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Alexandre Tadeu Seguim

LLM PERSPECTIVE

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I. INTRODUCTION

From a business perspective, a transfer price is "the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization."[1] It is one of the most important aspects of corporate taxation because it shifts the income from one place to another, thus modifying the source rules applicable. Transactions between unrelated parties within an efficient market are priced in accordance with expectation of profits. However, when this same transaction occurs between related parties,[2] the practice of transferring the price of costs or the transactional costs, may have a sound basis, but might also lead to undesired tax consequences, such as the reallocation of income and penalty taxes.

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[*] Alexandre Tadeu Seguim is an Associate at Steel, Hector & Davis, LLP. He received his LL.M degree from Northwestern University School of Law and a Certificate of Management from J. L. Kellogg Graduate School of Management at Northwestern University. He received his Law degree from Pontificia Universidade Catolica de Campinas - PUCCAMP (Brazil) and his History degree from Universidade de Campinas - UNICAMP (Brazil). He is a member of the Brazilian Bar Association, the Brazilian Association of Fiscal Law and the International Fiscal Association.

[1] CHARLES T. HORNGREN and GARY L. SUNDEM, INTRODUCTION TO MANAGEMENT ACCOUNTING 336 (1993).

[2] The concept of "related parties" varies from country to country. The idea of a "related party," however, is rooted in the linkages among several entities, in which one is controlled by the other. In the United States, under Section 482 of the Internal Revenue Code, See I.R.C. § 482 and Treas. Reg. § 1.482-1(i)(4) (1997) the allocation of income occurs where two taxpayers are owned or controlled directly or indirectly by the same interest. The Internal Revenue Service (hereinafter the I.R.S.) will look at the realities of the situation in determining whether there is control or not, regardless of formal legal control.

Multinational enterprises (MNEs) developed and grew with the expectation of enhancing their position in markets all around the world. Currently international trade relies heavily on the operations of MNEs. Whether through branches or subsidiaries spread around one country or located abroad, there is an interdependence among these several entities that enables their management to structure strategies in which a certain cost may be diluted within the organization. Under such a scenario, taxes are fundamental to business planning and transfer pricing is an economic tool that may increase the company's value.

Through transfer price, the organization aims to evaluate and improve the performance of the related entity. The idea that transfer pricing is a mechanism designed only to avoid taxes is misleading. Actually, to transfer price is a sound and positive way to increase value.

The 1979 OECD Report on Transfer Pricing and Multinational Enterprises emphasized that the term is neutral: "the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes."[3] The 1995 OECD Report went even further by furnishing a transfer pricing guideline for MNEs and tax administrations.[4]

Thus, the tax aspects of transfer pricing refer not to its use and existence, but to its abuse. Tax administrations aim to regulate, limit and penalize organizations that use transfer pricing as a mechanism to avoid taxation. This piece will address the legal approaches adopted in Brazil with regard to transfer pricing.

II. TRANSFER PRICING IN BRAZIL

Until very recently there was no statute governing transfer pricing in Brazil. Situations in which prices were transferred with a tax avoidance purpose could be dealt with only as a disguised distribution of profits.[5] The principle underlying the income taxation in Brazil was mainly territorial, and transactions between Brazilian residents and non-residents could easily avoid taxation.

However, with the enactment of Law 9430/96,[6] effective January 1, 1997, the worldwide income principle[7] was adopted, and transfer pricing

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[3] *See* Hubert Hamaekers, *Transfer Pricing*, BULLETIN FOR INTERNATIONAL FISCAL DOCUMENTATION (Nov. 1997), and the *Associacao Brasileira de Direito Financeiro* in Sao Paulo, Brazil.

[4] *See* Hamaekers, *supra* note 3.

[5] Articles 432 - 438 of the Regulamento do Imposto de Renda approved by the Decree No. 1.041 of January 11, 1994, D.O.U. of January 12, 1994. The Regulamento do Imposto de Renda corresponds to the Internal Revenue Code in the United States. It is a federal law.

