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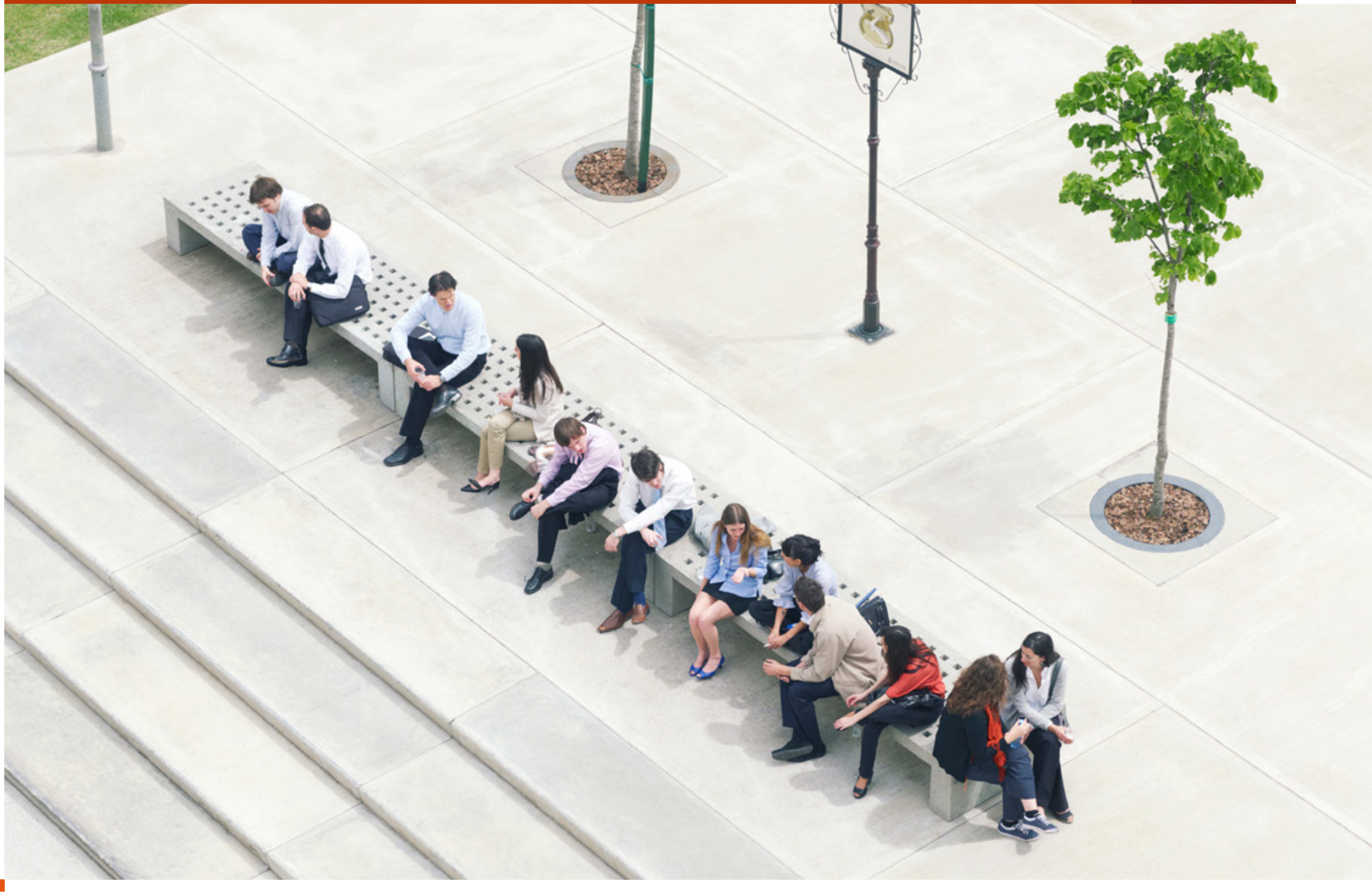
# FSTP Perspectives

## A publication for financial services industry tax and transfer pricing professionals

Spring 2013



*In this issue:*



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# Contents



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# Foreword

Welcome to the Spring 2013 edition of FSTP Perspectives. While the prior edition focused on the rapidly developing arena of transfer pricing, namely intercompany pricing issues around financial transactions, this edition focuses on regulatory changes and tax reforms throughout the world and their transfer pricing implications. This edition of FSTP Perspectives provides an overview of some of these key regulatory and regional developments. Highlights include:

