TRANSFER PRICING METHODOLOGY IN BRAZIL: A SIMPLE AND EFFICIENT APPROACH TO THE ARM´S LENGTH PRINCIPLE

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SUMMARY

The paper addresses the transfer pricing issue under the Brazilian methodology, which seeks to apply the arm's length principle with a simplified methodology in relation to the traditional OECD approach using RSP and CPM methods, by using margins predetermined by law. The article also explains other aspects of the Brazilian methodology such as a simplified CUP applied to commodities, specific rules for loans, and the use of safe harbors. The article states that this simplified methodology is a feasible alternative for tax administration of developing and less developed countries.

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Transfer pricing is a problem related to international transactions between related parties which affects allocation of taxable profits between countries. It is generally accepted that more than thirty percent of the world trade is performed between related parties, which makes transfer pricing one of the most, or even the most, important issue in international taxation. The importance of the problem is increasing because more and more transactions are becoming international and the companies are becoming more connected in a way or another.

Brazilian economy boomed in terms of international transactions from the 1990s. Before that time, Brazilian economy was more like a closed economy, and there were very few Brazilian companies operating outside the country. The expansion in 1990´s is also part of the phenomenon called "globalization". Then Brazil started to change legislation related to income tax to face the new scenario. Following this trend, Brazil adopted tax law imposing worldwide income taxation in 1995. The change in the law that allowed the taxation on a worldwide basis was made by means of the Federal Law n. 9.249, Dec. 29, 1995, that entered into force in Jan. 1, 1996. The Transfer Pricing law was enacted in 1996, and entered into force in Jan. 1, 1997 (Federal Law n. 9,430/96). The Federal Law 9,430/96 was then modified by Law n. 10,451/ 2002, and by Federal Law n. 11,196/2005, which introduced a modification to adjust exchange rate appreciation of the Real against foreign currency, and then by Law n. 11.727/2008. More recently, important changes were introduced by Law n. 12,715/2012 (former Provisory Measure n. 563, from April 3rd, 2012, converted into law by the Congress), which introduced a more flexible methodology for adjusting the profit margins to the Resale Price and Cost Plus Methods (RSP and CPM respectively), and established different margins for different economic sectors for the RSP, and a new methodology for CUP method regarding commodities. Most of the changes of Law n. 12,715/2012 to Law 9,430/96 would enter into force in January 1st, 2013; however, taxpayer may apply it in taxable year 2012, by option.

Brazilian regulations for transfer pricing must follow enacted law. It may be an Administrative Rule ("Portaria") issued by the Minister of Finance or through Normative Instructions ("Instrução Normativa RFB"), which is a sort of revenue and procedure ruling issued by the Federal Revenue Secretary, that are detailed regulations on the subject matter. Current transfer pricing rules are detailed in Normative Instruction SRF No. 243, issued in November 11, 2002, modified by Normative Instruction SRF No. 321, issued in April 14, 2003, and Normative Instruction No. SRF nº 382, issued in Dec, 12, 2003. Regulations establishing the procedure of petition for changes of gross profit and mark up margins were established by the Ministry of Finance through Administrative Rule Number 222, issued in Sept., 2008 (previous Portaria MF no. 95, de 1997). There are other Regulations dealing with adjustments to exchange rate appreciation (issued in 2005, 2006, 2007, 2008 and 2011).[1]

This article aims to address current Brazilian TP practices, with focus on the traditional methods (RSP and CPM) with fixed margins, and other particular features of the Brazilian methodology.

1. *Law and regulations are available at: www.receita.fazenda.gov.br/Legislacao/LegisAssunto/PrecosTransf.htm (Texts in Portuguese)*

1. GENERAL VIEW AND DESCRIPTION OF BRAZILIAN METHODOLOGY

1.1. General view

In general, Brazilian legislation adopts the arm's length principle.[2] However, there are some simplifications of the traditional methodology in order to make it more practical. If this principle is not observed, the law authorizes tax authorities to reallocate income for income tax and social contribution for tax collection purposes. Lack of compliance may result in tax penalty of 75% based on unpaid tax (up to or 150% penalty in case of willful tax evasion or fraud).

