

Tax Newsletter

Timely news and information on national tax issues

SOFR as the new risk-free rate for intercompany financing transactions

In the financial market, the central banks have suggested to investors, financial and non-financial companies, a change in their reference rate (risk-free rate or alternative benchmarks). One of the most important aspects in financing contracts is that these agreements (in US dollars) are based on a LIBOR¹ benchmark rate.

With hundreds of billions of US dollars in contracts based on LIBOR that will now be referenced to a wide range of new risk-free rates, the transition will require the full attention of all organizations to avoid interruptions, with the help of data and the proper conversion tools.

Financial and non-financial companies must find ways to avoid operational, legal, accounting and commercial disruptions, and make the transition to alternative reference rates to properly value assets.

This document analyzes the main implications of this transaction for those financial transactions based on USD LIBOR risk-free rates.

The transaction at a new reference rate does not imply a simple substitution of the rate. Strictly speaking, market participants should understand where LIBOR rates are obtained from and how to replace them.

For transactions in dollars of the United States of America, the SOFR (*Secured Overnight Financing*

¹ LIBOR is the average interbank interest rate at which a selection of banks on the London money market are prepared to lend to one another. Since

the beginning of 2022, LIBOR comes in max 5 maturities (from overnight to 12 months) and in 3 different currencies.

Rate)² is the main proposed alternative. However, USD LIBOR and USD SOFR differ from each other, as discussed:

- SOFR has higher market volatility than LIBOR.
- SOFR is a secured rate, initially produced daily, low credit risk, and based on real transactions.
- LIBOR is an unsecured rate, produced for various terms, greater credit risk, and based on quotes.
- SOFR may not align to multiple LIBOR maturities (monthly, quarterly, semi-annually, and annually).

When determining benchmark rates (market ranges) applied to financial transactions, these types of differences between benchmarks somehow impact the “spread” or basis points (bps) determined in the financial instruments.

Volatility in benchmarks

According to Alexandre Hardouin, Director of Fixed Income Desktop, “aside from the technical differences, there is an important procedural difference between the methodology of calculation. SOFR is a straightforward average of market rates and is much more sensitive to day-to-day market movements than LIBOR”.

Table 1: daily average for SOFR and LIBOR

Month / Rate 2022	Average LIBOR (overnight)	Average LIBOR (annual)	Average SOFR (overnight)
January	0,076 %	0,760 %	0,05 %
February	0,077 %	1,198 %	0,05 %
March	0,198 %	1,731 %	0,16 %
April	0,327 %	2,365 %	0,29 %
May	0,773 %	2,685 %	0,72 %
June	1,216 %	3,377 %	1,10 %
July	1,639 %	3,753 %	1,61 %
August	2,315 %	3,985 %	2,28 %

² SOFR is an interest rate published by the Federal Reserve Bank of New York. SOFR can be seen as the average interest rate for secured loans issued in US dollars with maturity of 1 day (overnight).

Month / Rate 2022	Average LIBOR (overnight)	Average LIBOR (annual)	Average SOFR (overnight)
September	2,578 %	4,512 %	2,51 %
October	3,063 %	4,931 %	3,04 %

Source: Prepared by the authors with data from Global Rates

According to the historical data of the reference rates (as shown in table 1), it is possible to notice the following situations:

- At the end of February 2022, the average daily SOFR rate was 0.5%. For the closing of September 2022, the average SOFR rate was 2.51%.
- In those contracts where the reference is the annual LIBOR rate (or any other rate other than overnight), it would not be technically appropriate to substitute an overnight SOFR, without first making a capitalization at a maturity equivalent to LIBOR.

According to Alexandre Hardouin, “technical adjustments will be required to align the risk-free overnight SOFR rate to the mixed matured and credit sensitive LIBOR rates. And SOFR should remain closely linked to LIBOR as long as the Fed is expanding liquidity. However, SOFR probably will ultimately be a more volatile benchmark than LIBOR.”

Final Considerations

For local purposes, the Tax Authority has not established the application of an explicit methodology and/or variables that need to be considered in the analysis of financial transactions. Therefore, each type of transaction of this nature should be evaluated on an individual basis so that the taxpayer ensures its compliance with the arm’s length principle, as well as with that indicated in Article 62-A of the Tax Code.

However, it is recommended that for those intercompany contracts based on LIBOR rates, and in those transactions in which the borrower is domiciled

in a country other than the lender's, the following variables be technically evaluated:

- i. Risk-free rate (LIBOR and its technical transition to SOFR for transactions in USD)
- ii. Return or margin (basis points according to the financial or debt instrument)
- iii. Credit risk of the borrower (credit rating)
- iv. Country risk (if not included in the credit risk);
- v. Adjustment of terms (due to temporary differences between the financing analyzed versus the financing obtained in the market).

Finally, for those financial transactions based on a currency other than USD, there are (by way of example) other alternative risk-free rates that will require their own technical transition, as applicable:

- Sterling Overnight Index Average (SONIA) for sterling.
- Tokyo Overnight Average Rate (TONAR) for yen.
- Swiss Average Rate Overnight (SARON) for Swiss francs.
- Euro short-term rate (€STR) for the Euro (replacing the EONIA). EURIBOR also remains in effect.

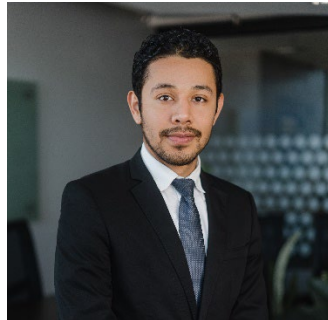
We suggest that our clients and friends keep the previous considerations in mind, in order to properly value their financial transactions and other assets.



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Tax Calendar

October 2022

The updated 2022 tax calendar is now available on the Tax Administration's website, which includes public holidays and deadlines for all tax obligations.

S	M	T	W	T	F	S
						1
2	3	4	5	6	7	8
9	10	11	12	13	14	15
16	17	18	19	20	21	22
23	24	25	26	27	28	29
30	31					



Download the 2022
Obligations Calendar

October 14

VAT

Declaration and payment of the Tax on the Transfer of Movable Goods and the Rendering of Services (F-07).

Financial Income and Transactions

Monthly declaration of Payment on Account, Tax Withheld on Income from Financial Transactions, and the Special Contribution for Citizen Security and Coexistence (F-14).

Specific and Ad-valorem

Declaration and payment of Specific Taxes, Ad Valorem Taxes and Special Contribution (F-06).

Other Obligations

- Report on donations (F-960)
- Report on Specific and Ad Valorem Taxes on Producers and

Importers of Alcoholic Beverages, Potable Ethyl Alcohol and Beer, Carbonated Beverages, Isotonic Beverages, Fortified Beverages or Energy Drinks, Juices, Nectars, Soft Drinks and Concentrated or Powder Mixtures for the Preparation of Drinks (F-955).

- Report on Specific and Ad Valorem Taxes on Producers and Importers of Firearms, Ammunitions, Explosives and Similar Items, Producers of Tobacco and Producers, Importers and those that clear fuels through customs (F-988).
- Monthly Report of Sales to Producers, Distributors or Retailers of Tobacco and Tobacco Products (F-956).
- Report on Authorizations of Accounting Systems, Legal

Accounting Books, VAT Books or Records, Certifications and Reports issued on Modifications to Legal Books, Subsidiary Books and Special Records (F-463).

October 21

VAT

- Monthly Report on Withholdings, Collections, or Payments on Account of VAT (F-930).

Printing Presses

- Monthly Report on Documents Printed for Taxpayers Registered under the VAT (F-945).

October 31

Trade Unionist Day

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