computing the appropriate gross profit percentage are comprised only of direct costs, the cost of producing the property involved in the controlled sale must be comprised only of direct costs. The term cost of producing includes the cost of acquiring property which is held for resale.

(3) Appropriate Gross Profit.- The appropriate gross profit percentages is equal to the gross profit percentage (expressed as a percentage of cost) earned by the seller or another party on the uncontrolled sale or sales of property which are most similar to the controlled sale in question. The following are the most important characteristics to be considered in determining the similarity of the uncontrolled sale or sales:

(i) The type of property involved in the sales. For example: machine tools, men's furnishings, small household appliances;

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(ii) The functions performed by the seller with respect to the property sold. For example: contract manufacturing, product assembly, selling activity, processing, servicing, delivering;

(iii) The effect of any intangible property used by the seller in connection with the property sold. For example: patents, trademarks, trade names;

(iv) The geographic market in which the functions are performed by the seller. (In general, the similarity to be sought relates to the probable effect upon the margin of gross profit of any differences in such characteristics between the uncontrolled sales and the controlled sale. Thus, close physical similarity of the property involved in the sales compared is not required under the cost plus method since a lack of close physical similarity is not necessarily indicative of dissimilar profit margins.)

(4) Evidence of Appropriate Gross Profit.- Whenever possible, gross profit percentages should be derived from uncontrolled sales made by the seller involved in the controlled sale, because similar characteristics are more likely to be found among sales of property made by the same seller than among sales made by other sellers. In the absence of such sales, evidence of an appropriate gross profit percentage may be derived from similar uncontrolled sales by other sellers whether or not such sellers are members of the controlled group. Where the function performed by the seller is similar to the function performed by a purchasing agent which does not take title, such purchasing agent will be considered a seller for the purpose of determining an appropriate gross profit percentage under this subparagraph and the commission earned by such purchasing agent, expressed as a percentage of the purchase price of the goods, may constitute the appropriate gross profit percentage. In the absence of

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data on gross profit percentages of particular sales or groups of sales which are similar to the controlled sale, the prevailing gross profit percentages in the particular industry involved may be appropriate.

(5) Adjustments.- Where the most similar sale or sales from which the appropriate gross profit percentage is derived differ in any material respect from the controlled sale, the arm's length price which is computed by applying such percentage must be adjusted to reflect such differences to the extent such differences would warrant an adjustment of price in uncontrolled transactions. The differences referred to in this subdivision are those differences which have a definite and reasonably ascertainable effect on price.

Article 1040.09-22- Cost Contribution Arrangement

(a) In General.- A Cost Contribution Arrangement (hereinafter, “CCA”) is a framework agreed among controlled taxpayers to share the costs and risks of developing, producing or obtaining assets, services, or rights, and to determine the nature and extent of the interests of each participant in those assets, services, or rights. A CCA is a contractual arrangement rather than necessarily a distinct juridical entity or permanent establishment of all the participants. In a CCA, each participant’s proportionate share of the overall contributions to the arrangement will be consistent with the participant’s proportionate share of the overall expected benefits to be received under the arrangement, bearing in mind that transfer pricing is not an exact science. Further, each participant in a CCA would be entitled to exploit its interest in the CCA separately as an effective owner thereof and not as a licensee, and so without paying a royalty or other consideration to any party for that interest. Conversely, any other party

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would be required to provide a participant proper consideration for exploiting some or all of that participant's interest. In a CCA there is always an expected benefit that each participant seeks from its contribution, whether the benefit is short term or in long term, including the attendant rights to have the CCA properly administered. Each participant's interest in the results of the CCA activity should be established from the outset, even where the interest is inter-linked with that of other participants.

(b) Supplemental rules for transfer of intangible property or services.- The Rules of this Article are supplementary guidance where resources and skills are pooled and the consideration received is, in part or whole, the reasonable expectation of mutual benefits. Therefore the provisions of Article 1040.09-20 and Article 1040.09-18, as well as the provisions of this Article 1040.09-22 regarding the methods of transfer pricing are superior in hierarchy than the rules and guidance set forth in this Article.

(c) Difference between a CCA an ordinary intra-group transfer of property and services.- CCA are distinguishable from ordinary transfer of property or services between related parties in that CCA are structured with the main intention of beneficiating all the participants of the CCA and all the parties expect benefits for each other when polling resources and skills through a CCA.

