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"TRANSFER-PRICING RULES IN BRAZIL"*/

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TRANSFER-PRICING RULES IN BRAZIL

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Introduction

Transfer pricing is one of the most controversial tax issues of the 90's. In recent years, restrictions on international trade and investment have been eased and in some cases barriers have been removed altogether. The globalization of the economies has provided multinational enterprises (MNC's) with increased opportunities to minimize tax payments by allocating their net income among domestic and foreign entities. National governments have become increasingly concerned about protecting their domestic tax base from this arbitrage.

Manipulation of transfer prices is possible only within a multinational organization and in the absence of arm's length markets for the commodities in question. The economic problems caused by improper transfer pricing practices are of three kinds: misallocation of resources and distortion of the pattern of economic activity, evasion of foreign exchange controls, and erosion of the tax base. However, the transfer pricing legislation enacted by the governments have been essentially concerned with the last problem. As the countries become capital importers, legislation tends to become more protective of their tax bases, and capital exporters react accordingly.

The United States has been particularly zealous in this area, as the country has shifted from being primarily an exporter of capital to being a net capital importer. The US transfer pricing rules are the most complex in the world and have set the pattern for other legislation. To prevent a general statism of the MNC's transaction procedures, the OECD has been working for several years to achieve an international consensus on transfer-pricing rules. The international consensus has been constructed around the arm's length standard. This standard is recognized in Article 9 of the OECD Model Tax Convention and allows for the re-allocation of profits which would be earned by one enterprise within a group of associated companies but for any special conditions that would not apply as between independent persons. The adoption of rules which are inconsistent with this standard and which were not accepted by other countries, would cause the possibility of economic double taxation, increasing uncertainty for the business community with a consequent disruption of trade.

This report will present the current situation of the Brazilian rules regarding transfer-pricing practices. Before that, some stylized facts about the MNC's international trade will be presented to underscore the fiscal relevance of this subject. The last part is critical regarding

* I acknowledge the helpful comments on the Brazilian legislation and tax figures provided by Luis Carlos Viana, Murilo Rodrigues da Cunha, and Marcos Vinicius Neder. As always, I am the sole responsible for the mistakes.

the Brazilian way of dealing with this matter. The conclusion points out some ideas to help implementing the transfer-pricing legislation in the country.

Some Stylized Facts about MNC's

Tax policy philosophies differ a great deal in the international context. There is a major philosophical difference between the US and the European tax policies. The fiscal harmonization process within the EEC has led to an increasing reliance on the value-added tax and small emphasis on other forms of corporate taxation. Export sales are exempt of VAT and the tax paid on domestic input purchases for the production of export goods may be claimed as a credit against tax payable on domestic sales. Capital cost allowances are more generous in the EEC than in the US, and the tax enforcement is laxer in the EEC. Under these circumstances, the incentive to understate transfer prices on exports or to overstate them on imports is non-existent for European firms involved in transactions with the US.

On the other hand, the US tax policy is concerned with the fact that foreigners should bear their fair share of taxes. If foreign companies do not make a suitable contribution to the US Treasury, Americans are prepared to forgo the transactions. As an example of the sentiment that foreigners are not paying their fair share, President Clinton's campaign plan -- Putting People First: A National Economic Strategy for America -- proposed a \$220 billion federal spending package over four years. The package would be partially financed by additional taxation: \$92 billion from wealthy Americans, \$13 billion from US corporations, and \$45 billion from foreign MNC's by tighter enforcement. This plan triggered a worldwide question: will Clinton's plan lead to a global tax war?

The great majority of the Less Developed Countries (LDC) do not take part in the process of controlling the MNC's income allocation. Their trading patterns are governed essentially by quotas and exchange controls rather than by tariff or tax incentives. Most are eager to industrialize and quite willing to forgo tax revenues to secure manufacturing exports. Since most of these countries experience the growth constraint from the external sector, they are essentially concerned with import and export prices. Controlling international transaction prices is difficult in the case of some products where no significant free market exists, moreover in the case of intangible goods.

The philosophical difference prevailing among the More Developed Countries (MDC) has caused the EEC countries and Japan to react to the US regulations basically through political negotiations. LDC countries are not in the game, and chances are that MNC's would prefer to shift income to the more developed countries to prevent the risks of income adjustments and penalties in the MDCs.

