

Chapter 10.1 Brazil country practices

10.1.1 Introduction - General explanation

10.1.1.1 Brazil introduced a law on transfer pricing, through Law n. 9430/1996, in 1996.¹ The bill was proposed to deal with tax evasion through transfer pricing schemes, and according to the proposal, it adopted the arm's length principle.

10.1.1.2 The methodology introduced by the law listed the traditional transaction methods (CUP, cost plus method (CPM) and resale price method (RSP)) but denied the use of transactional profit methods (the profit split method and TNMM) and formulary apportionment. Regarding the CUP, for export or imports, the law introduced a methodology that is similar to OECD practices (see 10.1.2. below). However, with regard to the cost plus and resale price methods, instead of making use of comparable transactions, the law established fixed margins for gross profits and mark up.

10.1.1.3 For a period of time the fixed margin for the resale price method was 20 percent. Later it was changed to 20 and 60 percent (this applies to situations where the imports were subject to manufacturing in Brazil). In 2012, the law was changed by adopting different margins for certain specific sectors, but in general maintained 20 percent as a prescribed margin. The Brazilian perspective is that the conventional use of resale price and cost plus methods implies some uncertainty and juridical instability, since they are implemented by the taxpayer without previous consent or summary review by the tax authorities. This affects the stability and expectations in economic and fiscal relations.

10.1.1.4. Brazil's resale price and cost plus methods with fixed margins are applicable to both export and import operations. In order to make it easier to understand, they are presented in the following paragraphs disregarding practical distinctions. A more detailed explanation to differentiate the application from import and exports and how to deal with that will be discussed separately. This is because the Brazilian transfer pricing law details the application of the two methods (RSP and CPM) for exports and imports in a separate set of rules. There are also specific methods for tradable commodities and interest that will be addressed in part 10.1.3. of this Chapter.

10.1.1.5. Brazil's resale price and cost plus methods with fixed margins are not 'safe harbour' methods. For these purposes, safe harbours mean provisions that apply to a defined category of taxpayers or transactions that relieve eligible taxpayers, at their option, from certain obligations in pricing controlled transactions otherwise applicable under the arm's length standard. The resale price and cost plus methods with fixed margins can be applied by the taxpayers. The fixed margins are subject to the modifications authorized by the Minister of Finance, discussed in sections 10.1.2.2 and 10.1.3.2 below.

10.1.2 Resale Price Method with Fixed Margins

10.1.2.1. Explanation on the methodology

The mechanism of the resale price method using fixed gross profit margins is considered by Brazil to be similar to the conventional resale price method with margins, except that the gross margins are asserted, rather than being based on comparables. See Figure 1 below. In order to determine the transfer price (deemed arm's length price, or parameter price, as called in Brazilian TP laws), the

¹ Law n. 9430/1996 was modified by Law 9.959/2000, Law n. 10.451/2002, Law n. 11.727/2008, Provisional Measure n. 478/2009, and more recently by Provisional Measure n. 563/2012, converted into Law n. 12.715 of September 17, 2012.

resale price that the reselling company (Associated Enterprise 2) charges to an unrelated customer (Independent Enterprise) is reduced by a fixed gross profit margin. The remainder is the acceptable transfer price between associated parties (Associated Enterprise 1 and Associated Enterprise 2), which is the parameter price.