- Findings from the PwC FSTP global network survey covering 40 countries will be presented. The aim was to gather key information on the current legislative transfer pricing environment on intercompany loans as well as outlining our own experience with tax authorities' attitudes towards transfer pricing of financial transactions. The survey offers general guidance to the reader on a range of intercompany financial transactions, related transfer pricing issues and provides an aid for transfer pricing policy implementation.
- An overview of initiatives by the OECD to introduce and provide guidance on what can be referred to as the "substance-over-form" concept in international taxation. The article provides some considerations on how these key characteristics can be addressed in the context of transfer pricing by providing some economic concepts.
- A discussion on the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") and the challenges facing financial institutions in designing and implementing globally consistent transfer pricing policies and complying with the operational and strategic implications of the DFA implementation. The Volcker Rule and Section 716, two crucial and complementary provisions of the DFA, are perhaps the main catalysts for the DFA's ensuing changes.
- A discussion on the new Law 12715 issued by the Brazilian government introducing changes to the existing Brazilian transfer pricing regulations specifically on deductibility and pricing of interest on related party loans. The Brazilian tax authority is expected to issue further regulations in the following months to provide guidance on determining the average market spread to be applied for the calculation of the benchmark interest rate.

Finally, we would like to invite you to the upcoming 2013 Financial Services Transfer Pricing Masters Series sessions in Hong Kong on June 26, Boston on July 18, and London on September 24 where discussions and presentations on the above mentioned topics as well as other transfer pricing topics will take place. Please feel free to reach out to your local PwC financial services tax/transfer pricing contact for more information on the Financial Services Transfer Pricing Masters Series sessions, the topics covered in this publication or other transfer pricing matters.

Best regards,

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*The impact of the global financial crisis on credit markets and the Euro crisis has put continuous pressure on credit availability for multinationals.*

# Navigating through the complexity of transfer pricing for financial transactions - results of a global survey

*Wout Moelands*

## Introduction

The impact of the global financial crisis on credit markets and the Euro crisis has put continuous pressure on credit availability for multinationals. Furthermore, the terms and conditions that third-party providers of credit are willing to accept are, in many cases, substantially more conservative than those which were prevalent in prior years. As such, making optimal use of the funds already available within a group is becoming ever more important.

Given these economic circumstances and the current environment of government deficits and the resulting changes in tax regulations[1] and treaties, multinationals have devoted significant resources in developing treasury business models that promote a higher degree of self-funding and tax optimisation through the use of intercompany loans, guarantees and tools such as cash pooling.

This higher degree of self-funding, together with budget pressures experienced by governments, resulted in an increased focus of tax authorities on the transfer pricing of financial transactions.

As a result, the correct application of transfer pricing legislation has become top priority for taxpayers as the potential for incurring double taxation through adjustments and penalty payments, as well as the negative publicity linked to tax disputes and litigation, has increased. Ensuring that a robust transfer pricing policy is in place is becoming a key management focus.

## Survey

Considering these developments and the uncertainty in this environment, the PwC FSTP global network conducted a survey covering 40 countries to gather key information on the current legislative transfer pricing environment on intercompany loans as well as our own experience with tax authorities' attitudes towards transfer pricing of financial transactions.[2]

In particular, we asked our transfer pricing specialists about the specific transfer pricing rules regarding the treatment of intercompany loans and/or guarantees in their country; specific corporate income tax rules on thin capitalisation; the specific procedures in place to obtain certainty on the transfer pricing treatment of intercompany financial transactions (e.g., Advance Pricing Agreements, Advance Thin Capitalisation Agreements, etc.); which transfer pricing methods are preferred/generally accepted by the tax authorities in your country with respect to pricing intercompany loans and guarantees; how is dealt with implicit support/passive association with respect to pricing intercompany loans and guarantees; etc.