The American sentiment that MNC's are not paying their fair share in taxes is sustained by indicators about MNC's transactions, declared income, and some conflicting figures about the amount of tax foregone. Hipple (1995) indicates the following evolution of the US-operating MNC's international trade from 1975 to 1989:

MULTINATIONAL COMPANIES INTRAFIRM TRADE AND US TOTAL
 MERCHANDISE TRADE
 1975 - 1982 - 1989
 (Billions of Dollars)

	1975			1982			1989		
	Export	Import	Flow	Export	Import	Flow	Export	Import	Flow
Total US	109.2	96.6	205.8	216.4	243.9	460.3	363.8	473.2	837.0
All MNC Trade	58.9	53.6	112.5	111.9	130.8	242.7	182.4	259.2	441.6
All MNC Intrafirm	41.6	42	83.6	71.5	93.5	165.0	123.8	207.2	331.0
Non-US MNC intrafirm	12.8	20.7	33.5	25.0	52.0	77.0	34.3	130.0	164.3

Source: Hipple 1995.

The row labeled All MNC Trade includes all MNC international transactions, and the intrafirm row excludes the transactions between the MNC's and independent companies. The share of the MNC's in the US-merchandise trade flow has decreased from 54.7 percent in 1975 to 52.8 percent in 1989. The intrafirm trade share has decreased as well, but it represents, in 1989, a significant 39.5 percent of the total flow. Only the foreign-based MNC's increased their share from 16.3 percent in 1975 to 19.6 percent in 1989.

When the figures for the intrafirm trade share is compared with the IRS report for 1989, which states that all US firms reported net income equal to 3.1 percent of total receipts, but foreign firms doing business in the US reported net income of only 0.9 percent of total receipts, the sentiment of unfair share in tax payments of the foreign companies is fueled.

To make the fiscal paranoia worse, one can find all sort of estimates about tax evasion originated from transfer pricing in the US economy. In 1989, the Commissioner of Internal Revenue estimated that the US could collect \$3 billion per year. Hufbauer and Van Rooji (1993) estimated some \$6 billion annually. President Clinton's campaign figures on the MNC's additional income tax was some \$9 to \$13 billion per year. John S. Zdanowicz (in Boston Globe, April 1994) estimated that lost taxes in 1992, related to transfer pricing practices, amounted to \$28 billion. The wide range of revenue estimates in the United states has stimulated a very complex and somewhat protective transfer-pricing legislation. The 1992 initiative of Congressmen Dan Rostenkowski (D-IL) and Willis Gradison, Jr. (R- OH) which seeks to establish a minimum taxable income level for foreign firms doing business in the US, conflicts with the international recognized arm's length standard. In the same vein,

the provision about the profit split approach in the Section 482 Final Regulations has provoked some strong complaints from the Europeans.¹

This sort of question is at the core of the international dispute about income allocation. Those favoring the profit split method would point out that article 9 of the OECD model treaty requires only the allocation of profits, not the establishment of prices for transactions. It is not clear, though, whether article 9 refers to all profits or just profits from particular transactions. The problem with the profit split approach is that it is often inaccurate because it fails to deal with the underlying reasons for the profitability of a corporation.

Some other important technical issues are integrating parts of the dispute, standing on the elegant side of it. One such issue is very basic: should transfer-pricing rules be regarded as anti-avoidance rules or as basic income measurement rules? If they are anti-avoidance rules, they need only be applied in cases involving abuse (tax havens). This proposition is mostly sustained by the net capital exporting countries. If they are basic income measurement rules, they apply in every case where there are controlled transactions. Another issue is the periodic adjustment of royalties, as defined in the US-final regulation. Some experts say that periodic adjustments are inconsistent with the arm's length principle. Others say that it is appropriate since arm's length parties would have provided for a variable royalty. It is also disputed whether, in a functional analysis of the respective contributions of the members of a MNC, the functions assigned should respect the legal relationship between the parties or whether the functions can be assigned on some other basis. The capital importing countries tend to support the last proposition.

The international dispute about income allocation is tough, and technically sophisticated, where the major objective, unfortunately, seems to be the excessive protection of the tax bases. This objective may start a tax war among countries, leading to an international double taxation, and to what LDC countries are more concerned with: a stimulus to MNCs to shift their declared income away from LDCs.

To fight without bounds for the share of the income originated from the MNC's intrafirm transactions is not an *arm's length posture*. Future developments may lead either to a global tax war or to an improved process of international cooperation. The first scenario is associated with some arbitrary set of rules. The international cooperation scenario is associated with the same income maximization goal, but with the restriction of a fair international division of income, according to the arm's length standard. Countries with arbitrary transfer-pricing rules which view MNC's as public enemies and try to tax their supposed hidden incomes are bound to a collision course with all other foreign tax authorities, not to mention the undesired consequences on income allocation and on international trade.