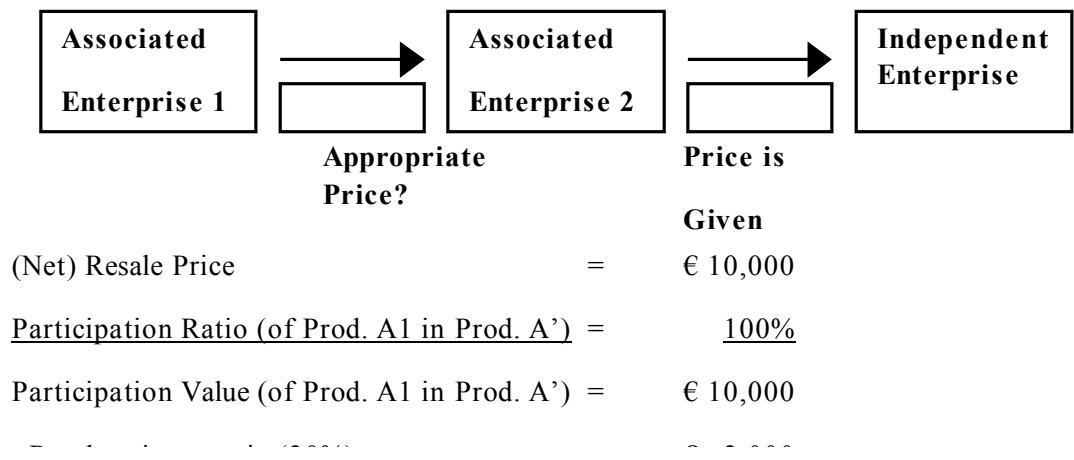
10.1.2.2. Reference is made below to two applications of how this method could be implemented for transfer pricing of products, including cases where the product is subject to manufacturing activities (value added costs) before it is resold.

10.1.2.3. The method is based on the participation of transferred goods in the product that is resold (which is 100% in a simple resale). Then the parameter price will be the resale price participation less a profit margin, fixed by law. Therefore, it is possible to elaborate this system to consider the influence of value added costs in one country, when other inputs are combined with the product traded between associated enterprises and the final goods are resold.

Pure Resale Price (without manufacturing)

10.1.2.4. If the product traded between related parties is not subject to any manufacturing modifications, the formula adopted will be the same and the participation ratio will be 100%, since the price of product A will be equal to the resale cost of product A':

Figure 1: Resale Price Method
(without manufacturing)



10.1.2.5 In this case the calculation is simple, the parameter price (deemed arm's length price) is the resale price of the same product (charged between independent parties) reduced by: unconditional discounts granted; taxes and contributions on sales; commissions and brokerage fees paid; and a fixed profit margin of, for example, 20% (according to current Brazilian law).

TP (parameter price) = NRP – GPM x NRP,

Where:

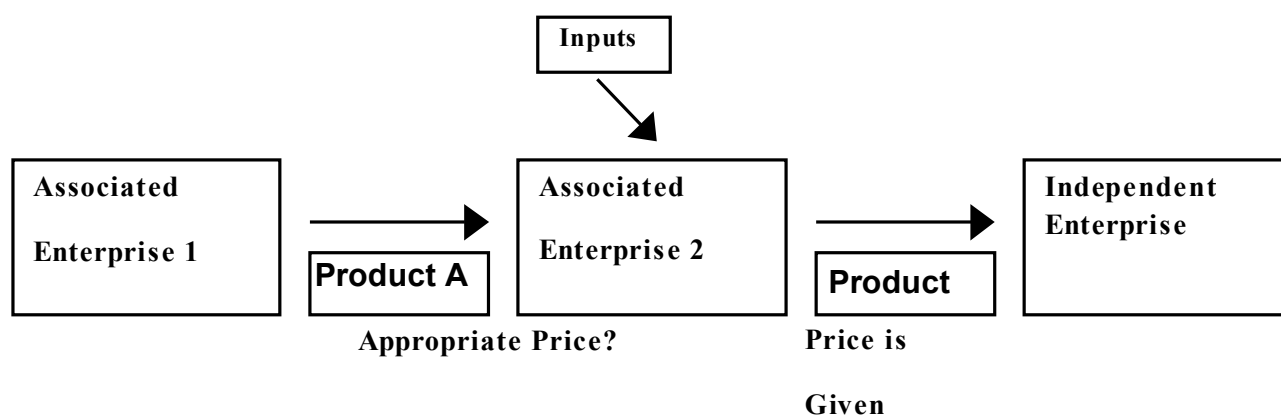
- TP (parameter price) = transfer price determined by Brazilian law. The maximum price on imports or the minimum price on exports.
- NRP = net resale price

- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations (30% in this simplified example).
- TP(parameter price) = NRP – GPM x NRP = NRP – 20% x NRP = 80% NRP

Hence:

• (Net) Resale Price	=	€ 10,000
• <u>- Resale price margin (20%)</u>	=	€ 2,000
• A1 Transfer Price under Brazilian law	=	€ 8,000

Figure 2: Resale Price Method
(with manufacturing)



(Where the Product A is an input for Product B)

