Some comments on Brazilian TP System with fixed margins for the resale price method (RPM) and cost plus method (CPM).

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Background

Legislation history

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

The methodology introduced by the law listed the traditional transaction methods (CUP, cost plus method (CPM) and resale price method (RSP)) but denied other methods called 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 has close similarity to the OECD practices. However, as for the cost plus and resale price methods, instead of making use of comparable transactions, the law established fixed margins for gross profits and markups. The methodology also differentiates between import and export operations.

For a period of time the fixed margin for the resale price method on imports was 20 percent. Later it was changed to 20 and 60 (this regards situations where the imports were subject to manufacturing in Brazil). In 2012, the law was changed to be more “comparables”-based by adopting different margins for certain specific sectors, but in general maintained 20 percent as a prescribed margin. However some modifications introduced by Provisional Measure n. 563/2012 will enter into force only in January 1st, 2013.

The reasons for the methodology

The use 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 margins and markups. These elements are usually not easy to find. They may be determined by the tax authorities and, moreover, by the taxpayer. These aspects, that influenced the implementation of the Brazilian transfer pricing methods, are more detailed bellow:

- For conventional transfer pricing methods access to information on comparables is necessary. However, due to difficulty 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. This puts into question the accuracy and reliability of the outcomes of the other methods used;
- The cost of access to the necessary information and the asymmetry of information can be seen as affecting the competition between enterprises. If one enterprise somehow finds a more favorable comparable than another does, the former will potentially be in a favorable position, since its tax expenses could be lower if that (more favorable) comparable is used;
- The applicability of the conventional transfer pricing methods depends also on the development and availability of (specialized) human resources (economists, accountants and other experts), that may be either scarce or very expensive in developing countries. The conventional transfer pricing methods depend highly on aspects such as valuation of risks incurred, assets used and functions performed, which usually need to be determined and calculated by people who are specialized in transfer pricing. To the extent that these human resources and technical knowledge are scarce in developing countries, one could question the accuracy of the outcome of such efforts or question the effectiveness of the costs for such efforts. These specialized resources could be more efficiently

employed in the public or private sector for the economic development of the country, for use within companies or for the revenue service.

- For some developing countries, from the tax administration point of view, considering other priorities, there may be a concern that tax audits of transfer pricing issues may constitute an unjustifiable time consuming and costly task;
- 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 the abovementioned reasons, adopting fixed gross profit margins and gross markups can be seen as increasing certainty and saving costs both for the taxpayer and the tax administration. In this case, neither the taxpayer nor the tax authority need 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 the tax administration.

Traditional resale price and cost plus methods with fixed margins are applicable to both export and import operations. Brazilian TP law details the application of the two methods (RSP and CPM) for exports and imports in a separate set of rules.

In the Brazilian approach there are also specific methods for tradable commodities, which is a sort f simplified CUP, and also a simplified methodology for interest in loans between related parties.

Resale Price Method With Fixed Margins

According to recent changes in the Brazilian TP legislations the margins for the RPM 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);

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.

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 to;

- 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.

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

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.

Examples of application of the methodology for RPM

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 Country Y, 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 Country Y, 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 Country B 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 (arm's length) = 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 and adjustment per unit of $64 per unit ($400 - $336).

Cost Plus Method With Fixed Margins

Similar to the resale price method with fixed margins, the cost plus method may be used with a predetermined gross profit markup. The basic functionality of this method is very similar to the non-predetermined margin (or traditional) cost plus method. The method focuses on the related product manufacturing or service providing company in transfer pricing with associated enterprises. As explained

above, the arm's length price is reached by adding a predetermined cost plus markup 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 margins per economic sector and line of business or products to calculate arm's length price.

The difference and benefit of using predetermined gross profit margins instead of a comparable one is that the taxpayer does not have to determine it. In other words, the taxpayer does not have to find comparable situations to use this method. This system guarantees equal conditions of competition between companies, among other benefits derived from its simplicity.

Differently from the resale price method, however, the cost plus method with predetermined profit markups does not require the taxpayer to calculate the ratio of certain inputs to the final product. Thus, the predetermined markup is applied to the costs as a whole to determine the arm's length price.

Predetermined markups

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

Example

Intercompany Distribution. PHARMAX, a pharmaceutical industry with headquarters in Country X, 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 Country X requires the exporter to stipulate prices taking into consideration a 30% gross profit markup so as to comply with transfer price rules. As a result, from country's X 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).

Considerations that are relevant to determine the (number of) fixed margins

Countries may establish different profit margins per economic sector, line of business or, even more specifically, per kind of goods or services to calculate arm's length prices. 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, which means it is more probable that the outcome reflects the arm´s length price.

On the other hand, depending on the actual amount and types of goods and services exported and imported by a country, it may not be able to justify establishing many different margins, since 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.

These margins may be established at different levels of specification, that is, the margins could be determined by economic sector (primary sector, that is retrieval and production of raw materials; secondary sector as manufacturing; tertiary sector 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 specification according to the necessity and possibility for 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%.

In order to determine the fixed margins, the tax authorities have to do pricing research, or buy such information from existing (public) databases, to find appropriate arm's length prices that could be used as a comparable. It is recommended that the relevant taxpayers or groups that represent the taxpayers 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, and reach a consensus about the average rate to be used. In short, this method suggests that a margin that is used for similar sector, line of business or specifics goods and services, can be used for similar situations. There is also a need for normative instrument (statutory law, regulation, etc.) necessary to introduce these profit margin modifications, and clear instruction as to how the margins operate.

It s 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 other will fall above that number. For example, let's assume that based on market research the average market gross profit for resale transactions in the pharmaceutical sector is 30%. However, let's also assume that it was found that some companies have a 28% margin and other a 34% margin. Thus it would be advisable to have a range, let´s say 28-34% as acceptable (this in the end will depend on the distribution of the margins). In any case, the fixed margin should be inside this range. The details depend on the market. If the range is very wide, it indicates the need for a further specification to line of products, or even a specific product. In line with this approach, 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.

Strengths of Resale Price Method and Cost Plus Method with predetermined margins

- it dismisses the need for availability of specific comparables;
- it does not distort competition among enterprises, since they are subject to the same tax burden, and they are not benefitting from asymmetry of information;
- it is adequate for countries with scarcity of human resources and technical knowledge of specific transfer price issues;
- it is easy to be implemented by tax authorities to audit taxpayers
- it is easy to be used by taxpayers;
- it stabilizes the expectations for juridical and economic areas;
- it is a low cost system to companies and tax administration;
- it has an emphasis on practicality.
- It is not another method it is not a safe harbor, it is a simplified approach to traditional resale and cost plus methods.

Other explanations on the Brazilian TP methodology

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.

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.

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 margin percentage as spread, to be set annually by act of the Minister of Finance based on the average market interest rate, pro-rated according to the period of the loan. Thus any amount exceeding this defined rate will not be accepted as deduction.