The methodology introduced by the law brought 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, both present in the OECD TP Guidelines) and formulary apportionment. Regarding the CUP, for export or imports, the law introduced a methodology that is similar to OECD practices, but Law n. 12,715/2012 introduced a simplification for CUP regarding goods that are considered commodities (for details see Subpart 2.3. 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. Furthermore, Brazilian law establishes different set of rules for import and export, despite of the fact the applicable principles are the same.

PIC (Comparable Uncontrolled Price for Imports) and PCI (Price under Quotation Method for Imports) are variations of CUP Method for imports, and PVEx (Price of Sale for Export Method) and PECEX (Price under Quotation Method for Exports) are variations of CUP for exports. While PIC and PVEx follows the general standards, PCI and PECEX are applicable only to goods and rights available in organized markets through mercantile and futures exchange.

PRL (Resale Price Less Profit Method) for imports, PVA (Wholesale Price in the Country of Destination Less Profit Method), and PVV (Retail Price in the Country of Destination Less Profit Method) for exports are variations of the Resale Price Method (RSP), with fixed margins, while the law establishes differences regarding it is applicable to import or exports, with different profit margins. CPL (Cost of Production Plus Profits Method) for imports, and CAP (Cost of Acquisition or Production Plus Taxes and Profits Method) for exports, are the same Cost Plus Method (CPM) with different set of rules and fixed margins regarding imports and exports.

Thus, there are two set of methods for goods, services and rights (in general), as follows:

For import transactions:

- Comparable Uncontrolled Price Method (PIC + PCI) (CUP)
- Resale Price Method (general 20% gross profit margin (PRL) (RSP) + Other margins

2. *The arm´s length principle is the general standard to achieve the price of transaction between non related parties. The principle is embodied in the art. 9, par. 1 of the United Nations Model Double Taxation Convention between Developed and Developing Countries and the OECD Model Tax Convention on Income and on Capital, and is the central pillar for the OECD Transfer Pricing Guidelines Multinational Enterprises and Tax Administrations (OECD TP Guidelines). See, e.g., Stig Sollund and Marcos Aurelio Pereira Valadao. The Comentary on Art. 9 – The Changes and Their Signifcance and the Ongoing Work on the UN Transfer Pricing Manual. BULLETIN FOR INTERNATIONAL TAXATION, v. 66, n.11, p. 608-611, 2012. However, there are controversies on other methodologies to achieve other acceptable results regarding transfer pricing adjustments.*

for specific sectors (see Part. 3.1.1 for details).
- Cost Plus Method (20% mark up margin) (CPL) (Cost Plus)

For export transactions

- Comparable Uncontrolled Price Method (PVEx + PECEX) (CUP)
- Wholesale Price in the Country of Destination Less Profit Method (15% margin) (PVA) (RSP)
- Retail Price in the Country of Destination Less Profit Method (30% margin) (PVV) (RSP)
- Cost Plus Method (15% profit margin) (CAP) (Cost Plus)

Compulsory profit margins are set between 15 and 40 percent, depending on the Transfer Pricing Method, the economic sector, and they differ for inbound and outbound transactions. The law specifies minimum and maximum profit margins, that is to say, the profit margins are statutorily set in the Transfer Pricing Law and are not dependent on comparable, uncontrolled transactions. However, it is also important to point out that the law foresees the possibility of modifying those margins by an act of the Minister of Finance, ex officio, or through an individual request submitted by the taxpayer. A request to modify a profit margin must be accompanied by documents that prove that the margin used by the taxpayer conforms to normal practices between unrelated parties under comparable circumstances.