(Net) Resale Price = € 10,000

Participation Ratio (of Prod. A in Prod. B) = 60%

Participation Value (of Prod. A in Prod. B) = € 6,000

(Where the Product A is an input for Product B)

(Net) Resale Price = € 10,000

Participation Ratio (of Prod. A in Prod. B) = 60%

Participation Value (of Prod. A in Prod. B) = € 6,000

- Resale price margin (30%) = € 1,800

Parameter Price = € 4,200

Resale Price (with manufacturing operation)

10.1.2.6 In this methodology the transfer price would be calculated having regard to the proportional participation of the goods negotiated between associated parties (product A = input) in the goods resold to an independent enterprise (product B). This methodology reduces the weakness of using the resale price method when the reseller adds substantial costs to the product traded between associated parties. The resale price to be considered shall be that price agreed upon by the reselling company with an independent enterprise.

10.1.2.7 In this more elaborated approach, the parameter price (deemed to be the arm's length price) would be the difference between the *participation value* of the sale price of goods (product A) in the net resale price (product B) less its "*gross profit margin*" participation. For this purpose, the

participation value of product A in the net resale price (product B) would be: the application of the *participation ratio* of the input (product A) to the total cost of the product B multiplied by the *net resale price* (of product B).²

10.1.2.8 The referred *participation ratio* is determined as follows: the ratio of the price of the product A (input) to the total cost of the good resold (product B), calculated according to the company's cost spreadsheet. The *net resale price* is the weighted average price of sales of the goods resold (product B), less unconditional discounts granted, indirect taxes on sales, and commissions and brokerage fees paid. "Unconditional discounts" are those that do not depend on future events and that are detailed in the invoice.

10.1.2.9 The *gross profit* of product A (in the resale of product B) is the application of, for example, 30% (gross profit margin) on the *participation value* referred above. As mentioned before, in this approach, the gross profit margin will be set forth by law. See Figure 1. The 30% margin may vary depending on the economic sector of the activity performed by the Associated Enterprise 2.

10.1.2.10 In order to avoid distortions between companies operating within Brazil, it is necessary to obtain accounting uniformity between the taxpayers of the country. If certain expenses are characterized as operating expenses by some companies and costs of goods sold by others, the system will not be satisfactorily implemented.

The formula for the intercompany transfer price would be (for a 30% margin):

TP (parameter price) = PV – GPMV,

Where:

- TP (parameter price) = deemed arm's length transfer price determined under Brazilian law. The maximum price on imports or the minimum price on exports.
- PV = participation value of the goods transferred to the associated enterprise in the net resale price = (price of product A ÷ cost of product B) x (net resale price of product B);
- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations (30% in this example).
- GPMV = GPM x PV = GPM x (price of product A ÷ cost of product B) x (net resale price of product B) = 30% (price of product A ÷ cost of product B) x (net resale price of product B).
- TP(parameter price) = PV – GPMV = ((price of product A ÷ cost of product B) x (net resale price product B)) – 30% x ((price of product A ÷ cost of product B) x (net resale price product B)) = PV (1 – GPM)

Fixed Margins for the Resale Price Method

10.1.2.11. According to recent changes in the Brazilian TP legislations the margins for the RSP method for imports are as follows (it includes simple resale operations and manufacturing operations):

I - **forty per cent**, for the following sectors:

- a) pharmaceutical chemicals and pharmaceuticals;
- b) tobacco products;
- c) equipment and optical instruments, photographic and cinematographic;
- d) machinery, apparatus and equipment for use in dental, medical and hospital;
- e) petroleum, and natural gas (mining industry), and
- f) petroleum products (derived from oil refineries and alike);

² It should be noted that the participation ratio has nothing to do with the fixed margin but depends on the cost of imported inputs and the COGS, see 10.1.2.8

II - **thirty percent** for the sectors of:

- a) chemicals (other than pharmaceutical chemicals and pharmaceuticals);
- b) glass and glass products;
- c) pulp, paper and paper products; and
- d) metallurgy; and

III - **twenty percent** for the other sectors.

