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In this article, the authors explain how Brazil's proposed changes to its transfer pricing regime will affect intercompany financial transactions.

Brazil — one of the largest economies and one of the world's largest commodity exporters — is in the process of shifting from its unique, historical transfer pricing system, which relied on standard fixed gross margins or markups, to an arm's-length standard largely consistent with the 2022 OECD transfer pricing guidelines. The proposed transfer pricing system would incorporate several key features of the OECD transfer pricing framework, including:

- transfer pricing method and valuation techniques;
- the possibility of testing related foreign parties to a Brazilian transaction;
- the OECD concept for cost contribution arrangements;
- rules addressing internal restructurings;
- authority for the Brazilian tax authority (Receita Federal do Brasil, or RFB) to enter into advance pricing agreements and conclude mutual agreement procedures; and
- expanded base erosion and profit-shifting action 13 documentation requirements, including master file and local file.

The new system also ensures consistency with transfer pricing recommendations for financial transactions aligned with Chapter X of the OECD transfer pricing guidelines. The RFB does not intend to allow any grandfathering of financial transactions executed under Brazil's historical transfer pricing system. This means that all existing Brazilian intercompany financial transactions will need to be reviewed and, if necessary, repriced, before multinational enterprises adopt the new system.

On December 28, 2022, the government issued Provisional Measure No. 1,152, which incorporated these changes. Although the provisional measure became effective immediately, it needed the approval of the Brazilian National Congress (the lower house (Chamber of Deputies) and the upper house (Federal Senate)) to, in effect, finalize the decision to embrace the new transfer pricing system. Both the Chamber of Deputies and the Federal Senate have now approved the provisional measure (with some minor modifications to the original bill) paving the way for an alignment of Brazilian law with the OECD's transfer pricing paradigm.[1]

Under the approved bill, taxpayers must apply the new transfer pricing rules to their Brazilian intercompany transactions for tax periods beginning on or after January 1, 2024. Significantly, the bill allows taxpayers to elect application of the new rules for the 2023 tax period. Taxpayers will need to make the irrevocable election to do so in September 2023.

Historical Transfer Pricing

The general rules applicable to transfer pricing in Brazil, including for financial transactions, were

[1] As of May 17, the bill still needed final approval by the Brazilian president to take effect.

Historical Transfer Pricing Approach

Currency/Interest Rate Type	Fixed	Floating
Brazilian reais	Interest rate capped at the market rate for reais-denominated sovereign bonds issued in international capital markets plus a spread of 350 basis points.	Interest rate capped at six-month U.S. dollar London interbank offered rate (6M LIBOR) plus a spread of 350 basis points.
U.S. dollar	Interest rate capped at the yield observed on U.S. dollar-denominated sovereign bonds issued by the Brazilian government plus a spread of 350 basis points.	Interest rate capped at 6M LIBOR plus a spread of 350 basis points.
Other currency	Interest rate capped at 6M LIBOR plus a spread of 350 basis points.	Interest rate capped at 6M LIBOR plus a spread of 350 basis points.

established in article 22 of Law No. 9,430/1996. Under these old rules, form was more important than substance when evaluating related-party arrangements. For intercompany loans, for example, elements such as contractual terms, credit rating, or the debtor's debt serving capabilities were irrelevant for the determination of the interest rate. Transfer pricing rules for interest rates on loans granted to Brazilian related parties didn't apply the arm's-length principle, but followed a formulaic approach outlined in the table.[2]

The historical Brazilian transfer pricing rules did not explicitly cover other types of intercompany financial transactions like financial guarantees, captive insurance, or cash pooling. Therefore, the application of the transfer pricing was challenging, given that in many cases, no comparable uncontrolled transactions (from the perspective of the Brazilian comparable uncontrolled price method (known in Brazil as PIC)) were available. As such, taxpayers faced considerable uncertainty regarding the pricing of a number of intercompany financial transactions. Formulaic approaches to interest rate setting, combined with a lack of guidance for other types of financial transactions, raised substantial threats of double taxation if the Brazilian methods yielded non-arm's-length outcomes.

Intragroup Loans

The new transfer pricing rules explicitly discuss: (1) accurate delineation of a transaction as debt or equity; (2) credit rating; (3) the arm's-length interest rate on intercompany loans; and (4) the impact of financial guarantees.[3] For any financing transaction, the first step would be to establish whether the transaction, as a whole or partially, will be treated as debt. This determination will be based on relevant characteristics of the transaction, including options realistically available to both the borrower and the lender. While the new rules do not explicitly define whether elements like industry-specific leverage structures and cash flow analyses confirming the serviceability of debt are essential, it is anticipated, based on the alignment with the OECD guidelines, that these analyses will be an important component in establishing the amount of funding supportable as debt.