[6] Law No. 9.430/96 of December 27, 1996, D.O.U. of December 28, 1996. As a federal law, it is considered an ordinary law, and corresponds in terms of enforceability to the Internal Revenue Code in the United States.

dispositions were for the first time expressly introduced in Brazilian tax legislation. In fact, with MERCOSUR[8] Brazil had to create mechanisms to prevent tax avoidance, and Law 9430/96 became a tool to restrict transfer pricing as much as possible. Perhaps because this law was the first attempt to deal with transfer pricing, it takes a rather defensive approach to it, as this study will demonstrate. This defensiveness exhibits a clear misreading of the concept as described above.[9] It must be mentioned that the Brazilian Internal Revenue Service has already enacted a Normative Instruction, which is similar in its effect to the Treasury Regulations enacted by the IRS in the United States, regulating the application of Law 9430/96.[10]

It is also important to note that the federal corporate income tax in Brazil has been going through substantial changes since 1995; these revisions attempt to adapt the tax legislation to a more complex and international economic reality wherein globalization directs the flow of wealth. Some key provisions include the exemption of income tax for distribution of profits or dividends introduced by the Laws 9249/95[11] and 9250/95,[12] both effective January 1, 1996, in an attempt to abolish the double taxation regime for corporations. Other innovations include the taxation of profits and gains from foreign sources by including them in the worldwide income of the taxpayer and the reduction of the bracket of the tax on repatriation of income.

Law 9430/96 continued this modernization process by allowing the consolidation of the results from financial transactions made abroad with the ones made in Brazil with a tax credit allowance (another move towards the implementation of a worldwide income tax regime instead of a territo-

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[7] The worldwide income principle developed in opposition with the territoriality principle. According to the former, only income derived within the boundaries of a country would be taxable by this country. The worldwide income principle reaches beyond the territory of a country, and it includes all income derived by the resident of its country, regardless of its origin.

[8] The MERCOSUR is a common market among Argentina, Brazil, Paraguay and Uruguay that was formed in 1992 through the "Ouro Preto Protocol." The MERCOSUR comprises not only a free trade area, with the elimination of all tariffs and equivalent measures among its members, but also the coordination and integration of the members political economics.

[9] For instance, the following statement highlights that idea: "Because of the position taken by the Brazilian rules, one may end up with the conclusion that the concept of transfer pricing is actually attached to a deliberate shifting of profits.", ALEJANDRO E. MESSINEO, *Transfer Pricing in Latin America: New Rules in Mexico and Brazil*" 42, ITPJ, vol. 4, No. 2, (March/April 1997).

[10] Normative Instruction No. 38 of April 30, 1997 of the Internal Revenue Department, D.O.U. of May 1997.

[11] Law No. 9.249/95 of December 1994, D.O.U. of December 1994.

[12] Law No. 9.250/95 of December 1994, D.O.U. of December 1994..

rial system). Finally, transfer pricing provisions were enacted for the first time.[13]

In order to fully understand the scope of the transfer pricing legislation in Brazil it is essential to define what is considered a transaction between related parties, because this is the main aspect in determining whether the transaction complies with the tax provisions. Article 23 of Law 9430/96 enumerates ten situations in which a legal entity will be deemed a related party for the purposes of the application of the transfer pricing rules.[14]

Of particular importance is sub-item V of Article 23, which states that a legal entity domiciled abroad will be considered a related party when it and the company domiciled in Brazil are under common corporate or administrative control or when at least ten percent of the capital of each of them is owned by the same individual or legal entity.[15] The alternative rule ("or") in this paragraph broadened the concept so that it will be almost impossible to escape Article 23. The common corporate *or* administrative control means that the tax administration will look through the entity to find out who has managerial control over the legal entity. Going further, the same paragraph states that if this test fails there still remains an alternative,

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[13] For information concerning the modifications in the Brazilian federal corporate income tax, *see* MARY ELBE GOMES, QUEIROS MAIA, TRIBUTACAO DAS PESSOAS JURIDICAS 1-10 (1997).

[14] Article 23 of Law No. 9.430/96 of December 27, 1996, D.O.U. of December 28, 1996: "Related party- concept. Article 23- For the purposes of Articles 18 through 22, the following are considered as related to a legal entity domiciled in Brazil: I- its head office, when domiciled abroad; II- its affiliate or branch, domiciled abroad; III- an individual or legal entity, resident or domiciled abroad, whose holding in its capital characterizes it as its parent or associated company, in the manner defined in paragraphs 1 and 2 of art. 243 of Law 6.404 of December 15, 1976; IV- a legal entity domiciled abroad which would be characterized as its subsidiary or associated company, in the manner defined in paragraphs 1 and 2 of art. 243 of Law 6.404 of December 15, 1976; V- a legal entity domiciled abroad, when it and the company domiciled in Brazil are under common corporate or administrative control or when at least ten percent of the capital of each of them is owned by the same individual or legal entity; VI- an individual or legal entity, resident or domiciled abroad, who, together with a legal entity domiciled in Brazil, has a holding in the capital of a third legal entity, the sum of which characterizes them as parent or associated companies in the manner defined in paragraphs 1 and 2 of art. 243 of Law 6.404 of December 15, 1976; VII- an individual or legal entity, resident or domiciled abroad, which is its associate in a consortium or condominium, when defined as such in Brazilian legislation, in any venture; VIII- an individual resident abroad who is a relative or kin up to the third level, spouse or companion of any of its directors or of its controlling partner or shareholder in a direct or indirect participation; IX- an individual or legal entity, resident or domiciled abroad, who is its exclusive agent, distributor or dealer for the purchase and sale of goods, services or rights; X- an individual or legal entity, resident or domiciled abroad, in relation to which the legal entity domiciled in Brazil is its exclusive agent, distributor or dealer for the purchase and sale of goods, services or rights."