Based on the responses to the survey, it is clear that transfer pricing legislation and general practice with respect to these issues is inconsistent across territories and, in many cases, still evolving. Nevertheless, some key themes have emerged from the survey responses in relation to (i) whether transfer pricing and thin capitalisation rules are embedded in tax law; (ii) the generally accepted methods to evaluate the arm's length interest rate on intercompany loans; (iii) the preferred method to evaluate the arm's length nature of guarantee fees; and (iv) whether passive association (i.e., the creditworthiness of the subsidiary is evaluated

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1 For example, Brazil, Canada, Japan, Finland, The Netherlands all introduced new/amended tax legislation regarding the tax deduction of interest on intercompany debt effective 2013. Other countries such as New Zealand, Portugal and Sweden recently proposed changes to their thin capitalisation legislation.

2 The full survey is published on http://www.pwc.com/gx/en/tax/transfer-pricing/navigating-the-complexity-financial-transactions-transfer-pricing-global-survey.jhtml

recognising that the subsidiary is a part of a multinational group and assuming that the parent company/group will intervene if the subsidiary encounters financial difficulty) should be accounted for in analysing arm's length interest rates and guarantee fees.

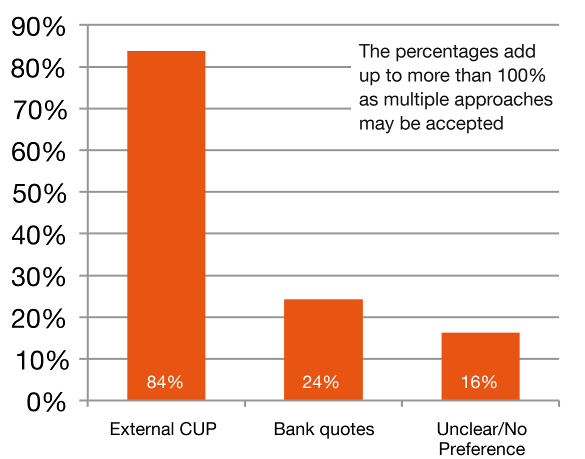
## *Transfer pricing and thin capitalisation rules*

Transfer pricing rules and thin capitalisation rules are embedded in the tax law of most responding countries. The transfer pricing rules; however, are often not specific to financial transactions. If transfer pricing rules explicitly address financial transactions, they primarily address intercompany loans (in particular in terms of volume and interest rate) with only limited rules addressing intercompany guarantees and cash pooling. To the extent that a country lacks specific guidelines for evaluating transfer pricing applied to intercompany financial transactions, the broader transfer pricing guidance provided in the OECD Guidelines is typically referred to.

## *Generally accepted methods to evaluate the arm's length interest rate on intercompany loans*

The most commonly accepted method to evaluate the arm's length interest rate on intercompany loans is the internal or external comparable uncontrolled price (CUP) method (over 80 percent of the respondents indicated that the CUP method is accepted; for the remaining respondents there were no clear guidelines on what methods are accepted or there are very specific rules embedded in the transfer pricing regulations).

**Survey results**




With respect to applying the external CUP method, this should typically take into account the specific terms and conditions of the loan and the creditworthiness of the related party debtor based on a credit scoring analysis as a distinct and separate enterprise. Bank quotes were accepted in approximately 1/3th of the responding countries; however, typically only as secondary evidence of the arm's length nature of the interest rate applied.

## *Generally accepted methods to evaluate the arm's length nature of guarantee fees*

The CUP method and the benefit method are the most commonly accepted methods to evaluate arm's length guarantee fees for intercompany guarantees.

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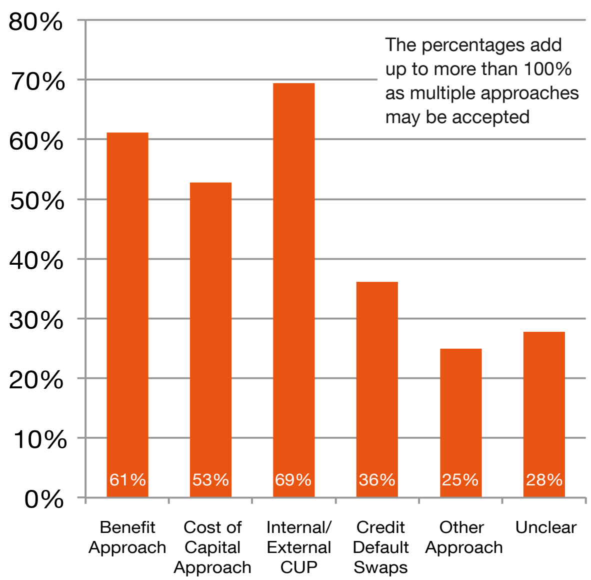
## *Navigating through the complexity of transfer pricing for financial transactions - results of a global survey*

The benefit approach analyses the interest rate benefit obtained as a result of the guarantee and splits this between the guarantor and the guaranteed.

