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**“INTERNATIONAL TAXATION ASPECTS THAT AFFECT MANAGEMENT
OF THE TAX ADMINISTRATIONS”**

Subtopic 2.1:

**“SPECIFIC METHODS FOR THE CONTROL OF TRANSFER
PRICING”**

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TRANSFER PRICING IN THE BRAZILIAN LAW

1) RATIONALE

In view of the ever-growing business within multinational companies owned by a common parent entity during the 90's, the Brazilian Government identified the need for a broader control of such activities, so as to avoid the manipulation of prices, both on import and export operations, that may indirectly lead to transfer profits abroad.

Brazil has decided to adopt a transfer pricing model according to its own economic reality, and not simply to import a model from other countries. Brazil does not have the same level of financial resources or investment capacity as that of developed countries. By consequence, the lack of financial resources is an obstacle to the implementation of a set of rules similar to the United States legislation.

In this context, the traditional transfer pricing methods have been adapted, in Brazil, in order to make it possible for the tax authorities to check on compliance with the Brazilian rules. Under such circumstances and in view of the high degree of subjectivity of the Advanced Pricing Agreement (APA) and the high costs of the APA procedure, the Brazilian Government has decided not to adopt the APA.

2) PRINCIPLES AND MECHANISMS

In general, the Brazilian legislation follows the directives set by the OECD Report "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations", especially with regard to the "Arm's Length Principle".

2.2 Methods

The Brazilian methods of determining parameter prices in order to control the prices set by companies are similar to the three traditional methods proposed by OECD, although with different names for export and import operations, but there are also innovative ones for commodities, as follows:

METHODS	BRAZIL	OECD Equivalent
IMPORT	PIC – (for “compared independent prices”)	CUP
	PRL – (for “resale price less margin”)	RPM
	CPL – (for “production cost plus margin”)	CPM
	PCI – (for “price under import quotation”)	-
EXPORT	PVEX – (for “exporting sale price”)	CUP
	PVA – (for “wholesale at destiny, less margin”)	RPM
	PVV – (for “retailer price at destiny, less margin”)	RPM
	CAP – (for “acquisition or production cost plus taxes and margin”)	COM
	Pecex – (for “price under export quotation”)	-

2.3 Differences between the Brazilian Transfer Pricing legislation and the OECD model

The Brazilian legislation is different from the OECD Model in that it presets profit margins wherever the methods are used to show the accuracy of prices established for commercial activities within the same controlled group.

The presetting of a margin actually represents a safe harbour and can be considered as an “adhesion model” or “adhesion APA”: if a taxpayer has a profit margin above the fixed margin 20% (twenty per cent), 30% (thirty per cent) or 40% (forty per cent), depending on the economy sector that the enterprise operates, the Federal Revenue of Brazil (RFB) will accept the established transfer pricing, even if this price does not follow the independent market pricing or does not seem to be in accordance with the “Arm’s Length Principle”.

The presetting by law of the profit margin is fundamentally designed to make it easier for both the taxpayer and the Brazilian tax authority to check the parameter price (the price to be accepted as a deductible cost or expense for income tax purposes). Besides, the presetting of a margin aims at adjusting the international transfer pricing rules to a peculiar feature of the Brazilian legal ordinance – objectivity – and eliminates a high degree of subjectivity, which is a characteristic of the OECD model.

The preset margins may, however, be altered. In the case of importation, the company may request a margin alteration from the Minister of Finance, if this company works with a lower profit margin compared to the fixed margin that has been set by law. Thus, the company has the burden of proof and must confirm that it achieves a lower margin and follows the “Arm’s Length Principle”, that is, the company must demonstrate that the lower margins are earned in operations with non-associated companies.

3) LAW 9,430/1996

3.1 Adjustments

According to Law No. 9,430, from 27 December 1996, amended by Law No. 9.959/2000, Law No. 12,715/2012 and Law No. 12,766/2012, import and export transactions of goods, services and rights, carried out by a company domiciled in Brazil with an associated person resident or domiciled abroad, or with an individual or a legal entity resident or domiciled in a tax haven, are subject to transfer pricing adjustments, for the purpose of determining the taxable profit.