10.1.2.12. In order to apply such margins, the law also states that in the event that the company develops activities framed in more than one of the activities mentioned above (I, II and III), the margin that should be adopted to apply the RSP method is the margin corresponding to activity sector to which the imported goods have been intended to be used. In the event of the same imported goods to be sold and applied in the production of one or more products, or in case the imported goods be subjected to different manufacturing processes in Brazil, the final price parameter is the weighted average of the values found by applying the RSP method, according to their respective destinations.

10.1.2.13. For exports the applicable margins in the foreign country are: 15% for wholesale, and 30% for retail sales.

10.1.2.14. The Minister of Finance, ex officio, or under request, is authorized by law to modify these margins. A request for modification presented by a taxpayer must be fully justified, and supplied with the proper documentation as established in the law.

10.1.2.15. Case Examples

Example 1: Resale of Same Product. A manufacturing enterprise domiciled in Country X, MCO, sells Product A with no similar product worldwide to an exclusive distributor domiciled in Brazil, YD, for \$16,000 per unit. YD, on its turn, resells the same product A to customers for \$18,750. According to transfer price rules of Brazil, the resale price method provides for a 20% gross profit margin (\$3,750). Therefore, the transfer price applicable to the transaction between MCO and YD would be up to \$15,000 on import and, on the other hand, at least \$15,000 on export. Thus for YD, the buyer, there will be a TP adjustment of \$1,000 per unit (\$16,000 - \$15,000). On the other hand, if the method was applied by country X for MCO, the seller, no TP adjustment would be necessary.

Example 2: Different Products, with manufacturing operation. A controlling enterprise domiciled in Country A, HOLDCO, sells inputs to a subsidiary domiciled in Brazil for \$400 per unit. On its turn, the subsidiary manufactures final products that are to be sold to local customers at \$1,200 per unit (net resale price). Along with the inputs acquired from HOLDCO, the subsidiary also uses other inputs, acquired in the host country, in the industrialization process of the final product. The cost of such additional inputs corresponds to 60% of the total cost of the final product, and so the participation ratio of the input sold by HOLDCO is 40% (\$400), thus the total cost is \$1000. The resale price method in Country B imposes a fixed margin of 30% in order to calculate the applicable transfer price. Based on the aforesaid information, the calculation is as follows:

PV = participation value of the good transferred to the associated enterprise in the net resale price = (price of product A ÷ cost of product B) x (net resale price of product B) = \$400/\$1000 x \$1200 = \$480;

GPM = 30% in this example

GPMV = GPM x PV = \$480 x 30% = \$144

Thus the parameter price (deemed to be the arm's length price) = PV – GMPV = \$480 - \$144 = \$336.

As a consequence, the subsidiary should pay for imported inputs sold by HOLDCO up to \$336 per unit in order to comply with transfer pricing rules. Thus there would be an adjustment per unit of \$64 per unit (\$400 - \$336).

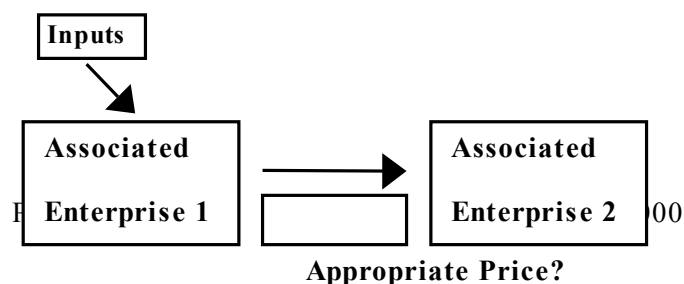
Example 3: Intercompany Software Licenses. SIRFRO, a service provider domiciled in Country A, in Europe, exports licenses of unique software to its affiliated company established in Brazil, named SARPRO. Each software license agreement provides grants the affiliated company not only the right to use the software but also to sublicense it within their respective territory. As a result, SIRFRO charges SARPRO a monthly royalty fee of \$140,000, while it makes \$160,000 out of sublicense agreements per month. According to transfer price rules of Brazil, the parameter price (deemed to be the arm's length price) in transactions like the one performed by SIRFRO shall be calculated by decreasing a 20% fixed gross margin of the sublicense price resold. Thus the parameter price would be equal to \$160,000 minus \$160,000 x 20%, which is \$128,000. Thus the TP adjustment would be \$12,000 per month (\$140,000 – 128,000) to SARPRO's tax basis, in Brazil. In country A, the royalties charged by SIRFRO on monthly basis should correspond to \$128,000, at least, in order to comply with the resale price method.