**Survey results**

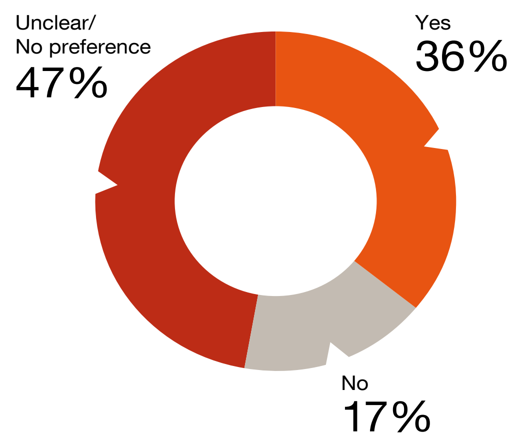



Other methods that are often accepted are the cost of capital approach, where the guarantee fee is determined based on the cost for the guarantor in relation to the guarantee (typically determined by analysing expected loss on the guarantee and the cost of capital to be maintained in relation to the guarantee), and analysing the fees paid on credit default swaps (CDS) on bonds with comparable characteristics as the guaranteed transaction (the main characteristic being the credit rating of the guaranteed). Examples of other approaches are calculating the guarantee fee as (i) the value of a put option; and (ii) the multiplication of the expected default frequency, the underlying asset valuation, and the loss given default of the guaranteed asset.

### *Passive association*

As the results show there is clearly no common approach for taking into account the concept of passive association in substantiating the arm's length nature of interest rates and guarantee fees.

**Survey results**

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# *Navigating through the complexity of transfer pricing for financial transactions - results of a global survey*

## *Conclusion*

Given the inconsistency in global transfer pricing rules, planning and management of intercompany financial transactions from a transfer pricing perspective is challenging; however, some common practices can be identified to help ease some of the compliance burden. These practices can also be used as a basis for a master file/policy paper addressing an organisation's main financial transactions, which can be modified to specific local needs where necessary.

In this respect, the survey offers general guidance to the reader on a range of intercompany financial transactions-related transfer pricing issues and provides an aid for transfer pricing policy implementation.

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*Recent international developments continue to emphasize the importance of economic substance for underlying transactions within a multinational enterprise in creating a level playing field for corporate taxation in different tax jurisdictions.*

# It's all about substance

*Daniel Lierens and Martin Riemslag*

## 1. Introduction

Recent international developments continue to emphasize the importance of economic substance for underlying transactions within a multinational enterprise in creating a level playing field for corporate taxation in different tax jurisdictions. The OECD study addressing Base Erosion and Profit Shifting commissioned by the G-20[1] and an action plan to strengthen the fight against tax fraud and tax evasion prepared by the European Commission[2] are two of these international developments.

These studies build on the continuing efforts by the OECD since the publication of the 1995 and 2010 OECD Transfer Pricing Guidelines to introduce and provide guidance on what can be referred to as the substance over form concept in international taxation. This article discusses these initiatives by the OECD and in doing so provides the key characteristics on what the OECD considers the substance requirements. The article then provides some considerations on how these key characteristics can be addressed in the context of transfer pricing by providing some economic concepts of control.

## 2. OECD initiatives on substance

Substance can be considered to be anchored in article 4 of the OECD Model Tax Convention. If a taxpayer is considered a dual resident, i.e. the person is a resident of two contracting states, but a dual resident entity will only be treated as a resident of the state in which its place of effective management is located. However, there has been a lack of consistency in interpreting the concept in treaty practice. This lack of consistency can be considered to be in line with the view by the OECD that additional guidance is warranted on the interpretation of substance in the context of international tax structures.

