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Brazil Relaxes Barriers to Disputing Set Margins; Treaty Negotiations Stall
By Molly Moses and Ed Taylor, *BNA Daily Tax Report*

Transfer pricing practitioners laid out the numerous challenges of operating in Brazil during a Webcast Oct. 16, even as the country's tax department announced a relaxation of the rules covering company challenges to profit margins set by the government.

Meanwhile, Catherine Schultz, vice president for tax policy at the National Foreign Trade Council in Washington, D.C., said Oct. 14 that treaty negotiations between Brazil and the United States are at a standstill.

Unless Brazil is willing to change its laws to permit transfer pricing and the competent authority process, Schultz said, "there's really no reason to continue discussions with them." She added, "I see no signs of that happening."
While Brazil is not a member of the Organization for Economic Cooperation and Development, it has the same "enhanced engagement" status as China and India in that it is working toward membership in the organization.

For inbound related-party transactions, the country generally requires use of the resale-minus method, which imposes profit margins of 20 percent for direct resale and 60 percent for the purchases of inputs and raw materials. For exports, the cost-plus method is used, with a set margin of 15 percent.

Because no treaty exists with the United States, the competent authority process is not available. However, the countries signed an information exchange agreement in March 2007 (62 DTR I-1, 4/2/07).

Fixed Transfer Pricing Margins.

Cristina Medeiros of PricewaterhouseCoopers in Sao Paulo, speaking at a Webcast sponsored by her firm, said that as well as imposing fixed markups, the tax laws prohibit the use of profit-based transfer pricing methods and require methods to be applied on a product-by-product basis. Advance pricing agreements are not available, and a 75 percent penalty applies for failure to adjust transfer prices to within the specified percentages, she said.

Normative Ruling 222, published in Brazil's official gazette Sept. 26, allows companies to demonstrate that the fixed transfer pricing margins are incorrect by using examples of trading operations between themselves and unrelated firms. If they do not have such operations, they may present examples of trading operations similar to theirs but between two other, unrelated firms.

According to Carlos Ayub of Deloitte Touche Tomatsu's Brazilian subsidiary, Norm 222 is more flexible than the norm it replaces. He noted, however, that the

norm also prohibits companies from appealing denials of their challenges within the administrative structure of the tax department.

Norm 222 revokes Normative Ruling 95, which was adopted in April 1997. A series of tax department rulings between 1996 and 1997 gave tax officials broad latitude to determine what documents and proof companies must submit in disputing fixed margins.

While Law 9430 of 1996 ostensibly permits those challenges, only two have been filed since 1997, and both were rejected. The first ruling took four years.
Audits.

With the country's specialized tax auditors located only in Sao Paulo, Medeiros said 40 companies there have been audited in 2008, resulting in $3 billion in adjustments and approximately $2.6 billion in taxes, interest, and penalties. Chief targets for transfer pricing examinations, which currently involve 2003, are those in the pharmaceutical, automotive, and electronics sectors, she said.

Medeiros said issues commonly challenged by the tax authorities include:

- failure to present transfer pricing documentation or to choose a method;
- failure to properly back up the method chosen;
- an assumption of differences in inventory due to deficient controls; and
- calculation of a transfer pricing method contrary to regulatory norms.

Several of the assessments related to the use of Normative Ruling 32, which was revoked and replaced by Normative Ruling 243 in November 2002, Medeiros said.

Change to 60 Percent Calculation.

Norm 243, among other provisions, changed the application of the 60 percent margin under the resale-minus method, requiring importers of goods used in production processes to have an actual, effective gross profit of at least 60 percent on the raw materials' participation in the sale price of finished goods. This requirement results in gross profit margins substantially in excess of those effectively achieved by Brazilian companies that import from related parties.

Medeiros said most taxpayers are calculating the resale price method in disagreement with Norm 243, arguing that it is more restrictive than, and thus contradicts, Law 9430 of 1996. Norm 243 was intended to apply for year 2002, but because it caused in a higher tax burden for taxpayers, the authorities put off that aspect of the ruling until 2003, she noted.

“I would say companies have been widely calculating the resale-minus method based on [Norm] 32,” she said. The tax authorities are challenging these

interpretations, she said, and with 2003 currently under audit, “we will have results from that probably two or three years from now.”

Documentation.

As of Jan. 9, taxpayers under audit will be required to submit transfer pricing documentation data electronically to the Brazilian Federal Revenue “on a regular basis” using the Data Generator Program of the International Audit Systems, according to Medeiros. While she said the automated procedures are expected to be in place by November, some of the pilots “have not worked out very well.”