Under Article 23 of Law No. 9,430/1996, the following conditions qualify a company or individual as associated with an entity in Brazil:

- a) The head-office, when it is domiciled abroad;
- b) Its agency or branch, when domiciled abroad;
- c) An individual or legal entity, resident or domiciled abroad, whose shares in the capital stock characterises it as a controlling or associated, pursuant to Law No. 6,404, article 243, 15th December 1976¹;
- d) A legal entity domiciled abroad that is characterised as its controlled by or associated with company, pursuant to Law No. 6,404/1976;
- e) the legal entity domiciled abroad, when this entity and the company domiciled in Brazil are under a common share control or common administrative control or when at least 10% (ten per cent) of the stock capital of each company belongs to the same individual or legal entity;
- f) an individual or legal entity, resident or domiciled abroad, which along with the company domiciled in Brazil, has a corporate interest in the capital stock of a third company, with the total value of this interest characterising them as a unit or of the third company, pursuant to Law No. 6,404/1976.
- g) The individual or legal entity, resident or domiciled abroad, that is associated to it in any undertaking under a consortium or a condominium modality;
- h) the individual resident abroad who is related to or in-law within the third degree, spouse or partner of any of its directors or of its partner or controlling shareholder in a direct or indirect participation;
- i) The individual or legal entity, resident or domiciled abroad, that is its exclusive agent, distributor or a dealer in transactions of purchase or selling of goods, services or rights;
- j) the individual or legal entity, resident or domiciled abroad, that, in relation to the legal entity domiciled in Brazil, is its exclusive agent, distributor or dealer in transactions of purchase or selling of goods, services or rights.

¹ Law Nr. 6.404/1976, states about incorporated companies.

3.2 Methods

According to the the Arm's Length Principle, the adjustments to determine the transfer pricing must follow the Methods established by the legislation. However, taxpayers may choose one of the methods, except in case of commodities that are compulsory the utilization of PCI and Pecex, as long as under the conditions set forth by the Brazilian law.

3.3 Importation

3.3.1 Common rules to Importation Costs

Under Article 4 of Normative Instruction SRF No. 1,312, from 28 December 2012, a Regulatory legislation, the importing legal entity may opt for any method listed in Articles 8 to 16 of the same IN No. 1,312/2012, except in the case of importing commodities.

3.3.2 The following methods can be applied on importation cases, Normative Instruction SRF No.1, 312/2012:

Article 8

a) Comparable Uncontrolled Price Method (PIC-CUP), described as the arithmetic average of prices of identical or similar goods, services or rights found out in the Brazilian market or in other countries in purchase or sale transactions under similar payment conditions.

I – if sold by the same exporting company to a non-associated company, resident or not;

II – if purchased by the same importing company from non-associated legal entities, resident or not;

III – if in purchase and sale operations between other non-associated legal entities, resident or not.

Article 9, paragraph 1:

Values will be adjusted as to minimize the effects on prices, caused by differences in business conditions as well as in physical and contents-related aspects. In case of identical goods, services and rights, adjustments will be permitted only in relation to:

- I – terms of payment;
- II – quantities;
- III – guarantee on work;

- IV – obligation to advertise;
- V – responsibility for quality control costs;
- VI – intermediation costs;
- VII – packaging;
- VIII – freight and insurance.

Article 9, paragraphs 4-10:

Adjustments deriving from differences in quantities will be made according to documents issued by the selling company, able to prove the larger is quantity the lower will be the price.

In case of adjustments deriving from guarantee on work, the respective value included in the price cannot exceed the result of the division of the total costs incurred in the previous verification period by the amount of goods, services and rights in use in the domestic market during that same period. If the good, service or right has not yet been sold in Brazil, the cost in national currency corresponding to the same guarantee granted abroad will be admitted.

As to obligation to advertise and responsibility for quality control costs, the price of the good, service or right acquired from an associated company domiciled abroad, which bears the cost of such expenses in Brazil, may exceed the price practiced by a company that does not, at up to the value incurred per unit by the exporting company. If the advertisement or publicity aims at promoting:

I – the company's name or brand, costs will be proportionally distributed amongst all goods, services or rights sold in Brazil, based on quantities and respective value;

II – a product, the costs division will be based on its quantities.

Where data are utilized from a purchasing company which has borne the intermediation costs involved in the purchase of a good, service or right whose price is a parameter for the price practiced in a purchase/sale operation with an associated company, non-subject to such expense, the price practiced by the latter may exceed the first's, up to the value correspondent to the intermediation costs.