[15] *Supra* note 14.

which is the ownership of at least 10% capital of each entity (the United States has a similar rule regarding controlled foreign corporations (CFC)).[16]

Paragraph 1 of Article 2 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department interprets sub-item V of Article 23 of Law 9430/96 in a very broad sense. Common corporate control will be deemed to exist whenever the same individual or legal entity, regardless of the location of residence or domicile, is the holder of a shareholder's right in each one of the assumed related parties which assures on a permanent basis preponderance in the corporate deliberations of these companies and the power to elect the majority of its management.[17] Common administrative control will exist when: a) the administrative council president or the director-president of both companies is the same person; or b) the administrative council president of one and the director-president of the other is the same person; or c) the same person is a director, with decision powers, of both companies.[18]

Assuming a transaction falls within Article 23, transfer pricing provisions will apply whether an arm's length transaction has taken place or not. The approach adopted in Law 9430/96 demonstrates that the Brazilian Congress views transfer pricing as a mechanism created by organizations to inherently avoid taxation, instead of applying the OECD's approach which assumes transfer pricing as an economic reality derived from the operations of MNEs. There is a substantial likelihood that the Brazilian approach will conflict with other transfer pricing systems, such as those of the United States which adopt the arm's length principle[19].

[16] Subpart F of the I.R.C. (1997) was enacted to "discourage U.S. taxpayers from using foreign corporations to defer U.S. taxes by accumulating certain types of income in foreign "base" companies in low-tax jurisdictions". RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 250 (3rd ed. 1997), § 957 (a) of the I.R.C. (1997) defines a controlled foreign corporation (CFC) if United States shareholders own more than 50% of the total combined voting power of its stock or more than 50% of the stock's total value. Direct, indirect and constructive ownership are tested in determining whether a foreign corporation is a CFC or not.

[17] Article 2, paragraph 1, sub-item I of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department, D.O.U. of May 1, 1997.

[18] Article 2, paragraph 1, sub-item II of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department, D.O.U. of May, 1997.

[19] The arm's length principle relies in the concept of equal treatment or the neutrality principle. A broad definition of the principle is that prices set for transactions between related parties should not be different from the prices applied in transactions between unrelated parties under similar open market conditions. In the United States there is no explicit reference to the arm's length principle in the IRC. The same "implicit" reference is found in Belgium, France and Norway. Countries that specifically refers to the arm's length principle in their income tax legislation are Australia, Argentina, Austria, Canada, Denmark, Italy, Japan, Spain and the United Kingdom. German, Netherlands and Switzerland developed the principle with reference to transfer pricing. *See* Hamaekers, *supra* note 3.

Law 9430/96 guarantees a minimum revenue insurance for the Brazilian government, and the transfer pricing provisions aim to limit this practice by establishing a ceiling for deductible expenses on imports, a minimum gross income for exports and a safe harbor for interest payment to related parties whenever the loan contract is registered with the Brazilian Central Bank, otherwise a limitation on the deduction of interest becomes applicable.

A. Transfer Pricing On Imports Of Goods And Services

Article 18 of Law 9430/96 limits deductions of expenses and charges relating to goods, services and rights stated on import or acquisition documents up to an amount not exceeding the price determined by one the methods established in the statute. There are three methods to calculate this deduction:

(a) the comparable independent price method (PIC), which defines the transfer price as the arithmetic average of the sales prices for the same or similar goods, services or rights prevailing between unrelated prices. Under this method, the price to be taken into account is the contract price, regardless of the economic circumstances, such as geographical location, market size, governmental regulation, and others described by the OECD in its Guidelines for Transfer Pricing;[20]

(b) the resale price less profit margin method (PRL), which defines the transfer price as the arithmetic average of resale prices of good or rights reduced by discounts, taxes and commissions and a 20% profit margin. Obviously, services transfer prices cannot be calculated under this method;

(c) production cost plus profit margin method (CPL), which includes the average cost of production of similar goods, services or rights in the country where they were originally produced, increased by export-related taxes and a 20% profit margin.