The electronic requirements were issued in conjunction with documentation penalties in May 2007. Those penalties—which apply for a lack of documentation, incomplete documentation, or failure to meet submission deadlines—are:

- 5 percent of the operation amount in the case of incorrect or omitted information, limited to one percent of the company's annual gross revenues; and
- 0.02 percent per day for failure to provide the electronic files by the deadline, limited to one percent of the company's annual gross revenues.

Those penalties are distinct from the 75 percent penalty for companies that fail to adjust their transfer prices to within margins.

Medeiros, asked about the consequences for a taxpayer that failed to complete the transfer pricing section of its annual income tax return, said the omission by itself would not incur a significant penalty. However, she warned that tax inspectors could have difficulty understanding or “cross-matching” the taxpayer's information with the tax return data, which “would not help in the case of a tax audit.”

Practitioners have said they expect the electronic requirements will cause a significant increase in the number of transfer pricing examinations and tax assessment amounts.

Detailed Report Recommended.

Medeiros recommended compiling a detailed transfer pricing report before the initiation of a tax audit. The report, she said, should include:

- an inventory of intercompany transactions;
- the method selected and detailed information on the assumptions considered;
- a computation of the average annual information for both benchmark prices and import and export transactions;
- a reconciliation of the computation information with books and records;

- a compilation of documents backing up the computation, such as proof of foreign costs, foreign invoices, and a depreciation charge calculation; and
- a report from third parties certifying the costs of products imported and exported.

A PwC survey of participants in the Webcast indicated that 13.6 percent maintained no documentation for their Brazilian operations. Another 25.6 percent said they maintained a “foundation level,” while 21.6 percent responded that their companies maintained in-depth transfer pricing documentation.

Tax Havens.

Nelio Weiss, also of PwC's Sao Paulo office, said a new provision—Law 11,727 of 2008, which takes effect Jan. 1, 2009—will broaden the definition of a tax haven to include countries or dependencies that:

- do not allow access to share ownership or information on the beneficiary of earnings;
- grant tax benefits without requiring substantial economic activity or make benefits contingent on a lack of economic activity;
- impose tax of up to 20 percent on earnings generated outside their jurisdiction; or
- do not allow access to information related to the ownership of shares, goods, rights, and information on economic transactions.

Previously, Brazilian law considered countries to be tax havens if they did not tax income or if their maximum income tax was under 20 percent.

The law applies Brazil's transfer pricing legislation to all “privileged fiscal regimes,” an enlarged concept of tax havens that is expected to include the U.S. state of Delaware as well as the country of Uruguay (126 DTR I-3, 7/1/08). Tax officials have said they will issue a revised list of tax haven countries and regions under the expanded definition by the end of the year.

Cost Sharing.

Turning to cost sharing, Pena relayed a question from a Webcast participant about whether the tax authorities would approve such an arrangement—for example, in the case of a worldwide group implementing a software system.

Medeiros said cost sharing, which is not covered in Brazil's regulations, would need to be assessed on a case-by-case basis, but also noted that the arrangements do not require specific preapproval from the authorities.
Pena noted that the question of how to allocate costs from shared service centers has become increasingly common as those centers have proliferated. Often, he said, not all of the countries come online at the same time.

"If you put in a very simplistic formula to allocate costs across the world, and it turns out the benefit is not aligned in the same fiscal year, you may experience significant risk of nondeductibility," he warned.

On the other hand, he said, if several large countries are rolling out the system first, "maybe you have a cost sharing arrangement between those countries, and you treat everybody else as a recipient of services when they get the service." Under that approach, he said, the smaller countries "don't have ownership of the technology, they simply pay for the service with an incremental cost."

Comparable Transactions.

Juan Carlos Ferreiro of PwC in Buenos Aires, when asked whether Brazilian authorities would accept comparable transactions from other Latin American countries, said he had succeeded in using non-Brazilian comparables in the automotive industry. "The comparison should be established according to Brazilian parameters, but it can be used," he said.

Medeiros, asked about Brazil's acceptance of prior-year information, said it was permissible, with adjustments, "to the extent we can prove there is no current-year information available."

Weiss, asked whether he thought Brazil ever would allow profit-based methods, said the tax authority in the past contended it did not have enough personnel with the technical skills to conduct the appropriate economic analysis. However, "the fact is these regulations have been out there for 11 years now and they haven't been able to come up with the necessary technical skills, so I don't think that justification is the real one," he said.

Weiss predicted that if the authorities were to allow profit-based methods, they, like the current methods, would contain restrictions.

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