In a transfer pricing context, the OECD introduced the substance over form concept in the publication of the OECD Transfer Pricing Guidelines in 1995. According to paragraph 1.37 of the OECD Transfer Pricing Guidelines, a tax administration may disregard the parties' characterization of a transaction, and re-characterize it in accordance with its economic substance, where the economic substance of a transaction differs from its form. In paragraph 1.26 it was considered to assess whether a purported allocation of risk is consistent with the economic substance of a transaction, complemented by paragraph 1.27 which mentions that in arm's length dealings it generally makes sense for parties to be allocated a greater share of those risks over which they have relatively more control. However, the OECD Transfer Pricing Guidelines do not provide a detailed discussion on what control entails. Additional guidance has been provided by issuing in 2010 a new chapter IX on business restructurings in the OECD Transfer Pricing Guidelines and with the issuance, also in 2010, of the OECD report on the allocation of profit to a permanent establishment (PE).

In chapter IX of OECD Transfer Pricing Guidelines on business restructurings, the OECD further defines control as: "The capacity to make decisions to take on the risk (decision to put the capital at risk) and decisions on whether and how to manage the risk, internally or using an external provider." This would require the company to have people - employees or

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1 Reference is made to the OECD report on "Addressing Base Erosion and Profit Shifting", as published by the OECD on February 12, 2013 at http://www.oecd.org/tax/beps.htm.

2 Reference is made to the report on "An action plan to strengthen the fight against tax fraud and tax evasion", prepared by the European Commission" and published on December 6, 2012 at http://ec.europa.eu/taxation_customs/taxation/tax_fraud_evasion/index_en.htm.

directors – who have the authority to, and effectively do, perform these control functions. Thus, when one party bears a risk, the fact that it hires another party to administer and monitor the risk on a day-to-day basis is not sufficient to transfer the risk to that other party.” In addition, chapter IX states that in order to control a risk, one has to be able to assess the outcome of the day-to-day monitoring and administration function in case this activity has been outsourced. It can be concluded that control over risk and therefore the substance of a specific transaction is related to the authority structure of a multinational enterprise. Another factor in assessing substance in light of chapter IX is to determine which party has the anticipated financial capacity to bear the risk.

At the same time, the OECD introduced the allocation of profit to a PE, an authorized approach which attributes to a PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of those risks are performed by people in the PE. The economic ownership of assets is to be attributed to the PE based on where the assets are used in performing the relevant functions and the risks attributed to the PE in that context. Then it is determined how much equity (and debt) is to be attributed to the PE to cover those assets and to support the risks assumed. The relevant functions in the context of a PE profit allocation analysis are referred to as significant people functions (“KERT - Key Entrepreneurial Risk Taking Functions” in the context of the financial services industry) and the risk and asset allocation provides the basis for allocating profit to a permanent establishment. When defining the significant people functions, it is important to consider these to be the functions relating to the day-to-day management of activities as opposed to the authority to make decisions.

Economic substance is also addressed in the draft guidance by the OECD on transfer pricing for intangibles. In that respect, the OECD places considerable emphasis on the functions performed, assets used and risks assumed by related parties in determining whether an intangible exists for transfer pricing purposes. Specifically, the contractual owner of an intangible should bear the various costs associated with the intangible and should, through

*If a taxpayer is considered a dual resident, i.e. the person is a resident of two contracting states, but a dual resident entity will only be treated as a resident of the state in which its place of effective management is located.*

its own employees, physically perform the important functions related to the development, enhancement, maintenance and protection of the intangible. The concept of economic substance for transfer pricing in relation to intangibles therefore aligns with the concepts of control over risk and financial capacity to bear the risk that have been introduced in the OECD Transfer Pricing Guidelines, and in a different context, in the OECD report on the allocation of profit to a PE.

As a final note, the concept of economic substance is also addressed in the proposals concerning the meaning of beneficial ownership in articles 10, 11 and 12 of the OECD Model Tax Convention.[3] Beneficial ownership can be considered a result of having the appropriate amount of economic substance in a specific tax jurisdiction. Thus, one may conclude that the ongoing position of the OECD is to consider the amount of economic substance underlying activities in a specific tax jurisdiction to ultimately define the appropriate amount of profits to be allocated to such tax jurisdiction. The required economic substance for transfer pricing purposes is a result of having the appropriately skilled employees that perform the required functions to control risks allocated to them, in addition to performing the required functions to manage the capital that has been put at risk.

