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Transfer Pricing in Brazil: Timing is Everything

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Now that Brazil has officially shifted to a TP system largely consistent with the OECD Guidelines, MNEs operating in Brazil should quickly work to analyze and carefully document their Brazil operations for TP purposes—and try to minimize year-end TP adjustments, say KPMG practitioners.

On January 1, 2024, Brazil—one of the world’s largest economies—officially shifted from its traditional, formula-based transfer pricing system to an arm’s length standard largely consistent with the 2022 OECD Transfer Pricing Guidelines (OECD Guidelines). This significant shift from the previous system, which relied upon Brazil-specific transfer pricing methods based on standard fixed gross margins or mark-ups, has left many taxpayers grappling with the implications. While taxpayers had the option to apply the new rules to the 2023 taxable period, most taxpayers opted for the mandatory adoption in 2024 and – while the adoption started January 1, 2024 - are currently in the process of understanding the functions performed assets used and risks assumed by their Brazil operations to apply this new transfer pricing regime. Many are finding that the adoption of the new transfer pricing regime will mean a significant change in 2024 to the overall profitability of multinational enterprises (“MNEs”) operating in Brazil. A critical question from these taxpayers is if the Brazilian Tax Authority (“Receita Federal do Brasil” or “RFB”) will accept their approach and results.

Complications have also arisen from 2023 early adopters regarding, for example, complexities of making year-end adjustments related to the quarterly calculation of the corporate income tax as well as restrictions by the foreign exchange regime. Given lessons learned from these early adopters, it seems prudent for companies that haven’t firmed up their 2024 analyses, to advance the work quickly to understand and document their Brazil operations and adjust transfer prices, as needed.

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Current Status of Change

The final bill to adopt the arm's length standard was approved on June 14, 2023. While the bill contained details on the overall approach, questions remained about how the underlying regulations or "normative instructions" would be written and how the RFB would interpret these rules. Taxpayers received some input from the RFB in September 2023, when the first set of final normative instructions were published. Normative Instruction 2,161/23 included details on:

- The types of transactions subject to transfer pricing analysis (including transactions involving intangibles, cost sharing agreements, business and corporate restructuring);
- The definition of a related party (Brazil has a broader scope of related parties than the Model Tax Convention or OECD Guidelines);
- How taxpayers should perform the accurate delineation of controlled transactions and the comparability analysis;
- The various methods (which align with the OECD Guidelines);
- Circumstances in which the controlled transaction might be recharacterized or disregarded (Brazil included the possibility of disregarding the transaction if it lacks a non-tax business purpose);
- Simplification measures for low value adding services;
- How and when taxpayers can make transfer pricing adjustments; and
- Requirements for transfer pricing compliance/documentation and related penalties (including simplification measures depending on the total value of controlled transactions).

Three interesting facets MNEs have been grappling with that differ from how transfer pricing regulations are often interpreted in other countries are as follows:

1. Treatment of external comparable companies with losses: the normative instructions note that when analyzing multiple years of data with external comparables, no comparables should be used that have more than one year of losses or those that have losses across the multi-year period. This has clear implications for taxpayers that apply the transaction net margin method (TNMM) and will have an impact for taxpayers that use regional comparable sets.

2. Country-risk adjustment: the normative instructions have a clear preference for the use of domestic comparables; however non-domestic comparables can be used as long as any certain adjustments are performed. The normative instructions provide an example of how one could perform such an adjustment by using a country risk adjustment factor (the difference of country risk premium of the comparable and the Brazil tested party) to the capital employed by each comparable. This adjustment would be added to the operating profit of each comparable company -- adjusting upwards the selected profit level indicator if the set contains US companies.

3. Independence filter: Brazilian tax authorities require the application of an independence filter that excludes external comparables with a participation percentage of 20%. Only in cases in which a number of less than four comparables is identified as a result of the combination of all appropriate filters, will the use of a 25% independence criteria be allowed.

Since the September normative instructions, taxpayers have been waiting for the RFB to issue more details on commodities, intangibles, restructurings, advance pricing arrangements (APAs), financial

transactions and possible simplification measures, including the implementation of Pillar 1 Amount B for distributors.

It is expected that a new normative instruction will be issued over the summer or fall, providing not only more details regarding the particular transactions, but also some adjustments to the normative instruction currently in force, mainly related to operational transfer pricing.

How Will Taxpayer's Support Their New TP?

A key question for taxpayers is how to support their new transfer prices. For many, the adoption of the new rules means a significant reduction in the profitability in Brazil or even the restructuring of the activities performed locally. How will taxpayers explain this to the government?