(d) Arm's Length.-

(1) In General.- Conditions established between controlled taxpayers for a CCA must be structured as such that they are in accordance with the arm's length standard set forth in Article 1040.09-3 of this Regulation. For the conditions of a CCA to satisfy the arm's length standard, a participant's contributions must be consistent with what an uncontrolled taxpayer would have agreed to contribute under comparable

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circumstances given the benefits it reasonably expects to derive from the arrangement. If the participant's contributions are not consistent with what an uncontrolled taxpayer would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to derive from a CCA, the consideration received by at least one of the participants for its contributions will be inadequate, and the consideration received by at least one other participant for its contribution will be excessive, relative to what uncontrolled taxpayerswould have received. In such a case, the arm's length principle would require that an adjustment be made. The nature of the adjustment will depend upon the facts and circumstances, but most often will be an adjustment of the net contribution through making or imputing a balancing payment. Where the commercial reality of an arrangement differs from the terms purportedly agreed by the participants, the Secretary may disregard part or all of the terms of the CCA and make the necessary adjustments in order to determine the appropriate taxable income.

(2) Expectation of Mutual Benefit.- To apply the arm's length standard to a CCA, it is necessary to determine that all the parties to the arrangement have the expectation of mutual benefits by agreeing to pool resources and skills without separate compensation. Then, it is necessary to calculate each participant's relative contribution to the joint activity (cash, assets, services, etc.), and finally, it is necessary to determine whether the allocation of CCA contributions (as adjusted for any balancing payments made among participants) is proper. For example, when comparing the CCA with a CCA that would have been agreed by uncontrolled taxpayers, it must be noted that uncontrolled taxpayers would require that each participant's proportionate share of the actual overall contributions to the arrangement is consistent with the participant's

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proportionate share of the overall expected benefits to be received under the arrangement.

(3) Beneficial Interest as prerequisite.- A participant in a CCA must be assigned a beneficial interest in the property or services that are the subject of the CCA, and have a reasonable expectation of being able directly or indirectly (for example, through licensing arrangements or sales, whether to associated or independent enterprises) to exploit or use the interest that has been assigned. Therefore, a party may not be considered a participant if the party does not have a reasonable expectation that it will benefit from the CCA activity itself (and not just from performing part or all of that activity).

(4) Value of participant contribution.- In order to meet the arm's length principle, the value of each participant's contribution should be consistent with the value that independent enterprises would have assigned to that contribution in comparable circumstances. Therefore, it will be necessary to determine the proportion of the assets used or services that relate to the CCA activity in a commercially justifiable way with regard to recognized accounting principles and the actual facts.

(e) Terms of a CCA.- A CCA shall contain, as minimum, the following information:

(1) A list of participants that will be involved with the CCA activity or that are expected to exploit or use the results of the subject activity;

(2) The scope of the activities and specific projects covered by the CCA;

(3) The duration of the arrangement;

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(4) The manner in which participants' proportionate shares of expected benefits are measured, and any projections used in this determination;

(5) The form and value of each participant's initial contributions, and a detailed description of how the value of initial and ongoing contributions is determined and how accounting principles are applied consistently to all participants in determining expenditures and the value of contributions;

(6) The anticipated allocation of responsibilities and tasks associated with the CCA activity between participants and other enterprises;

(7) The procedures for and consequences of a participant entering or withdrawing from the CCA and the termination of the CCA; and

(8) Any provisions for balancing payments or for adjusting the terms of the arrangement to reflect changes in economic circumstances.

(f) Additional information and documentation.- The Secretary may, from time to time, establish additional information and documentation requirements through circular letters, administrative determinations, informative bulletins, or any other official publication in regards to Cost Contribution Arrangement."

EFFECTIVENESS: In accordance with the provisions of Act No. 170 of August 12, 1988, as amended, known as the "Commonwealth of Puerto Rico Uniform Administrative Procedure Act", this Regulation shall become effective thirty (30) days after its filling at the Department of State.

Approved in San Juan, Puerto Rico on _____, 2016.

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CPA Juan Zaragoza Gómez

Secretary

Filed at the Department of State on _____, 2016.

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