¹ For example. Association Of German Chambers of Industry and Commerce and Federation of German Industries . Letter of October 28. 1994. to Mr. Jeffrey Owens (Head of OECD Fiscal division). Comments on OECD Transfer Pricing Guidelines. Intertax. 1995. 2. -- "... We reject all attempts to establish profit comparison or profit split as methods of transfer pricing".

Brazilian regulations and Transfer Pricing

Transfer Pricing is a concept not present in the Brazilian tax legislation. The Brazilian legislation provides some guidance concerning the export and import price controls, and the income tax law has some provisions on related parties. However, internationally accepted transfer pricing principles are not applied, and as a result, ad hoc mechanisms are provided for determining transaction prices without comparable market prices. To some extent, the Brazilian tax rules are contrary to such principles, which is best exemplified by the blocking of certain intercompany payments (royalties).

Export and Import Price Control.

Export and Import prices are monitored by the Foreign Trade Secretariat of the Industry and Commerce Ministry (SECEX). Import prices are also monitored by the Internal Revenue Secretariat of the Ministry of Finance (SRF).

The price control carried out by SECEX is set to prevent capital flight. All merchandise exports are registered at the SISCOMEX, which is a computerized system to control all export transactions, not operational for imports yet. Unit prices are compared to some reference prices. Usually, these prices are obtained from stock exchange, special publications and an average of previous year prices.

SECEX is in charge of issuing export and import licenses. The SRF is in charge of collecting the import taxes. In practical terms, the SRF is not supposed to accept the invoice value of imports for tax purposes that differ from the value licensed by SECEX. Whenever the invoices differ from the licensed transaction value, importer has to obtain an additional license from SECEX.²

Brazil has accepted the terms of the article VII of the GATT convention, since 1986 (Decree 92 930). The Internal Revenue Secretariat (SRF) is in charge of assessing the import prices for tax purposes. The Decree endorses six alternative methods, to be applied whenever the transaction is carried out by independent parties. When the transaction is between related parties, the transaction will be accepted only if certain aspects prevail: i) the transaction price must be observed in transactions between independent parties and between the same countries; ii) re-sale price or cost-plus methods; and iii) comparable uncontrolled price, when comparing to a similar product, which is manufactured in a different country.

In practical terms, however, the SRF has not been able to comply with the legislation, and the first article of the GATT convention resulted to be the only applicable method ("Imports

² On exports, SECEX controls 13.000 prices (using SISCOMEX), being 127 prices controlled in advance, according to well known price list (automobiles, electronic products, commodities, ect). Export licenses are automatically issued when exporters register the transactions in SISCOMEX. Should the registration prices differ from listed prices, the registration is not accepted. On imports, it is estimated that SISCOMEX will be operational as of January 1996. Among other functions, SISCOMEX will control prices of the so-called sensible products (pharmaceutical products, fire-arms, and other appointed products).

will be assessed according to the effective transaction price, that is, the price to be effectively paid".) The truth is that the SRF has not been able to apply the methods specified in the legislation. The related import price control routine is non-existent, since the prevailing price is the invoice price. The testimony of a SRF's employee about the SRF procedures implicit in the legislation is worth noting: "The issuing of such a legislation on price control has resulted in a big trap for us."

Income Tax

Brazil has signed double taxation treaties with 23 countries, in accordance to the article 9 of the OECD Model Tax Convention. It is interesting that the special provisions on paragraph 2 of that article, related to profit adjustments, have not been accepted by the Brazilian authorities, which cast some doubts on the full effectiveness of such treaties. The treaties should also correspond to an improved process of international information exchange, but in practical terms Brazilian authorities have not developed such channel of information, and the gathering of external information has been dependent on fortuitious answers.

The income tax legislation includes a provision on the so-called disguised profit distribution. The disguised profit distribution takes place whenever the transactions between related parties result in prices that are not market prices. In such occasions, the income is properly adjusted and the tax payer has the burden of the proof.³

Payments of royalties and technical assistance are not fully deductible. Some restrictions apply: i) it is necessary to prove that the service existed and that the payment was made; ii) the deductibility is restricted to the first five years since the beginning of the service; iii) Service contracts must be registered and accepted by the National Institute of Industrial Property (INPI) and the Central Bank, iv) the maximum amount to be deductible is restricted to 5 percent of the company's net income. The Minister of Finance may change the 5 percent cap according to specific circumstances and the high technology industry, including some capital good producers, may deduct 10 percent. Royalties and technical assistance payments remitted abroad are taxed at the 25 percent rate.