1. Standard compliance/documentation: The first compliance requirement is the Transfer Price Return as part of the electronic corporate income tax return ("ECF") which is due by end of July for the preceding year. The annexes X360 – X375 require the taxpayer to provide not only qualitative information on restructurings and the application of the low-value adding services simplification measure but also extensive transactional information by transaction partner that include segmented P&L and benchmark ranges. Early adopters urgently need to verify the status of preparation of the annexes X360 – X375.

In addition, and following the international mainstream, Brazil taxpayers will need to prepare a Master File and a Local File in addition to the country-by-country report adopted in 2016. These documents will be filed formally through the RFB's portal; for 2024, taxpayers have until the end of 2025 to prepare and file these documents. Taxpayers with intercompany transactions greater than BRL 500 million in the preceding year will be required to prepare detailed documentation. For companies with intercompany transactions between BRL 15 million and BRL 500 million in the preceding year, a more simplified documentation is allowed.

The Master File and Local File provide an excellent opportunity for taxpayers to tell their story to support their approach to transfer pricing. In the world of transfer pricing documentation being required around the world, often taxpayers use one "core" Local File for all similar types of entities. However, given the newness of the Brazil regulations to their taxing authorities, taxpayers should consider performing and providing a deeper functional analysis and augment the description of the selection of transfer pricing method and economic analysis.

Of key importance, the Brazilian detailed documentation digs further into every selection performed by the taxpayer, requiring not just the reasons as stated in the OECD Guidelines, but also a justification, increasing the burden of proof allocated to the taxpayer. Although there are materiality thresholds applicable to tangible assets and services, all the remaining controlled transactions must be fully reported. In addition, given the clear preference for local comparables, documentation should include a discussion surrounding if these domestic comparables exist. Also, the county risk adjustment is a marked difference to how most US MNCs apply the TNMM – meaning the Brazil local file may need to look different when compared to those of other countries.

2. Value Chain Analysis (VCA): Taxpayers should consider performing a value chain analysis to show not only the functions performed in Brazil but also of the other key entities in the corporate group. Brazilian

legislation focuses on concepts introduced in BEPS Actions 8-10, such as the six-step risk control framework for analyzing transactions involving intangibles and development, enhancement, maintenance, protection, and exploitation (“DEMPE”) functions. Specifically, a VCA that focuses on DEMPE functions should help taxpayers support their positions. These analyses could either be incorporated into the formal transfer pricing documentation or be prepared as part of a defense file to use at audit.

3. Advance Pricing Agreements: Unilateral APAs will be possible in Brazil although there is uncertainty given that the normative instructions have not yet been released to provide details, and the law establishes a consultation procedure, which tax authorities can reject without further explanation.

4. Governance: One key component in a company’s transfer pricing defense file will be documents showing they have appropriate governance procedures in place and that they are implementing the company’s transfer pricing policy appropriately. The first step here would be the creation of a tax policy that includes a description of the transfer pricing policy. Once the tax policy is established, the next step would be to ensure the commitments made in the strategy are operationalized and implemented – essentially making sure the appropriate tax governance, risk management and controls are in place. This is achieved by implementing a transfer pricing compliance process by 1) developing a tax risk management policy, 2) identifying and developing adequate governance and controls, 3) reviewing and addressing gaps in written instruments, and 4) evaluating the controls to ensure compliance with the policy.

Based on the September 2023 normative instruction, the taxpayers must retain a book of contemporaneous documents able to support the transfer prices adopted in controlled transactions. Whenever required, these documents must be made available within the timeframe of 20 days to tax authorities, if not extended, subject to a 5% penalty. It seems clear that having the governance will be an important component of getting the RFB comfortable with the taxpayers’ transfer pricing position – and sustaining the taxpayer’s position.

Conclusion

The seismic change in the Brazilian transfer pricing regime means that the RFB may question taxpayer’s new transfer pricing positions. It is crucial for taxpayers to perform a robust functional analysis to justify their characterization of the Brazilian entity and how transfer prices are established. Both a value chain analysis and materials supporting governance will be instrumental to supporting the taxpayer’s position at audit.

In terms of establishing the appropriate transfer pricing approach for 2024, it is advisable for taxpayers to establish their pricing quickly so that they can minimize the need for year-end adjustments. While year-end adjustments are permitted under the Brazil rules, early adopters in 2023 have struggled with the overall mechanics, withholding tax, and indirect tax uncertainties.

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