There are special rules for financial operations. The interest paid or credited to a related person, due to the a loan agreement, will only be deductible for purposes of determining taxable income to the amount not exceeding the calculated value based on the rate London Interbank Offered Rate - LIBOR for deposits in U.S. dollars for six months plus a margin percentage, as spread, of three percent, which can be changed by the Minister of Finance based on market average rate (within the range of zero to three percent). It may considered a sort of safe harbor for loans.

Brazilian TP legislation does not apply the “best method” approach. There is no preferable method, taxpayer may use the one that better fits (or works) to his/her operation, but cannot use other methods such as Profit Split and TNMM. However, Tax Administration can challenge the taxpayer’s option when the taxpayer’s does not follow the applicable rules.

1.2. Transactions subject to TP in Brazil

Brazilian Transfer Pricing Regulations apply to juridical persons (companies) and individuals. Under certain circumstances it also applies to transactions performed between unrelated parties. However it does not apply to transactions with royalties and the remuneration for the transfer of technological know-how. Briefly transactions that are subject to TP regulations include:

- Imports and exports of goods, services, and rights with related parties;
- payments or credits for interest paid or received on loans with related parties not registered with the Central Bank of Brazil.

Related parties are juridical persons (legal entities) or individuals that have common interests (branch, controlled companies, participation holders, exclusive distribution rights owners, etc), in accordance to a set o complex rules established by tax legislation. Under TP Regulations, related parties are the Brazilian entity and:

- the parent company when it is domiciled in a foreign country;
- a foreign branch or subsidiary of the Brazilian entity;
- a non-resident individual or legal entity, domiciled abroad, when it holds at least 10 % of the shares or control of the Brazilian company;
- a legal entity domiciled abroad in which the Brazilian company holds at least a 10 % participation or is a controlled company;
- a foreign company that are under common corporate or administrative control, or when

at least 10 % of the shares of each belongs to a common shareholder;

- a non-resident individual or legal entity, domiciled abroad that jointly hold at least a 10 % participation or control a third legal entity;
- an individual or legal entity resident abroad that are associated in any form of condominium, consortium or co-ownership in any enterprise, in accordance with Brazilian Law definition;
- a non-resident individual who is a relative to the third degree of kinship, or is the spouse (legally or by common law) of any director or directly or indirectly controlling partner or shareholder;
- an individual or legal entity resident abroad, that acts as exclusive agent and distributor (or private concessionaire) for purchase and sale of goods, services and rights;
- an individual or legal entity resident abroad, to whom the legal entity in Brazil acts as exclusive agent and distributor (or private concessionaire) for purchase and sale of goods, services and rights.[3]

Transactions examined under Brazilian Transfer Pricing Regulations also include operations performed by individuals and legal entities in Brazil with any individual or legal entity, residing or domiciled in a country that do not tax income or that tax income up to a maximum rate of 20 percent, and operations performed with persons entitled to privileged tax regimes in a foreign jurisdiction, regardless of whether the latter is a related part. This rule also applies to jurisdictions that offers secrecy to the ownership structure of legal entities or does not allow for identification of the beneficial owner. Current Normative Instruction RFB No. 1.037, issued in June 4, 2010, brings a list of jurisdictions that fulfill the aforementioned conditions.

As stated before, Brazilian Transfer Pricing Regulations are not applicable to royalty payments, technical assistance, and scientific and administrative fees (when it represents payments for technology transfer). It is because these expenses are subject to limited deduction (up to five per cent of the turnover derived from it). They are also subject to withholding tax in the remittance of income. These limited deductions replace TP regulations application, and in some cases would lead to an analogous result derived from its application.

Brazilian Transfer Pricing Regulations also apply to transactions between parties that are not related parties in a “uncontrolled transaction” when the transaction is performed through an “interposed person”, which is a third party that is not directly associated to the related parties, but is engaged in business (international transactions of the same nature) connecting the two related parties, through a previously conceived scheme. It applies when the interposed person acts as “Conduit Company”. Actually, it is an anti-tax-avoidance rule.