In the current landscape, in light of recent international developments, it is of significant importance for multinationals to have a business model in place that aligns with the required economic substance in a specific tax jurisdiction given the transfer pricing model that is implemented, and vice versa. A functional analysis, as part of a transfer pricing analysis, is key in determining whether such is the case and to potentially redesign the business and/or transfer pricing model. The following section briefly touches upon economic concepts of control that could be applied when conducting transfer pricing analyses to determine the economic substance of related parties to a transaction as part of a functional analysis.

## 3. Economic concepts of control

The definition of control in the context of management literature can be understood to be: "the ratification and monitoring of decisions (which also answers what functions or decisions typically amount to control)." The definition of control can be further explained in the context of the three systems that make up the organizational architecture of organizations, being:[4]

- A system that measures performance;
- A system that rewards and punishes performance; and
- A system that divides and allocates decision rights.

A framework is provided in the article that can be used in analyzing control in an organization setting, which can be used in conducting a functional analysis.

This framework looks at:

- The relationship between decision-control and knowledge;
- The relationship between decision-control and budgets; and
- The relationship between decision-control and responsibility accounting.

In terms of economic substance and having the required capital at risk, the determination of such appropriate level of capital could be, for example, performed by drawing an analogy to Basel III requirements that set out international rules for banks that define how much capital a bank should have in order to absorb losses resulting from the materialization of risks. Another approach may be to align with the authorized methods for determining the appropriate allocation of assets, including capital, to PE's as part of the OECD report on the allocation of profit to a PE.

3 Reference is made to the report on "OECD Model Tax Convention: Revised Proposals Concerning the Meaning of "Beneficial Owner" in Articles 10, 11 and 12", prepared by the OECD and published on October 19, 2012 at http://www.oecd.org/ctp/treaties/Beneficialownership.pdf.

4 A Note on Controlling Risks from a Transfer Pricing Perspective, Clive Jie-A-Joen, Daniel Lierens, Omar Moerer, BNA Tax Management Transfer Pricing Report, Vol. 18, No. 12, November 2009.

## *4. Conclusion*

Recent international developments continue to emphasize the importance of economic substance for underlying transactions within a multinational enterprise in creating a level playing field for corporate taxation in different tax jurisdictions. From an OECD perspective, the required economic substance for transfer pricing purposes is a result of having the appropriately skilled employees that perform the required functions to control risks allocated to them, in addition to performing the required functions to manage the capital that has been put at risk.

It is therefore of significant importance for multinationals to have a business model in place that aligns with the required economic substance in a specific tax jurisdiction given the transfer pricing model that is implemented, and vice versa. A functional analysis, as part of a transfer pricing analysis, is key in determining whether such is the case and to potentially redesign the business and/or transfer pricing model. Some management concepts could be used when conducting transfer pricing analyses to determine the economic substance of related parties to a transaction as part of a functional analysis.

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*The Volcker Rule (the "Rule"), a key provision of the DFA, intends to limit banking entities from engaging in risky behaviors that will not benefit their customers.*

# Transfer pricing implications of the Volcker Rule and Section 716 of the Dodd-Frank Act for banking and capital market institutions

In response to the 2008 worldwide financial crisis, as part of a major overhaul of the United States financial regulatory system, on July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") into law. The DFA along with similar proposals in other countries have significant tax implications and raise major transfer pricing issues for actors operating in the financial services industry. Namely, more than ever before, financial institutions now face the challenging tasks of designing and implementing globally consistent transfer pricing policies and complying with the operational and strategic implications of the DFA implementation. Two crucial and complementary provisions of the DFA, the Volcker Rule and Section 716, are perhaps the main catalysts for the DFA's ensuing changes.

The Volcker Rule (the "Rule"), a key provision of the DFA, intends to limit banking entities from engaging in risky behaviors that will not benefit their customers. The Rule can be expected to have three salient effects on banking entities and their affiliates' activities operating in the U.S. (i.e., U.S. and non-U.S. entities) since:[1]

1. It prohibits banks from conducting proprietary trading activities;
2. It prohibits banks from investing or sponsoring hedge funds and private equity funds subject to certain exceptions;[2] and
3. It allows banks to conduct core banking activities (i.e., market-making, underwriting, hedging) to the extent that no proprietary trading activities are involved.