10.1.3. Cost Plus Method With Fixed Margins

10.1.3.1 Explanation of the methodology: Similar to the resale price method with fixed margins, the cost plus method may be used with a predetermined gross profit mark up. The basic functionality of this method is similar to the non-predetermined margin (or traditional) cost plus method except that the gross margins are asserted, rather than based on comparables. The method focuses on the related product manufacturing or service providing company in transfer pricing with associated enterprises. As explained above, the parameter price (deemed to be the arm's length price) is reached by adding a predetermined cost plus mark up to the cost of the product or services. This will be a maximum value on imports or a minimum value on exports.

10.1.3.2. Unlike the resale price method, the cost plus method with predetermined fixed gross profit mark ups does not require the taxpayer to calculate the ratio of certain inputs to the final product. Thus, the gross profit mark up is applied to the costs as a whole to determine the parameter price. See Figure 3 below.

Figure 3: Cost Plus Method



Costs for Associated Enterprise 1	=	€ 5,000
<u>+ Gross Profit Mark Up (20%)</u>	=	<u>€ 1,000</u>

The calculation formula is:

TP (parameter price, which is deemed to be the arm's length price) = $PC + GPM \times PC = PC \times (1 + GPM)$

Where

- TP (parameter price) = transfer price determined by Brazilian law. The maximum price on imports or the minimum price on exports.
- GPM = gross profit mark up, as determined by law or tax regulations (20% in this simplified example, which is the fixed gross profit mark up for export operations according to Brazilian law).

This method may be also applied for cases where the product is not subject to substantial modification, that is, where Associated Enterprise 1 merely resells the product to Associated Enterprise 2. This method can also be used for services and intangibles, however the existence of cost sharing agreements in this last case will make it more complex to apply.

Fixed Margins for the Cost Plus Method

10.1.3.3. Brazilian TP law provides two sets of fixed gross profit mark ups for the Cost Plus Method, regarding import and export operations. For export operations the fixed gross profit mark up is 15%, and for imports it is 20% (which is the required gross profit mark up for the export country).

10.1.3.4. The Minister of Finance, ex officio, or under request, is authorized by law to modify these margins. A request presented by a taxpayer must be fully justified, and supplied with the proper documentation as established in the law.

10.1.3.5. Case Example

Example: Intercompany Distribution. PHARMAX, a pharmaceutical industry with headquarters in Brazil, acquires the active ingredient of a drug produced in its laboratories from an independent enterprise. The price paid in the acquisition of the active ingredient is \$100 per unit, while PHARMAX exports medicine to companies of the same economic group for \$120 per unit. The cost plus method in Brazil requires the exporter to stipulate prices taking into consideration a 30% gross profit mark up so as to comply with transfer price rules. As a result, from Brazil's perspective, PHARMAX should not sell medicine to its affiliates in the other countries for less than \$130 per unit, thus there would be a TP adjustment of \$10 per unit (\$130 - \$120).

10.1.4. Differences between the application of the methods regarding import and export operations.

The RPM and CPM with fixed margins are applicable both to export and import operations.

Considering the RSP with fixed margins, depicted in Figures 1 and 2 of this Chapter, it would be applicable in the country of Enterprise 1 for export operations, and in the country of Enterprise 2 for import operations, hence:

- For exports: $TP \text{ (parameter price)} > PV - GPM$, which means that $(PV - GPM)$ is the minimum acceptable transfer price for tax basis calculation.
- For imports: $TP \text{ (parameter price)} < PV - GPM$, which means that $(PV - GPM)$ is the maximum acceptable transfer price for tax basis calculation.

Considering the CPM with fixed margins, in Figure 3 of this Section, it would be applicable in the country of Enterprise 1 for export operations, and in the country of Enterprise 2 for import operations, hence:

- For exports: $TP \text{ (parameter price)} > PC (1 + GPM)$, which means that $PC (1 + GPM)$ is the minimum acceptable transfer price for tax basis calculation.