It is clear that Brazilian TP rules to define related parties (associated interprises) are broader than the Model Convention. On the other hand Brazilian TP law allows for safe harbor in specific situations (see Part 4 below).

1.2.1. Documentation

Brazilian taxpayers must inform in their annual tax return for juridical person (DIPJ) if there is any kind of relationship with related individuals or legal entities, resident or domiciled abroad. If the tax administration challenges the TP adjustments of the taxpayer, the burden of proof is on the tax administration. Documentation used to demonstrate the TP adjustments must be available for the tax administration for five years (statute of limitations). Administrative TP Regulations issued by the Federal Revenue Secretary does not allow a “basket approach” or intentional set-offs to make TP adjustments.

3. *Art. 23 of Law n. 9.4350/1996.*

Brazilian TP Regulations states that the chosen method must be applied to each good, service or right individually considered in a determined taxable period (for imports and exports). Thus, it does not allow adjustments to be made taking into consideration a basket of products (which allows reciprocal price compensations), or even intentional set–offs that are common when two companies negotiate products and services at the same time.

Regulations require that the following elements be presented as documentation:

- Official publications or reports from the government of the seller or buyer's country of origin, or a declaration of the tax authorities when said country has a tax treaty in force with Brazil;
- Market research performed by a recognized institution or technical publication that specifies the industry sector, period, companies researched, and the profit margins for each selected comparable company;
- Domestic and international stock market price quotes; and
- Research performed under the auspices of international research institutions, such as the OECD and WTO.

1.3. The CUP and the commodities approach (PCI and PECEX)

Price under Quotation Method for Imports (PCI), and Price under Quotation Method for Exports (PECEX) are variations of the traditional CUP Method. This specific methods were recently added by Law n. 12,715/2012 to substitute the traditional CUP method, for imports (PCI) and exports (PECEX), when the prices of the goods and rights are available in organized markets through mercantile and futures exchange.[4] The aim is to avoid discussions on prices when there is a defined market that sets the price globally. This price is deemed to be the arm´s length price. The law defined the methods as follows:

Price under Quotation Method for Imports - PCI is defined as the average daily price of goods or rights subject to public prices in commodities futures and internationally recognized exchange markets.

Price under Quotation Method for Exports-PECEX is defined as the average daily price of goods or rights subject to public prices in commodities futures and internationally recognized exchange markets.

In both cases the Law allows for adjustment of the price regarding the market premium at the date of the transaction. When there is no transaction in the organized market in an specific date, the price to be taken in consideration is the last price information available in the market. When there is no price available at all, the Law allows to the taxpayer and the tax administration to rely on international recognized database for price research.

This simplified CUP method is very useful, saving time on the search for comparable transactions when there is a defined and stable organized market that globally sets the price for certain type of goods.

1.4. Considerations on RSP and CPM with predetermined profit margins

The adoption of the resale price and cost plus methods depends on the publicity (or availability) of certain data, databases or reports and on the determination of the gross profit margin and gross profit mark-up. These last two elements are difficult to be found or determined by the tax authorities and, moreover, by the taxpayer. In fact, as previously mentioned, for conventional transfer pricing methods access to information on comparables is necessary and due to difficulty

4. *In this regard, Law n. 12,715/2012 introduced articles 18-A and 19-A to Law n. 9,430/1996.*

in getting access to (publicly available) data, in certain instances, other methods may need to be resorted to than those that would seem initially preferred.[5] Moreover, the cost of access to this information and the asymmetry of information may affect the competition between enterprises. Additionally, the applicability of these methods depends also on the development and availability of human resources (economists, accountants and other experts), that may be scarce or very expensive in many developing countries. The referred applicability is influenced by the human technical level about specific matters, such as valuation of risks incurred, assets used, and functions performed.