Profits and dividends remitted abroad are taxed at the 15 percent rate. However, these remittances will be tax exempt when the tax bill, now in Congress, is approved.

External loan contracts must be registered at the Central Bank. Should the interest rate prevailing in the contract differ from the international market rate, the Central Bank may not accept the contract. Such remittances are taxed at the 25 percent rate.

Information about income adjustment for transfer pricing reasons is not available, but the auditing effectiveness is very low, due to several reasons such as auditing improper procedures, legal requirements, etc. The effectiveness of the income tax audits can be evaluated by the collected-adjusted income ratio, as follows:

³ Related parties are: Partners or stockholders, managers, and relatives of all those related to the company's administration or control.

Corporate Income Tax Audits: Adjusted and Collected Income - 1994.

(US\$ million)

INCOME TAX EFFECTIVELY COLLECTED - TOTAL (A)	ADJUSTED INCOME TAX (1) (B)	EFFECTIVELY PAID FROM THE ADJUSTED INCOME TAX (C)	SUCCESS RATE (C)/ (B) (%)
4,190.0	8,007.0	63.4	0.8

SOURCE: SRF

(1) Fines, penalties, and interest are included.

The government has not been able to enforce the existing income tax legislation. Managerial, procedural, and legal inconsistencies account for the problems. In 1994, the SRF has worked on some 41 800 income tax audits (including non-corporate audits), and the above measured success rate is only 0.8 percent. Insofar as this rate relates to the whole income tax legislation, one may conclude that, even though the legislation is a necessary requirement, it will certainly be the least important part in the process of coping with the international transfer pricing problem. This low success rate is at the root of the government officials lack of interest in implementing the transfer-pricing monitoring process. In the words of one government official: "...What implement this transfer pricing thing for? We know we won't be able to manage it. We don't have enough trained personnel, nor a proper legal environment. The succes rate (collected-adjusted income ratio) will be low for sure, and people will call us dumb and lazy."

A critical view on the Brazilian Scenario

The underlying principle of the existing legislation on related trade cannot be characterized as arm's length principle. The price control imposed by SECEX on exports (and on imports in the future) is not even accepted in the Brazilian courts. In practice, SECEX has no choice but to issue additional licenses whenever the invoice transaction price differ from the one originally registered at SISCOEX. On the other hand, restrictions on royalty payments are determined by law (law 3470/58, article 74 and 4131/62, article 12). To bypass such restriction, enterprise can make use of the so-called CC5, which is a non-resident current account in the commercial banks. In fact, CC5 was implemented by the Central Bank as a first step to deregulate the capital account of the balance of payments. In practice, anyone can make a deposit in such account to pay "other expenses" abroad. If the company has the proper documentation for these "other expenses" the SRF inspector must accept it as deductible. Should the inspector deny the validity of the document, the courts would revert the result in favor of the company.

The legal constraint is the key determining factor in the auditing failures. The Brazilian legal system abides by the traditional Latin principle, according to which no reasonable economic evidence is sufficient to impose a penalty, if such fact or evidence is not described in the law. In this system, the jurisprudence does not make the law, but it is just a source for the law. Accordingly, any and all legal procedure must be described in the law. The transfer-pricing legislation is supposed to be comprehensive, and to include the evaluation methods as well. The restriction imposed by the legal principle is burdensome and pushes the legislator into the defensive side of the regulations. Differently from the Anglo-Saxon countries, transfer-pricing control in Brazil will tend largely to depend on legal interpretations.

Brazilian fiscal authorities have already taken some initiatives towards regulating transfer pricing. A SRF's Normative Instruction 39, issued in 1994, defined the so-called Valuation Centers, which would be a specialized center to analyze import and export prices, in special circumstances. In addition, a government workshop, in August 1995, reached some conclusions about a preliminary project of a transfer-pricing law. For some reason, both initiatives were not implemented. These initiatives led to comments and suggestions about both projects, and one can perceive from those comments the defensive nature underlying the proposals. SRF's officials tend to see the transfer-pricing regulation essentially as a fiscal protective device against the foreign enemy. Apparently, this is cultivated by the above mentioned legal principle that imposes an excessive defensive culture on those in charge of the monitoring tasks, including the necessity of showing a high success rate as the major indicator of an adequate performance. The culture which implies that the SRF efficiency should be measured according to the amount of fiscal proceedings is prejudicial to the launching of a transfer-pricing regulation in a globalized economy. This is so because whenever the arm's length standard becomes internationally enforced, no income adjustment for taxation purpose will take place. The launching of the legislation is needed in every economy to generate this sort of steady-state. The transfer-pricing control mechanism is not of an exclusively domestic concern. Should the defensive culture continue to prevail in the future transfer-pricing legislation, the country will be bound to an international litigious scenario and the MNCs to double taxation.