Consequently, sweeping organizational changes to banking and capital market institutions along with industry-wide changes are to be expected.[3] Additionally, Section 716 (the "Swaps Push-out Rule"), designed to curb excessive systemic risk taking behaviors, which prohibits federal assistance from being provided to "swaps entities"[4] and as such forces insured banks to push swaps into non-bank affiliates, will further exacerbate some of these impacts.

## Transfer Pricing Implications

From a transfer pricing perspective, banks will need to carefully examine the following issues:

1. How should the substantial compliance costs attributable to the Rule – stemming largely from the difficulty of disentangling the beneficial activities of banks (i.e., market-making and hedging) from the speculative ones – be allocated amongst the banks' head-office, their branches and subsidiaries? A thorough review and classification of the compliance costs at stake and an analysis of the benefits obtained by the service recipients will need to be undertaken by the banks to determine whether such costs should be allocated and if so, the markup each category of costs should be carrying.
2. Given the prohibition in place for banks to operate certain businesses, how should the transfer of such businesses be valued?[5] Which tax jurisdictions should then be considered for such transfer? Banks will need to assess the additional costs of pursuing their derivatives trading operations (i.e., capitalization of special purpose vehicles, impact of reputational risk…) versus their potential profitability benefits to determine where they

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1 The Rule's end of the conformance period is July 21, 2014.

2 Banking entities can own up to 3 percent of the total ownership interest of such funds subject to the limitation that the aggregated investments of the banking entity in such funds may not exceed 3 percent of the Tier 1 capital of the banking entity.

3 For instance, one would expect banks to re-focus on activities generating fees, commissions and spreads rather than profit from market volatility. Capital frictions introduced by the Rule are likely to affect liquidity in the marketplace and the cost of capital.

4 Under Section 716 of the DFA, "swap entity" refers to any swap dealer, security-based swap dealer, major swap participant, major security-based swap participant that is registered under the Commodity Exchange Act or the Securities Exchange Act.

want to carry on their businesses.

3. The banks' profitability and its risk profile will change under the Rule (e.g., in addition to prohibiting trade of certain asset classes, the ability to book trades in certain jurisdictions will be restricted triggering non-optimum capital usage and costs). Thus, banking entities will need to revisit their functional profile and comparable selections.
4. Movements of businesses prompted by Section 716's requirements will necessitate adjustments to booking models implying reviews of: (i) businesses' key entrepreneurial risk taking functions' locations; (ii) return on capital allocations; and (iii) losses allocations mechanisms.

## How have financial institutions responded to these changes?

Since the enacting of the Rule, affected financial institutions have spent considerable resources winding down proprietary trading positions, divesting their private equity stakes while simultaneously fine-tuning a comprehensive compliance development program involving direct supervision from senior management and the implementation of new quantitative risk metrics.

With respect to the Swaps Push-out Rule, as a result of an oligopolistic market structure,[6] two major types of responses can be highlighted:

1. Insured depository institutions which, prior to the Swaps Push-out Rule, already conducted their derivatives trading through entities legally separated from their depository institutions have not been directly affected by it and;
2. Financial institutions which, prior to the Swaps Push-out Rule, conducted their derivatives trading through entities not legally separated from their depository institutions have started the process of spinning off their swaps trading operations to separately capitalized nonbank affiliates.[7,8]

## Conclusion

While much clarity regarding the content and implications of the Rule has been gained over the past two and a half years, the full extent of its transfer pricing implications for financial institutions still remain to be seen. These effects will partly depend on the organizational structures (i.e., conducting banking activities through branches, central booking of trades) financial institutions are in the process of making. Section 716 will add additional layers of complexity for swaps entities and further highlight the need for banks and their affiliates operating in the U.S. to have a thorough and in-depth transfer pricing documentation to document the implementation of the changes and related valuations/transfer issues and to ensure that intercompany transactions are conducted according to the arm's length principle going forward.

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5 Transferring a book of derivatives requires firstly a fair market or fair model valuation of the book and generally a contemporaneous income statement recognition of profits and losses. Transferring a book of loans, typically recorded in the banks' financials at historical value, raises the additional transfer pricing issue of losses' recognition timing.

6 According to the Office of the Comptroller of the Currency (OCC), in the third quarter of 2012, four banks accounted for 93% of the banking industry's notional derivatives amounts and 81% of its net credit exposure (see OCC's Quarterly Report on Bank Trading and Derivatives Activities, Q2 2012). This credit exposure in derivatives transactions is mostly attached to swaps transactions.