Because there is no "best method rule"[21] under Law 9430/96, the taxpayer may choose any of the methods, and may deduct from the method with the highest transfer price. Also, the 20% mark-up under the PRL and the CPL is not absolute. If the company can prove with substantial technical official and private publications that such a percentage is not compatible with the market reality, then the Minister of Finance has authority to modify it accordingly. However, even when the company satisfies this burden, the Minister can deny the exception and he or she has the authority to push the

[20] OECD Guidelines, Chap. I, Part C(b).

[21] In the United States, the "best method" rule is described in Treasury Regulations § 1.482-1 (c) (1997). Under this rule, the method to be chose must be the one that under certain facts and circumstances gives the most reliable measure of an arm's length result.

mark-up to even higher levels, an approach which does not contribute to create a stable environment for business planning.

Royalties and technical or similar assistance fees are not included in Article 18, and deduction rules pertaining those situations are found in Article 227 of the Income Tax Regulation[22], which still applies the territorial system for income taxation.

B. Transfer Pricing On Exports Of Goods And Services

When revenue arises from exports transactions between related parties, Article 19 of Law 9430/96 establishes that the transfer price provisions will apply whenever the price charged is less than 90% of the average price practiced on the sale of the same goods, services or rights in the Brazilian market during the same period and under the same payment conditions.[23] If the price is less than 90%, then a new price is arbitrated according to any available method.[24] The average price used as a parameter must be made without regard to any tax discounts eventually granted and after the deduction of the freight and insurance charges borne by the exporter.[25]

Similar to the import pricing method, export transfer pricing is done under one the following four methods:

(a) export sales price (PVEx), defined as the arithmetic average of sales prices on exports made by the company itself to other customers or by any other local exporter of identical or similar goods, services or rights during the same period for which income tax is calculated;[26]

(b) wholesale price in the country of destination, less profit margin (PVA), in which the transfer price is determined as the arithmetic average of the wholesale prices in the destination country in unrelated transactions of the same or similar goods, services or rights under similar payment conditions less taxes included in that price and reduced by a profit margin equal to 15% of the wholesale price;

(c) retail price in the country of destination, less profit margin (PVV), the same as the PVA, except that the retail price and not the wholesale price is used in the determination of the arithmetic average, and instead of a 15% reduction in the profit margin, PVV reduces the margin by 30% of the retail price;

(d) purchase or production cost plus taxes and profit margin (CAP), in which the transfer price is defined as the average acquisition or production

[22] Article 227 of the Regulamento do Imposto de Renda approved by the Decreto No. 1.041 on January 11, 1994.

[23] Article 19 of Law No. 9.430, of December 26, 1996, D.O.U. of December, 1996.

[24] *Id.*

[25] Article 19, paragraphs 1 and 2 of Law No. 9.430/96 of December 26, 1996, D.O.U of December 1996.

[26] *Id.* at sub-item I of para. 3.

cost of the exported goods, services or rights plus any Brazilian related taxes or contributions increased by a mark-up equal to 15% of such cost.

The taxpayer can use more than one method, but the lowest transfer price obtained from the application of one these methods will prevail. Finally, Article 20 of Law 9430/96 gives authority to the Minister of Finance also to change the percentages concerning exports.[27] A company may also apply to a particular treatment due to the economic peculiarities of the industry.[28] Ordinance 95 of April 30, 1997 of the Minister of Finance establishes the procedures and cases in which profit margins may be lowered for transfer pricing purposes.[29] Also, Article 30 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department states that the percentages used in the transfer pricing methods, namely PRL, CPL, PVA, PVV, CAP and the 90% ceiling on exports prices may be modified by the Minister of Finance.[30]

C. Transfer Pricing On Interest

Finally, Law 9430/96 regulates transfer pricing on interest by limiting the deductible amount for any interest payment that does not comply with the requirements set forth in Article 22 of the statute. This is a safe harbor provision because it allows contracts registered in the Central Bank to apply the contractual interest. However, if the loan contract is not registered, then the interest payment deduction will be limited to the amount of interest calculated under the LIBOR rate for US-dollar six-month deposits, plus a three percent annual spread, proportionate to the period to which the interest relates.[31] The amounts that exceed the limitation must be added to the company's basis in the calculation of the taxable income. Paragraph 3 of Article 25 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department determines that the exceeding amount must be added to the taxable, presumed or arbitrated profits and to the calculation basis of the social contribution on net income.[32]

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[27] Article 20 of Law No 9.430 of December 26, 1996.