For comparison purposes, the prices of goods, services and rights will also be adjusted as regards differences in packaging materials as well as freight / insurance involved in each case.

Articles 10-11:

In the case of similar goods, services or rights, besides the afore-mentioned adjustments, prices will also be adjusted as regards differences in physical and contents-related aspects.

The comparison may take into consideration prices practiced in earlier / later periods provided there's an adjustment resulting from variations in reference currencies exchange rates, occurred between the dates of both operations.

In the case of adjustments deriving from variations in exchange rates, parameter prices, where resulting from operations carried out in countries whose currency cannot be translated into the national currency, will be firstly converted into American dollars and then, into Reais, at the exchange rate practiced on each operation's date.

Accidental variations in commodities prices, certified by national or international stock quotes, will also be considered.

b) Resale Price less Profit Method (PRL-RPP), described as the arithmetic average of the resale prices of goods, services or rights less discounts given on invoice, taxes imposed on sales, commissions and brokerage paid, and the profit margin². Detailed information regarding this method is given in the next topics of this Technical Report.

Article 12, paragraphs 2-5 and 9:

The average purchase/ resale price will be determined based on the quantities negotiated.

To determine the arithmetic average of prices, the stock values and quantities existing at the beginning of the verification period will be included.

The arithmetic average of prices will be determined from the purchase date to the end of the verification period.

If the operations comprise cash and installment sales, prices related to the latter must not consider any incidence of interest.

The RPP method utilizing a 20% profit margin will only be applied where no value is added to the cost, but a mere resale of the same imported goods, services or rights.

² The profit margin is:

- a) of 40% (forty per cent), when the imported goods are applied to production of cigarettes, pharmacochimicals and 30% (thirty per cent) for chemical products, among others (Law No. 9.430/1996, article 18; §12,I, II, introduced by Law No. 12,715, de 2012);
- b) of 20% (twenty per cent), in other cases (Law No. 9,430/1996, article 18;§12,III,)

c) Cost Plus Profit Method (CPL-CPP), described as the average production cost of identical or similar goods, services or rights in the country where they were originally produced added by taxes charged in the exportation country and the profit margin of 20% (twenty per cent), determined upon the incurred costs.

Article 15, paragraph 5:

For price determination purposes, it may be considered as part of the cost:

I – acquisition cost of raw materials, intermediate products and packaging materials;

II – cost of any other goods, services or rights employed or consumed in production;

III – personnel costs employed in production, including direct supervision, production facilities maintenance and surveillance, and their respective social duties;

IV – rental, maintenance and repair costs, as well as depreciation, amortization and depletion costs;

V – reasonable breakages and losses during production.

3.4 Exportation

3.4.1 Export Revenue

Normative Instruction SRF No. 1,312 determines under Article 20, paragraph 1:

The average price will be obtained by multiplying the prices practiced by quantities related to each operation; these results will be summed up and then divided by the total quantity, being thus determined the arithmetic average price.

3.4.2 Common rules to Export Revenue

Article 22, paragraph 1:

Values will be adjusted as to minimize the effects on the prices to be compared, caused by differences in business conditions as well as in physical and contents-related aspects. In the case of identical goods, services and rights, adjustments will be permitted only in relation to:

I – terms of payment;

II – quantities;

III – guarantee on work;

IV – obligation to advertise;

V – responsibility for quality control costs;

VI – intermediation costs;

VII – packaging;

VIII – freight and insurance;

IX – credit risks.

Article 22, paragraph 2:

Differences on terms of payment will be adjusted according to the company's rates.

Article 22, paragraph 4-10:

Adjustments deriving from differences in quantities will be made according to a document issued by the selling company, able to prove that the larger quantity a same purchaser orders the lower the price is.

In the case of adjustments deriving from guarantee on work, the respective value included in the price cannot exceed the result of the division of the total costs incurred in the previous verification period by the amount of goods, services and rights in use in the domestic market during that same period. If the good, service or right has not yet been sold in Brazil, the cost in national currency corresponding to the same guarantee granted abroad will be admitted.

As to obligation to advertise and responsibility for quality control costs, to compare the price of the good, service or right between a purchasing company that bears the cost of such expenses and a purchasing company that does not, the value incurred per unit must be deducted. The same rule applies to intermediation costs.