- For imports: TP (parameter price) < PC (1 + GPM), which means that PC (1 + GPM) is the maximum acceptable transfer price for tax basis calculation.

However, due to information accessibility RPM is usually more suitable when the Brazilian company imports and CPM is usually more suitable when the Brazilian company exports, as explained below.

10.1.5. Imports

10.1.5.1. Considering the case where the product resold is subject to value added costs or manufacturing by the reselling associated enterprise, the RPM is normally more useful for imports than for exports. The reason for this is that companies may not disclose their production or manufacturing costs, even to other associated companies located in Brazil. This aspect would jeopardize the method applicability for exports, because the necessary manufacturing cost data incurred by the associated importing enterprise would be unavailable for the associated Brazilian exporting enterprise and the Brazilian tax administration. Even if the enterprises involved have complete access to each other's account book data, there is still a problem of information availability to the Brazilian tax administration.

10.1.5.2. If RPM the method is applied for import transfer pricing, the manufacturing importer uses its own account book costs to calculate the correct transfer price, with no need to request the cost data incurred by the exporting associated enterprise. Furthermore in case of imports, the tax administration has full access to evaluate what are the uncontrolled operations (with independent enterprises). As a result, the resale price method with fixed margins is recommended for import operations.

10.1.6. Exports

10.1.6.1. For the corresponding reasons mentioned above as regards the resale price method, the CPM is more useful for exports than for imports. Companies may not disclose their production or manufacturing costs, even to other associated companies located in Brazil, which jeopardizes the method applicability for imports, because the necessary manufacturing cost data incurred by the associated exporting enterprise may be unavailable for the associated Brazilian importing enterprise. Even if the enterprises involved have complete access to each other's account book data, there is still a problem of information accessibility to the Brazilian tax administration.

10.1.6.2. If CPM is applied for determining the export transfer price, the Brazilian manufacturing exporter uses its own account book costs to calculate the correct transfer price, with no need to request any data from the non-Brazilian affiliate. Furthermore, in the case of exports, all necessary information can be accessed and verified by the Brazilian tax administration. As a result, the cost plus method with fixed margins is typically applied for Brazilian export operations.

10.1.6.3. The Brazilian TP Regulations establish that if the taxpayer finds a deviation of 5%, or less, between the actual transfer price and parameter price calculated in accordance with the Brazilian TP legislation, the taxpayer is not requested to make any adjustment. Thus, in practice there is a range for each price.

10.1.7. Strengths and weakness of Brazilian Methods with predetermined profit margins

10.1.7.1. The strengths of Brazil's predetermined profit margins to resale price and cost plus methods, which focus on simplicity, include:

- It dismisses the need for specific comparables.

- The use of the conventional resale price and cost plus methods depends on the availability of certain data, databases or reports to empirically determine the gross profit margin and gross profit mark-up. In general, these elements are usually not easy to find.
- It frees scarce human resources and can be applied without technical knowledge of specific transfer price issues;
- It stabilizes the expectations of taxpayers with respect to their Brazilian tax liability associated with intercompany transactions;
- It is a low cost system to companies and tax administration in that it does away with one aspect of a transfer pricing analysis, the need to empirically determine gross margins;
- it has an emphasis on practicality;
- it does not distort competition among enterprises located where the methodology is applied, since they are subject to the same tax burden, and they are not benefitting from asymmetry of information;
- it allows for simple implementation by tax authorities to audit taxpayers
- it is simple for taxpayers to use it;

10.1.7.2. The weaknesses of Brazil's predetermined profit margins (to resale price and cost plus methods) include:

- The approach may lead to double taxation in case there is no access to competent authority to negotiate relief of double taxation;
- The method requires clear classifications and accounting conformity with respect to allocation of expenses between COGS and operating expenses;
- It is unavoidable that some Brazilian enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability. This is because the fixed margin method applies regardless of the cost structures of taxpayers. For example, otherwise economically identical taxpayers with large COGS relative to operating costs will face higher tax burdens than taxpayers with low COGS relative to operating costs. In addition, application of the Brazilian fixed margin method may result in operating losses or in profits in excess of arm's length;

10.1.8. Other explanations of the Brazilian TP methodology

10.1.8.1. In case of import or export of commodities subject to trading in internationally recognized mercantile & futures exchanges, the method that should be used for imports is the "Imports with Price under Quotation" – PCI, which is a simplified approach to the CUP method for imports, as defined in the law, and for exports is the "Export with Price under Quotation" Method (PECEX), which is a simplified approach to the CUP method for exports, as defined in the law. This mandatory methodology for such products considers the average quotation price of the global market as the arm's length price.

