

Do you know the proper Transfer Pricing treatment of accounts receivable/payable?

Within the normal business activity of any company, the accumulation of trade balances pending collection and payment is quite common. Such balances would be expected to be settled within a term of days of credit no greater than the policies set for trade receivables and payables.

Notwithstanding the above, when these trade balances pending collection and payment arise between related companies, the policies used by multinational groups may differ from the procedures agreed with independent third parties, mainly reflected in the balances accumulated over the years, without such balances receiving proper transfer pricing treatment or categorization.

This specific situation can result in a reclassification of transactions, in accordance with article 61 of Decree 10-2012, which establishes that the Superintendency of Tax Administration -SAT- has the power to classify transactions according to their true nature, specifically, when the economic reality of the transaction substantially differs from what would have been adopted by an independent third party, thus limiting SAT from determining the appropriate transfer price.

When it is considered that the procedure for the accumulation of balances pending collection and payment between related companies differs from what would have been applied by independent companies behaving in a rational manner in comparable circumstances, there may be the need to characterize these transactions as financial transactions, which require a verification of the application of the arm's length principle to determine the conditions that independent third parties would have agreed in comparable circumstances.

To accurately delineate the identification of a financial transaction between related companies, the characteristics listed below may be useful and relevant for its characterization:

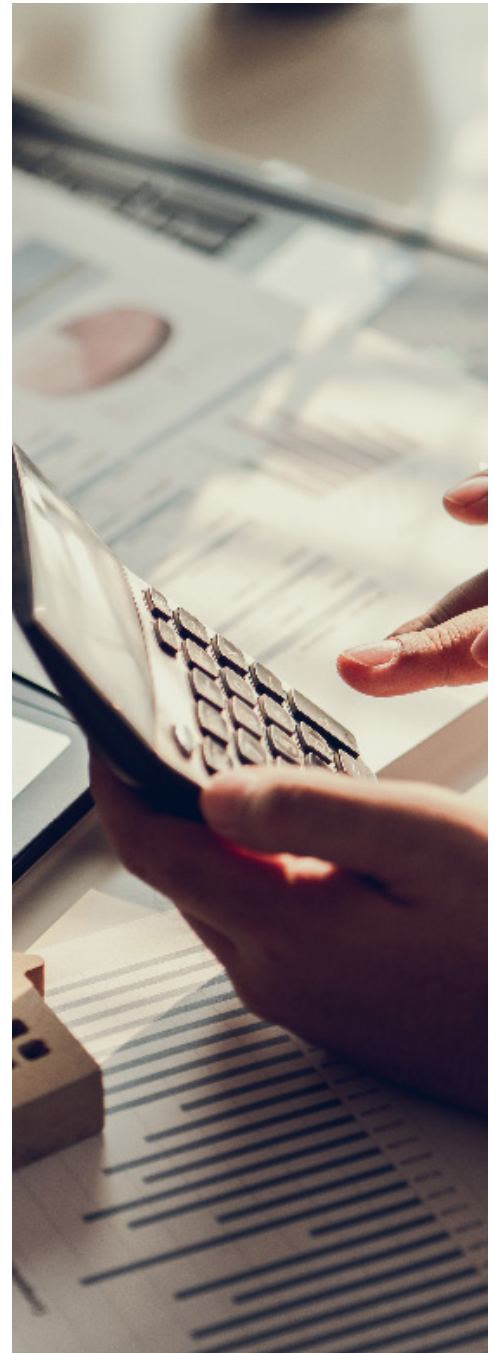
- Identification of an account receivable/payable, explicitly detailing in the description of the account that it is with related companies;
- Absence of an estimated date of collection/payment of the credit granted for commercial transactions or reimbursement of funds;
- The status of the funder in comparison to the regular corporate creditors of the business group;
- The existence of financial covenants and security between related parties;
- The lack of movements for making debt payments; and
- The ability of the recipient of the funds to obtain loans from unrelated financial institutions.



Independent companies, upon considering whether to enter into a particular financial transaction, will consider the perspective of each of the parties involved in the transaction to determine an interest rate that is in accordance with the borrower's capacity to pay its debt, its credit rating, its debt-equity ratio, and its reputation in the market, among others.

According to the analysis of comparable transactions established in article 58 of Decree 10-2012, the delineation of these types of financial transactions requires the understanding and identification of the economically relevant characteristics of the transaction, consisting of the commercial or financial relationships between the parties involved, as well as the economically relevant conditions associated with these types of relationships, including an examination of the contractual terms of the transaction, the functions performed, assets used, and risks assumed by the related parties involved, the characteristics of the financial instruments, the business strategies pursued, and the economic circumstances of the related parties and of the market.

Timely identifying and characterizing these types of financial transactions between related parties will allow for not only mitigating the risk of a possible reclassification of transactions, but will also define an interest rate on which compliance with the arm's length principle will be demonstrated in the periods in which the financings subject to transfer pricing will be carried out, taking into consideration the respective tax implications (for example, withholdings and deductibility), in order to avoid any possible contingency in the event of an audit by the tax authorities.



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