Prices will also be adjusted according to differences in costs related to packaging material, freight and insurance.

Adjustments resulting from credit risks:

I – will be admitted exclusively in relation to operations between purchaser and seller domiciled in Brazil;

II – will utilize a percentage obtained by comparing total losses and credits from the previous calendar year.

Articles 23,24,25,26:

The average export price is obtained by multiplying prices by quantities. These results are summed up and then divided by the total quantity, being thus determined the arithmetic average price.

In the case of similar goods, services or rights, besides the afore-mentioned adjustments, prices will also be adjusted as regards differences in physical and contents-related aspects.

The comparison may take into consideration prices practiced in earlier / later periods where it is not possible to identify sale operations at the same period. Accidental variations in commodities prices, certified by national or international stock quotes, will also be considered.

The share of revenue that exceeds the value already booked by the company must be summed up to the net profit for the purpose of determining the actual profit and the CSLL calculation basis. It also must be considered in order to determine the presumed / arbitrated profit.

3.4.3 Methods in exportation

a) Exportation Sale Price Method (ESP), described as the arithmetic average of export prices of identical or similar exported goods, services or rights sold by the company itself or its exporter to other clients, during the same period that the corporate income revenue tax is determined, in similar payment conditions.

Article 30, paragraph 1:

Only sales to clients non-associated with the Brazilian company will be considered.

b) Wholesale Price in Destination Country less Profit Method (PVA-WPP), described as the arithmetic prices of identical or similar goods, practiced in the wholesale market of the destination country and in similar payment conditions, reduced by taxes included in price, charged in the mentioned country, and the profit margin of 15% (fifteen per cent) over the wholesale price.

c) Retail Price in Destination Country less Profit Method (PVV-RPP), described as the arithmetic average price of identical or similar goods, practiced in the retail market of the destination country, in similar payment conditions, reduced by taxes included in the price, charged in the mentioned country, and the profit margin of 30% (thirty per cent) over the retail price;

d) Acquisition or Production Cost plus Profit Method (ACP), described as the arithmetic average of the acquisition or production costs of exported goods, services or rights, added by taxes charged in Brazil and the profit margin of 15% (fifteen per cent) over the full amount of costs and taxes.

4) OTHER DISPOSITIONS

4.1 Atypical Operations

Article 44:

Under no circumstances the use of goods, services and rights' prices practised in atypical purchase / sale operations such as stock liquidation, discontinuance of activities or government subsidised sales will be admitted.

4.2 Percentage Alteration

Article 45:

Percentage alterations referred to in this article may have a general, sectoral or specific character. They can be promoted *ex officio* or in compliance with a request from a class entity representing an economic sector in relation to operations carried out by the companies it represents, as well as in compliance with a request from the interested company itself. Requests for percentage alteration from economic sectors or companies will be analyzed by the Coordination-General of Taxation (Cosit). Even partially compliant decisions will be formalized.

In the case of compliance, Cosit must inform whether it agrees with the new margin's duration of effectiveness suggested by the entity / interested company. Otherwise, Cosit must propose a more suitable term.

4.3 Discrepancy margin

Article 51:

In operations with associated companies, where the price adjusted as a parameter diverges up to a plus or minus 5% in relation to the price extracted from the import / export documents, the confirmation will be deemed satisfactory. In this case, no adjustments will be required from the company.

4.4 Enforcement Procedures

Article 53:

The company under enforcement procedures must indicate the method adopted and produce the documentation utilized as the basis for price determination. The method not being indicated or documents not being produced – or if insufficient / unable to convince as to price – auditors can determine the price based on other documents at their disposal, by applying a method listed below.

5) USE OF THE MINISTRY OF FINANCE'S RULE No. 222, 24 SEPTEMBER 2008

5.1 Discretionarity

RFB decisions are based on provisions of the current laws and are not discretionary. As set forth by MF Rule No.222 the requests for alteration of the margin percentages are accepted if they are in conformity with the Brazilian laws.

5.2 Situations using different margins

MF Rule No. 222, is used in general or specific cases or by sector. The percentage alterations may be done in general or by sector in attention to the request made by an association representing an economic sector, regarding goods, services or rights involved in the operations of the represented companies. The percentage alterations may also be done specifically, as requested by the concerned company.