[28] Article 1 of Ordinance 95 of April 30, 1997 of the Minister of Revenue, D.O.U. of May 1997.

[29] Article 1 of Ordinance 95 of April 30, 1997 of the Minister of Revenue states: "The changes in percentages referred to in art. 18, II and III, and art. 19, caption, and sub-items II, III and IV of paragraph 3, all of Law 9.430/96, will be made on a general, sectorial or specific basis via an official notice or in reply to requests of class entities representing an economic sector, as regards transactions involving goods, services or rights of the represented companies, or, in reply to the request of an interested company itself."

[30] Article 30 of Normative Instruction of April 30, 1997 of the Internal Revenue Department.

[31] Article 22 of Law No. 9.430/96 of December 26, 1996.

[32] Paragraph 3 of Article 25 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department.

D. Special Provisions

There are some special provisions of the Brazilian transfer pricing provisions that warrant consideration. First, the similarity concept for the purposes of comparison set in Article 26 of Normative Instruction 38 states that whenever two or more goods (it mentions neither services nor rights) have the same nature and function, and they can be mutually interchanged for the function they are intended, they will be considered similar.[33] Why services and rights were excluded from the similarity concept is unclear and may create confusion when applying one of the transfer pricing methods to services or rights.

Another special provision is Article 24 of Law 9430/96[34], by which the transfer pricing provisions will apply to operations carried out by individuals or legal entities resident or domiciled in Brazil, with any individual or legal entity, even if not related, resident or domiciled in a country which does not tax income or which taxes it at a maximum rate of less than twenty percent.[35] Congress intended to avoid any transaction between a Brazilian company and an entity or individual domiciled in a tax haven. It is important to emphasize that transfer pricing provisions will apply even when the transaction occurs between unrelated parties.

As described above, the concept of transfer pricing has an economic basis and refers essentially to transactions between related parties. To extend transfer pricing provisions to transactions between unrelated parties denotes a gross misreading of the concept, and will certainly create problems. For instance, it is difficult to determine whether the price allegedly transferred would be different in other transactions between other unrelated parties. What about the circumstances underlying each transaction? How to presume that a transaction with a company domiciled in a tax haven has an inherent tax avoidance purpose? These and other questions will certainly emerge and hopefully will foster modifications in the statute.

Finally, Article 28 of Normative Instruction 38 is worth noticing. This provision is a safe harbor provision for prices transferred in export operations aiming to enter new markets.[36] In this case, if a Brazilian company is trying to enter new markets, it may price its goods, services or production rights at less than the 90% of average prices practiced in Brazil. The rationale for such a provision is to encourage Brazilian exports to new markets,

[33] Article 26 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department.

[34] Article 37 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department also address this issue.

[35] Article 24 of Law No. 9.430/96 of December 26, 1996.

[36] Article 28 of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department.

by considering the costs incurred by businesses to make their products known in a new market.

However, there are some requirements that must be fulfilled by the company. First, the goods, services or rights exported must be effectively entering the new market for the first time.[37] If the exporting company or any other related to it, located in any part of the world, has exported to this new market, then Article 28 will not apply. Second, the goods, services or rights must be resold in the destination country at a price less than that of any identical or similar goods, services or rights.[38] Third, the price must be demonstrated in an export plan approved by the General Taxation Coordination System (COSIT).[39] Fourth, it must be shown that the related company domiciled in the country of destination will not make any profit on these operations, and that if losses are expected for the company in Brazil, the expected term for their recovery must be demonstrated.[40] All four conditions must be met in order to Article 28 be applicable.

It is interesting to note that where the exporting company, which fulfills all the requirements set out in Article 28 of Normative Instruction 38, is trying to enter a new market that does not tax income or that has a tax lower than 20%, there is a conflict with Article 24 of Law 9430/96. In this case, Law 9430/96 would very likely prevail because it is above the Normative Instruction in the legislation hierarchy.

III. CONCLUSION

In sum, the fact that Law 9430/96 concerning transfer pricing is rather new may account for the statute's inconsistencies. This first attempt from the Brazilian government, however, is part of an ongoing modernization process, as described above. Small adjustments would suffice to create a strong legal framework that would encourage not only international trade, but sound economic practices such as to transfer prices.

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[37] Article 28, sub-item I of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department.

[38] Article 28, sub-item II of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department.

[39] Article 28, sub-item III of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department.

[40] Article 28, sub-item IV of Normative Instruction 38 of April 30, 1997 of the Internal Revenue Department.