The new transfer pricing rules are explicit about giving consideration to implicit support in the assessment of credit rating for any debtor. Therefore, any intercompany interest rate or guarantee fee (see the following section) will have to be priced based on a credit rating that reflects not only the financial strength and business prospects of the debtor, but also the debtor's relationship with the group or parent. While there is publicly available literature on how to assess

[2] There are similar, specific rules for outbound loan transactions. The new transfer pricing rules are applicable to both inbound and outbound transactions.

[3] Cash pool and captive insurance are also part of the new transfer pricing rules but are not analyzed in this article.

implicit support from a group or a parent, there is no single method that trumps all others. Therefore, for any multinational corporation, it would be critical to develop a reliable approach in assessing the impact of implicit support and ensure consistency in how these analyses are being performed for all relevant transactions. Some of the web-based tools from credit rating agencies offer objective solutions in estimating stand-alone credit ratings as well as implicit support; they could become instrumental in meeting the new transfer pricing requirements.

To the extent a funding transaction is respected as debt and its credit rating is assessed, the next step is determining the interest rate. The new transfer pricing rules split interest rate determination into three categories:

- For transactions in which the lender does not have the financial capacity or does not exercise control over the economically significant risks associated with the intercompany loan, the interest rate will be capped at a risk-free rate of return. The risk-free rate of return will be determined based on public securities issued by governments in the same currency as the functional currency of the lender.
- For transactions in which the lender has the financial capacity and exercises control over economically significant risks associated with the loan, the intercompany interest rate will reflect a risk-adjusted rate of return. This rate will bear a premium over the risk-free rate referred to above. Although the proposal does not provide details on how to benchmark the risk premium, we anticipate benchmarking analyses consistent with the OECD guidelines will be acceptable.
- For transactions in which the lender is acting as an intermediary and on-lending the funds directly from another party, the remuneration would be determined based on the functional profile of the intermediary, the risk it assumes, and the assets it employs. Therefore, if the intermediary is not employing any capital and does not bear any risk, it would presumably earn a return to cover only the administrative costs incurred in arranging for the transaction.

Intragroup Guarantees

The new transfer pricing rules explicitly include guidance for intragroup guarantees, which are similar to those under the OECD guidelines. For intragroup guarantees, MNEs will need to accurately delineate the transaction as either (1) a service, under which a benefit is provided or received through lowering the interest rate and, hence, a guarantee fee is applicable; or (2) a shareholder activity or a capital contribution under which no remuneration would be due.

To the extent remuneration is appropriate, the basis would be determined according to the benefit (for example, interest savings) obtained by the debtor that exceeds the benefit generated from implicit support. This remuneration may not exceed 50 percent of the value generated; however, the regulations allow for the possibility that another approach may be more appropriate under the arm's-length principle. Depending on the nature of the transaction, it may be possible to use alternative approaches based on expected loss and loss-given-default estimations, or some other means.

Implications

Updating transfer pricing for financial transactions can raise a multitude of unique complexities and tax consequences. Given that all Brazilian intercompany financial transactions will need to be analyzed, we have set forth some practical questions and considerations:

- Is the total amount of leverage supportable, or might a portion of the funding be recharacterized as equity under the new rules? All significant financial transactions would require evidence that both lender and borrower made an optimal decision regarding the quantum of debt, based on the terms and conditions of the debt, industry of operation, and current market conditions.
- Do lenders have sufficient economic substance? Because the new regulations are very clear about the limited interest payment allowed to lenders without financial capacity or economic substance, MNEs may need to refinance existing transactions when the funds are lent by thinly capitalized entities with no

employees. The new funding will have to come from lenders who have substantive operations and employees making conscious investment decisions.

- Are there other impacts of updating interest rates on existing intercompany loans? The new regulations require that existing loans be reevaluated by January 1, 2024, or earlier if 2023 adoption is elected. Simply updating the interest rate on the loan to a market-based rate may help meet the Brazilian regulations, but may also result in tax consequences in the lender's jurisdiction. For example, any change in the interest rate greater than 25 basis points has the potential of triggering a "significant modification"[4] under the U.S. tax rules, and a recognition of any gains or losses on the loan for tax purposes (among other consequences). These impacts will have to be carefully considered (along with the more straightforward transfer pricing challenges that could result from changing the pricing of an existing transaction).

[4] *See* reg. section 1.1001-3.

Summary

MNEs with Brazilian operations will have to carefully navigate the transition period as they move to the new transfer pricing rules, particularly with regard to intercompany financial transactions. Significant efforts will need to be undertaken to (1) review all transactions that require repricing or restructuring; (2) assess the impact of any related-party guarantees, both explicit and implicit; (3) identify appropriate entities to provide funding; and (4) evaluate tax consequences not just in Brazil but at the location of the counterparty to any intercompany financial transaction.[5] ■

[5] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.