In other words, especially the functional comparison requires the use of intensive human resources and technical knowledge, which may be scarce in developing countries and that are demanded to be used in other areas in public and private sectors. Thus, the intensive use of many professionals in transfer pricing issues may not justify the benefits, thus they could be employed in more important issues for the revenue tax service or for the economic development of the country. From the tax administration point of view, considering other priorities, some countries may be concerned that tax audit in transfer pricing may be an unjustifiable time and cost consuming task for tax authorities in countries where there is a reduced number of them.

Finally, 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 nor summary review by the tax authorities. This affects the stability and expectations in economic and fiscal relations.

For these reasons, a country may adopt fixed gross profit margin and gross profit mark up. In this case, neither the taxpayer nor the tax authority needs to determine such margins to find the arm's length price, since they are set forth by law. The company does not have to hire experts to determine the ratio margins to be applied, since they are previously determined by law.

In short, this system is simple, easy to implement and low cost to companies and tax administration. On the other hand, the predetermined margins should be carefully established, in order to accomplish the arm's length principle.

In this sense, countries should establish different profit margins per economic sector and line of business or products to calculate arm's length prices. The profit margins would be then adjusted considering the profitability of specific economic sectors or line of business or products. Each country would verify the normative instrument (statutory law, regulation, etc.) necessary to introduce these profit margin modifications, depending on the how the country´s legal system operates. By using these flexible profit margins, these methods can be also satisfactorily used for services and intangibles (rights).

Additionally, some countries may find appropriate to allow the taxpayers or associations to challenge the profit rates applicable to their specific enterprise. In this case, each country would determine the conditions to this procedure. Among the criticism towards the use of predetermined (fixed) margins by law one will find that the predetermined fixed margins must be carefully selected, in order to correspond to the arm's length principle, and that it is

5. *Tatiana Falcao has stated that "The search for comparables is one of the main concerns of developing countries, which do not have wide and open markets providing accessible information and reports about competing companies commercializing comparable or similar products. Sometimes, a company might be the only producer of a specific type of product, making the search for comparables impracticable if not impossible." In: Brazil's Approach to Transfer Pricing: A Viable Alternative to the Status Quo? TAX MANAGEMENT TRANSFER PRICING REPORT, Vol. 20 No. 20, 2/23/2012.*

necessary to determine different and appropriate profit margins. It is correct, the closer the margin set in the law is of the real margin, the closer is the price derived from the method to the arm´s length price. Indeed the width of the range of the arm´s length price obtained through traditional methodology is a problem; it may be very large, to the point that it is useless for the tax administration.[6] For this reason fixed margins may work very well, when correctly determined.

Other strong criticism is that some enterprises will be taxed at (higher or lower) profit margins not compatible with their profitability, and that it may lead to double taxation, depending on the methodology of the other country where the related party operates. Again, it is also true, however for the same aforementioned reason, taxpayers and tax administrations will probably reach different numbers due to width of the arm´s length range. In other words, no matter the method applied there will always be risk of double taxation. Again, if the margins are correctly determined the fixed margin methodology does not owe to the traditional methodology.

On the other hand predetermined margins methodology (to resale price and cost plus methods) presents remarkable strengths, which include:

- it dismisses the availability of specific comparables;
- it does not distort competition among enterprises in an specific country, since they are subject to the same tax burden, and they are not benefitted with asymmetry of information;
- it is adequate to countries with scarcity of human resources and technical knowledge of specific transfer price issues;
- it is easy to be implemented by tax authorities and taxpayers;
- it stabilizes the expectations for juridical and economic areas;
- the system guarantee equal conditions of competition between companies;
- low cost system to companies and tax administration;
- emphasis on practicality.

Traditional resale price and cost plus methods with fixed margins are applicable to both export and import operations. A more detailed explanation to differentiate the application from import and exports and how to deal with it will be exposed in a specific topic.