10.1.8.2. Brazilian TP legislation does not apply to cases of royalties and technical, scientific, administrative assistance or similar activities, which remain subject to the conditions for deductibility set out in the tax legislation.

10.1.8.3. There are also specific rules for loans in Brazil. According to the recent change introduced by Provisional Measure n. 563/2012 (which made the rules more simple), interest paid or credited to a related person, due to the loan agreement, will only be deductible up to the amount not exceeding the calculated value based on LIBOR rate (London Interbank Offered Rate) for deposits in U.S. dollars for six months, plus 3 % margin as spread, pro-rated according to the period of the loan. Thus any amount exceeding this defined rate will not be accepted as deduction (the Ministry of Finance may adjust the 3% margin, but only to make it lower).

10.1.9 Comments for countries considering the adoption of fixed margins

10.1.9.1. Countries may establish different profit margins per economic sector, line of business or, even more specifically, by the kind of goods or services, to calculate the parameter price. The more accurately and the more margins are established, the more likely it is that the use of the margins will neither distort the system nor the decisions of the players involved.

10.1.9.2. It may not be possible to justify establishing many different margins, depending on the actual amount and types of goods and services exported and imported by a country. This is because it is possible that the country does not export or import a sufficiently large amount or many types of those goods and services and the determination of such margins, or even their applicability, could lead to some difficulties.

10.1.9.3. If a country opts for the application of different margins, these margins may be established at different levels of specificity. In other words, such margins could be determined by economic sector (e.g. primary sector that is retrieval and production of raw materials, secondary sectors such as manufacturing and tertiary sectors such as services). The country may go deeper into this specification process, so that the margins could be determined by line of business at different levels of specificity according to the necessity and ability of a country to determine them. For example, the country could use a margin for the chemical industry as a whole, or different margins for different types of products of the chemical industry (agrochemical, petrochemical, explosives, cosmetics etc). The possibilities are nearly limitless. The differentiation per industry into types of products is adopted by Brazil, where, for the RSP method for imports, the margin for chemicals sector in general is 30%, while the margin for pharmaceutical chemicals and pharmaceuticals is 40% (see part. 10.1.1.2.2 above).

10.1.9.4. Each country should determine, according to its specific circumstances, the amounts involved and types of goods and services, how specific the margins should be and whether more margins are merited. Besides, a country may combine different levels of margin specifications if it seems appropriate; it may set forth some general margins for a line of business in addition to more specific margins for some goods.

10.1.9.5. In order to determine such fixed margins, the tax authorities have to do pricing research, or buy such information from existing (public) databases, in order to find appropriate prices that could be used as a comparable. Then, if it seems necessary to specify more profit margins, tax authorities have to statistically determine a range of profit margins, that is, a maximum and a minimum profit margin that statistically corresponds to relevant data of uncontrolled transactions. The maximum and minimum profit margin is simply an acceptable divergence margin.

10.1.9.6. It is recommended that relevant taxpayers or groups that represent them verify the research, and that the margin found for that sector, line of business, good or service could be applicable to any, or the vast majority of transactions in that situation. In short, this method suggests that a margin that is used for similar sector, line of business or specific goods and services, can be used for similar situations.

10.1.9.7. It is important to emphasize that what will be applied, in practical terms, are not 'margins' but "ranges". As a result, what will be identified for a specific sector is an average. Thus, some companies may understand that they will fall below the average number, while others will fall above that number. For example, it is assumed that based on market research in a specific country the average market gross profit for resale transactions in the pharmaceutical sector is 30%. It may well be the case that it is established that some companies have a 25% margin and others a 38% margin. Thus it would be advisable to have a range – in this case say 28-35% - as acceptable. The exact calculation of the range will depend on the distribution of the margins; in any case, the fixed margin should be inside the range. The details depend on the market, and if the range is very wide, that in itself indicates the need for further specification to line of products, or even a specific product.