7 Amongst the major swaps market players approximately one-third of them already conducted their swaps trading activities through non-bank affiliates prior to the enacting of the Swaps Push-out Rule. Another third of them had not started to setup independent legal structures for their swaps trading businesses. Banks belonging to the remaining third category had started the transitioning at the time of the Swaps Push-out Rule's enactment.

8 Given the OCC's recent announcement that it was prepared to grant applications to delay compliance with Section 716 for up to two years, financial institutions generally have now until July 16, 2015 to comply with the Swaps Push-out Rule.

*In September 2012, the Brazilian government issued Law 12715, which states that any interest paid or received by a Brazilian taxpayer on a related party loan registered or not with the Brazilian Central Bank should comply with maximum and minimum interest rates.*

# New Brazilian transfer pricing rules for intercompany loan agreements with foreign related parties

*Alvaro Taiar and Ivo Rocha*

## Background

Until 2012, the interest rate applied in an inter-company loan agreement entered into between a Brazilian taxpayer (i.e., as a lender or a borrower) and a foreign related counterparty or a beneficiary domiciled in a low tax jurisdiction, was not subject to Brazilian transfer pricing requirements, as long as the transaction was registered with the Brazilian Central Bank by the time of the remittance or inflow of interest. Any interest paid by a Brazilian taxpayer on a loan not registered with the Brazilian Central Bank would be deductible, for income tax purposes, only up to an interest rate equal to six-month US dollar LIBOR plus a 3 percent spread. Any taxable income related to any interest received by a Brazilian taxpayer had to be equal to or higher than LIBOR plus a 3 percent spread.

In September 2012, the Brazilian government issued Law 12715, which states that any interest paid or received by a Brazilian taxpayer on a related party loan registered or not with the Brazilian Central Bank should comply with maximum and minimum interest rates. Subsequently, Law 12766 was introduced in December 2012 to provide guidance on how to calculate these limits.

## New applicable transfer pricing requirements

According to Law 12766, a Brazilian taxpayer must adopt new limits on any interest paid or received by a foreign related party, regardless of whether the transaction was registered with the Brazilian Central Bank.

The interest paid by a Brazilian taxpayer to a foreign related party or a beneficiary domiciled in a low tax jurisdiction would be deductible for income tax purposes up to the amount that does not exceed the spread to be determined by the Ministry of Finance based on an average market spread plus the applicable rate based on the following rules:

I. Brazilian sovereign bond rate issued in US dollars in foreign markets for transactions in US dollars subject to a fixed interest rate;

II. Brazilian sovereign bond rate issued in Brazilian Reais in foreign markets for transactions in Brazilian Reais subject to fixed a interest rate; and

III. Six-months LIBOR for any other transactions.

In the case of a transaction carried out in Brazilian Reais subject to a floating rate, the Ministry of Finance may determine a different base rate, which was not established at the time this article was published.

For a loan (covered in item III above) denominated in a currency for which there is no specific LIBOR rate available, six-month US dollar LIBOR should be applied.

The deductibility limit must be verified on the contract date, and will apply proportionally for the duration of the full contract term. The new rules will affect transactions to be carried out as of January 1, 2013. Thus, loan transactions already in place by January 1, 2013 would be grandfathered into the new rules. However, it should be noted that, a renewal or a renegotiation of a loan agreement will be treated as a new agreement under this new rule.

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## *New Brazilian transfer pricing rules for intercompany loan agreements with foreign related parties*

In the event a loan is provided by a Brazilian taxpayer to a foreign related party, the criteria mentioned above must be considered in determining the minimum interest income to be subject to taxation in Brazil.

### *Transfer pricing deadline*

A transfer pricing analysis is required to be made on an annual basis at the end of each calendar year; therefore, the Brazilian taxpayer should compare the interest expense and revenue booked during the entire year with the benchmark interest based on the new rules. In the event an excess of expense or insufficiency of revenue is calculated, the resulting difference should be added to the corporate income tax base.

In this manner, the Brazilian tax authority is expected to issue further regulations in the following months especially providing guidance on determining the average market spread to be applied for the calculation of the benchmark interest rate and provide additional guidance.

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