6. *As it was put by Michael Durst "In fact, the arm´s-length ranges produced under the flawed methods used today almost are far too wide to provide tax authorities information that is useful in enforcement. The excessive width of what are supposed to be the arm´s-length ranges causes tax administration around the world to leave a great deal of money sitting on the table when attempting to enforce transfer pricing rules… " Fixing Double Nontaxation Under the Transfer Pricing Guidelines", TAX NOTES, May 7, 2012, pages 785-789, as quoted by David Spencer. Will OCDE adjust to reality?, JOURNAL OF INTERNATIONAL TAXATION, n. 23, p. 35-52, 2012, p. 48.*

2. BRAZILIAN METHODOLOGY WITH FIXED (PREDETERMINED) MARGINS FOR RESALE PRICE AND COST PLUS METHODS[7]

2.1. Resale price method with fixed margins

The mechanism of resale price method using fixed gross profit margins does not substantially deviate from the resale price method with margins based on comparables of the traditional methodologies (OECD TP Guidelines). In order to determine the arm's length transfer price, the resale price that the resale company charges to an unrelated company is reduced by a fixed gross profit margin. The remainder is the acceptable transfer price (arm´s length presumption) between associated parties. In exports, this price will be minimum revenue and, in imports, the remainder value will be a maximum deductible expense or cost.

The method is basically the ratio of the transfer price to the product resold value less a proportional profit margin. 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 good is resold.

In this methodology the transfer price would be calculated having regard to the proportional participation of the good negotiated between associated parties in the good resold to an independent enterprise. This is called participation ratio, which is 100% in a simple resale. This methodology reduces the weakness of using the resale price method when the reseller adds substantially costs to the product traded between associated parties. The resale price to be considered shall be that agreed upon the reselling company with an independent enterprise.

The price at arm's length (or deemed to be at arm´s length) would be the difference between the participation value of the sale price of good in the net resale price less its "gross profit margin".

General example: Product A (input) >> imported by Brazilian Company (from a related company) which resale it (same product A) or manufacture it and sale product (namely good "B").

For this purpose, the participation value of an input (A) in the net resale price of the good to be sold (B) would be: the application of the participation ratio of the input to the total cost of the good multiplied by the net resale price of the good.

The referred participation ratio is determined as follows: the ratio of the price of the input (A) to the total cost of the good resold (B), calculated according to the company's cost spreadsheet. The net resale price is the weighted average price of sales of the good resold (B), less unconditional discounts granted, indirect taxes on sales, and commissions and brokerage fees paid.[8] For the calculation of the net resale price some adjustments may be made such as payment term; inventory; quantities traded; guarantees that imply costs related to inspection of quality; and freight and insurance.

The gross profit value of product A (in the resale of product B) is the application of, for example, 20% (gross profit margin) on the participation value as referred above. As mentioned before, under Brazilian methodology, the gross profit margin will be set forth by law. The margin

7. *This part of this article is mainly based on the Chapter 10.1 of the United Nations Practical Transfer Pricing Manual for Developing Countries, which this author also authored, available at http://www.un.org/esa/ffd/tax/eighthsession/Chap10_CPBrazil_%20 20121002_v6_HC-accp.pdf*

8. *"Unconditional discounts" are those that do not depend on future events and that are detailed in the invoice.*

may vary depending on the economic sector of the activity performed by the associated party subject to transfer price adjustments.

In order to avoid distortions between companies of a same country, it is necessary accounting uniformity between the taxpayers of the country. For instance, if certain debts are qualified as operating expenses by some companies and simultaneously qualified as costs of goods sold by others, the system will not be satisfactorily implemented.

Pure resale price (without manufacturing)

If the product traded between related parties is not subject to any manufacturing modification, the formula adopted will be the same and the participation ratio will be of 100%, since the price of input (which now is the good itself) will be equal to the resale cost of good (final product).

General example would be: Product A >> imported by Brazilian Company (from a related company) which resale it (same product or good “A”).

In this case the calculation is simple, the arm’s length price (charged between associated parties) 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 profit margin.