Conclusion: Some suggestions to implement a transfer-pricing legislation in Brazil.

The Central Government has reduced its appetite for the income tax revenue, and the income tax has lost its importance as a fiscal policy instrument. According to the 1988 Brazilian Constitution, the Central Government must split all the income tax proceedings with the local governments. Because of that, the fiscal policy has strengthened the legislation and inspection onto other non-transferable taxes. In the period 1985-1988, the income tax represented 4.9 percent of GDP, in 1990 it reached 4.63 percent, decreasing since then to 3.6 percent in 1994. On the other hand, other taxes (non-transferable) increased from 1.0 percent of GDP in 1990 to 1.87 percent in 1994. The overall tax burden went up from 23-24 percent in the first period to 28 percent in 1994.

The diminished importance of the income tax in terms of the fiscal policy has certainly something to do with the lack of interest of government officials on the transfer-pricing

legislation. Therefore, the first and essential condition to implement a transfer-pricing control routine in Brazil is the political definition about the subject. As of 1995, such a definition cannot be perceived, and in fact one can blame the lack of political decision as the reason why the mentioned feeble initiatives of monitoring transfer prices have been discontinued. To stimulate the political decision, the multilateral development agencies should promote seminars on the subject, in Brazil and abroad, oriented toward congressmen and top government executives. The subject is to a large extent still virgin in Brazil.

On the operational side, the following measures would be useful:

1) To set a study group to analyze the transfer-pricing regulations applied in the MDCs, specifying, among other things, the major experienced problems in terms of implementation, control, and international dispute. In addition, the SRF should set up a basic data base on intrafirm transactions through a census of the MNCs.⁴

2) To promote an institutional reform to concentrate in the SRF all the information referring to intrafirm transactions, specially those related to the financial transactions that are presently under the supervision of the Central Bank.

3) To reorganize the SRF to create an international division, which would be the responsible unit for the transfer-pricing control. Accordingly, this division should have a low start to prevent the usual despair caused by the mismatch between the amount of resource allocated to the division and the associated return in terms of income tax proceedings. For example, the SRF's international division should start working with the 30 biggest MNCs exporters (information on importers was not available). These companies are distributed in 8 economic sectors: Mining, oil, steel, automobile and parts, food, paper, capital goods, and tobacco, and represent some 31 percent of total exports in 1994. If in the beginning, let's say for the first 2 years, each pair of employee can take care of 3 companies, within the same economic sector, the division would start with 20 transfer-pricing inspectors. Since the learning by doing component comes with the job, the scale 2-to-3 can be augmented after few years, resulting in the reduction of the operational costs.

4) To proceed a thorough training program, emphasizing the importance of the arm's length standard and the related methods.⁵

5) To negotiate with the judicial branch a proper legal framework, aiming at transferring the bulk of the legislation to the SRF's normative instruction level, avoiding the necessity of a law each time the regulations are change. This is certainly a very difficult step.

In sum, the globalization of the Brazilian economy will make it explicit the need of a transfer-pricing regulation. A freer worldwide capital market has to a some extent been

⁴ Following the examples of other studies developed in the MDCs. in October 1995. ECLAC has contacted several MNCs operating in Brazil in order to gather information on transfer pricing. A specific questionnaire was prepared for this purpose. and presented to the companies. As of December. none of the contacted companies had answered the questionnaire.

⁵ The U.S.-IRS offers specific training program for foreign government officials.

compensated by a tighter fiscal control in the MDCs. The majority of the LDCs are more concerned with the control of the foreign exchange flow. The sophisticated international capital market has shown that the so-called capital flight is somewhat inevitable whenever the macroeconomic scenario lights up the red sign. On the other hand, capital importing countries came to understand that, given the increasing importance of the MNCs in the world output, the monitoring of the international income allocation outruns that of the foreign exchange. The consequent problem, however, has been the over defensive trend of the transfer-pricing regulations concerning fiscal revenue. The MDCs have negotiated this problem on the grounds of the OECD principles. Notwithstanding, LDCs have been at large of such negotiations, mainly due to the lack of an enforceable arm's length regulation.

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