5.3 Alteration of margins according to the "arm's length principle"

The Federal Revenue admits the evidence that the taxpayer follows a different margin from the one foreseen in the law, in accordance with the "arm's length principle", provided that the information rendered by him is complemented by the documents requested in MF Rule No. 222.

Adoption of the "arm's length principle" must be evidenced in accordance with the documents mentioned in MF Rule No. 222. The importance of the requested documents is to make evident that the margin applied by the taxpayer really meets the "arm's length principle".

The Federal Revenue may request other documents that it may find necessary to prove the allegations of the concerned entity or company. The Federal Revenue may consider other documents that could prove the allegations of the concerned entity or company.

The Federal Revenue may consider comparable third parties financial-economic information.

5.4 Taxpayers requests

The margin alteration procedure foreseen in Rule No. 222 has not been frequently used. So far there have been only two requests for margin alteration concerning the application of the Resale Price Method – RPM (article 18, item II, letter d, of Law no. 9,430, of 1996).

5.5 Discussions with other governments

In the last five years, the Federal Revenue has discussed only one case regarding transfer pricing in a mutual agreement procedure.

The international tax agreements signed by Brazil do not contain provisions regarding corresponding adjustments.

5.8 Advanced Pricing Agreement

The Brazilian transfer pricing laws do not adopt the Advanced Pricing Agreement concept due to the high degree of subjectivity and the high costs involved for the tax administration, when implementing this procedure.

6) TREATMENT OF ROYALTIES IN THE BRAZILIAN LAWS

Payments of royalties are subject to withholding tax at the rate of 15% and are not subject to the transfer pricing laws.

The Brazilian transfer pricing laws are not applicable to the deductibility of the expenses deriving from payments of royalties and fees for technical, scientific, administrative or similar assistance. The deductibility is restricted to the conditions set forth in the domestic law, which assigns to the Minister of Finance the power to set a percentage – up to five percent (5%) – of the net sales of the product concerned as a ceiling for the deductibility of such expenses (Decree 3.000/99, Article 355).

7) CHANGES MADE BY LAW No. 12,715/2012

Law No. 12,715/2012 went into effect on September 18, 2012, as a result of modifying Provisional Measure No. 563, of April 3, 2012, MP 563 had been responsible, among other matters, for creating new rules on import and export methods.

Concerning to the PIC method, MP had established the criterion of minimum representativeness of transactions that may be used as a parameter for comparison with the effective cost of importation: 5% of the value of imports subject to transfer pricing control, during the period that the calculation method is applied, in the absence of transactions representing 5% the percentage may be supplemented with imports in the preceding calendar year, adjusted for exchange rate differences.

Regarding to new methods PCI and PECEX, Law 12,715 provides that is compulsory their utilization for goods from internationally recognized commodities and negotiated in futures markets, in the absence of prices, the reference methods shall use, in setting price parameters, data obtained from independent sources provided by internationally recognized research institutions. With respect to the PECEX, the law also provides for comparisons with prices set by regulators or agencies that are published in Brazil's Official Gazette of the Union.

Law No. 12,715 entered in force in January 1, 2013, but provides to the taxpayer the option of applying its provisions for the 2012 year calendar. With regard to tax auditing dispositions, they are in force since April.

8) CHANGE MADE IN INTEREST PAYMENTS BY LAW 12,766/2012

Law 12,766, from 27 December 2012, introduced a significant change on intercompany loan rules. It determines a limit of a rate plus spread for paid interest to be deductible from income tax. Different rates are provided, depending on the type of transaction, the currency used, and other factors. The spread will be determined by the minister of finance, according to market average. The new Law also states, in paragraph 9, that the moment of verification is on the contract date of transaction and not periodical.

9) REPRESENTATIVENESS OF INTERCOMPANY TRANSACTIONS

The representativeness of intercompanies transactions has grown in the last decade, as the chart below shows. Furthermore, the total of tax assessments from 2008 to 2012 was 355 that launched in taxes and fines BRL 16,965,244.59.

Tabela 1

Calendar Year	Importation ³ (%)	Exportation ⁴ (%)
2005	29	32
2006	28	36
2007	39	45
2008	29	34
2009	33	32
2010	32	37
2011	37	45

³ Relation between intercompany import of goods and total of import.

⁴ Relation between intercompany export of goods and total of export.