TP (arm’s length) = NRP – GPM x NRP,

Where:

- TP (arm’s length) = transfer price at arm’s length. 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.
- TP(arm’s length) = NRP – GPM x NRP = NRP – GPM% x NRP
- TP(arm’s length) = NRP (1 – GPM%).

Resale price with manufacturing

General example would be: Product A (input) >> imported by Brazilian Company (from a related company) which manufacture it and sale the production (namely good “B”).

The formula for the transfer price in intercompany would be:

TP (arm’s length) = PV – GPMV,

Where

- TP (arm’s length) = transfer price at arm’s length. The maximum price on imports or the minimum price on exports.
- PV = participation value of the good transferred to the associated enterprise in the net resale price = (price of input ÷ cost of production of the good) x (net resale price of the good);
- GPM = gross profit margin = the value of gross profit margin ratio, as determined by law or tax regulations.
- GPMV = gross profit value = GPM x PV = GMP x (price of input ÷ cost of production of the good) x (net resale price of the good)
- TP (arm’s length) = PV – GMPV = PV (1 – GPM%)

2.1.1. Fixed margins for the resale price method

For a period of time the fixed margin for the resale price (RSP) method was 20 percent. Later it was changed to 20 and 60 percent (the higher margin applied to transactions when 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. According to the recent changes in the Brazilian TP legislation the margins for the RSP method for imports are as follows (it includes simple resale operations and manufacturing operations):

- **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);

- **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

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

For exports the margins are fifteen percent when the operation in the export country is a wholesale operation, and thirty percent when it is a retail operation (PVA and PVV methods, as aforementioned).

2.2. Cost plus method with fixed margins

Similarly to the resale price method with fixed margins, the cost plus method may be used with predetermined gross profit mark up. The basic functionality of this method is very similar to the non-predetermined margin cost plus method. The method focuses on the related product manufacturing or service providing company in transfer pricing with associated enterprises. The deemed arm's length price is reached by adding a predetermined cost plus mark up to the cost of the product or services. It will be a maximum value on imports or a minimum value on exports. As explained above, it is recommended that the countries establish different gross profit mark up per economic sector and line of business or products to calculate arm's length price.

The difference in using predetermined gross profit mark up instead of a comparable one is that the taxpayer does not have to determine it. In other words, again the taxpayer does not have to find comparable situations to use this method.

Differently from resale price method, the cost plus method with predetermined fixed gross profit mark up does not require to calculate the ratio of certain input to the final product. Thus, the gross profit mark up is applied to the costs as a whole to determine the arm's length price.

The calculation formula is:

TP (arm's length) = CP + GPM x CP = CP x (1 + GPM)

Where

- TP = transfer price at arm's length.
- CP = Cost of products or services
- GPM = gross profit mark up, as determined by law or tax regulations

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

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). 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.

2.3. Differences of the application of these methods regarding import and export operations

The RSP and CPM with fixed margins are applicable both to export and import operations. However, due to information accessibility, RSP is more suitable for imports and CPM is more suitable for exports, as explained below. Other features regarding the application this method will also be further considered.
Imports

Considering the case where the product resold is subject to value added costs or manufacturing by the reseller associated enterprise, the RSP is normally more useful for imports than to exports for trade and commercial secrecy reasons. The reason for this is that companies normally do not accept to open their production or manufacturing costs, even to other associated companies located in other countries. 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 exporting enterprise and its 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 tax administration. In addition, the margins may vary from country to country, which make it more difficult to handle.

If 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 exporter associated enterprise. Furthermore in case of imports tax administration has full access to evaluate what are the uncontrolled operations (with independent enterprises).

The conclusion is that the resale price method with fixed margins is recommended for import operations.

Exports

For the corresponding reasons pointed to resale price method, the CPM is more useful for exports than to imports for trade and commercial secrecy reasons. Companies normally do not accept to open their production or manufacturing costs, even to other associated companies located in other countries, what jeopardize the method applicability for imports, because the necessary manufacturing cost data incurred by the associated exporting enterprise are unavailable for the associated 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 tax administration.

If CPM is applied for export transfer price, the manufacturing exporter uses its own account book costs to calculate the correct transfer price, with no need to request the any data. Furthermore, in the case of exports, all necessary information can be accessed and verified by the tax administration of the exporting country

The conclusion is that the cost plus method with fixed margins is recommended for export operations.

3. SAFE HARBORS IN BRAZILIAN TP LAW

It must be clear that Brazilian TP methodology with fixed margins for RSP and CPM is not a safe harbor. Firstly because safe harbors are options to taxpayers, secondly because safe harbors must take into consideration specific situations. It is not the case for RSP and CPM whir fixed margins under Brazilian methodology. Basically there are two types of safe harbors: all inclusive and “de minimis” operations. All inclusive means that a whole set of operations are out of TP regulations if they use a set of standards (let´s say a minimum level of interest rate in intercompany loans); “de minimis” safe harbor means that the operations are not relevant in terms of value or volume, so they should not be submitted to TP regulations. It is considered that the two types of safe harbors are workable. However, the “de minimis” approach will differ from country to country because what is economic relevant in small country might not be relevant in a big country. Brazilian TP regulations apply both types of safe harbors, below a brief description of them is given.

- Brazilian taxpayers which have a net profit originating from export sales to related parties (before taxes on income), taking into consideration the current taxable year and the two preceding years, of at least 5% over such sales, will not have to make TP adjustments regarding income deriving from exports.
- Brazilian taxpayers are not subject to transfer pricing in exports when it is shown that net export revenues in taxable year is equal to or less than 5% of its total net revenues of the same period.
- For exports, Brazilian taxpayers are not subject to transfer pricing regulations if the average sales price in international controlled transactions is equal to or higher than 90% of the average sales price in uncontrolled transactions with unrelated parties in the Brazilian market, during the same period and under similar payment conditions.
- Market conquest special rules. Operations targeted to conquest market for Brazilian goods and services, when previously adapted to certain conditions (such as transactions to be part of an export plan, previously approved by the RFB) are not submitted to TP regulations.
- A 5% gap between prices assumed as uncontrolled prices (parameter price), in transactions between related parties, and the import and export prices in transaction documents is acceptable. It reflects the range approach to arm´s length principle.
- Special rules for intercompany loans may also be deemed to be safe harbor (see Subpart 2.1). It is because once the transaction is performed according to those rules, there is no need for TP adjustments. It is worth mentioning that Before the change in TP law in 2012, the simple registration of loans at Brazilian Central Bank would avoid application of TP rules, thus the previous legislation was indeed a “pure” safe harbor which no longer exists.

It is important to note that the rules set forth in items 1, 2 and 4 are not applicable for sales to related parties established in low tax or non transparent jurisdictions, as defined by Brazilian TP Regulations.

4. FINAL REMARKS

Despite of the fact that lots of the details of the Brazilian TP laws and regulations were omitted here (these details give room to some adjustments for specific situations), Brazilian methodology is far simpler than the OCED[9] Transfer Pricing Guidelines. It is worth mentioning that the recent UN Manual on Transfer Pricing for Developing Countries follows the TP Guidelines, however, it brings four country practices (Brazil, China, India and South Africa), which may be very useful.

The author is sure that the use of traditional transaction methods with fixed margins, which is the Brazilian methodology main feature, due to its simplicity and practicality, is a feasible alternative to developing and less developed countries to deal with the important issue of transfer pricing.

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9. *Accordingly Tatiana Falcao affirmed "Now that developing countries have become significantly more important because of their economic capacity and their economic potential, the OECD could consider modifying its transfer pricing guidelines to accept Brazil's system as an alternative for other developing countries that have not yet been able to implement the OECD's more complex transfer pricing guidelines due to a of lack of resources, qualified personnel, or comparables." Op. cit, supra note 5, p. 8*