Funding the Future

Brazil's new approach to transfer pricing

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The Tax Management Transfer Pricing Report is carrying an article by Tatiana FalcÃ£o, a Research Associate at the International Bureau of Fiscal Documentation (IBFD) in Amsterdam. Entitled Brazil’s Approach to Transfer Pricing: A Viable Alternative to the Status Quo? it is an important document that demonstrates a working and workable alternative to the OECD's jealously guarded rules on transfer pricing. (Read an introduction to the basic principles of transfer pricing here.) As FalcÃ£o's article states:

"*The Brazilian transfer pricing rules could serve as a basis for transfer pricing rules to be adopted by other developing countries.*"

And it provides this refreshing perspective:

"*Brazil tends to go its own way in regulating cross-border and international tax situations. Brazil is at times somewhat averse to international conventions, mainly because they tend to limit the ability of Brazilian tax authorities to tax.*"

Indeed - and we have long been critical of international transfer pricing rules, which are dominated by the OECD: rules which the U.S. tax expert Michael Durst says are "based on a fundamental misunderstanding of practical economics." A key problem is that the OECD system depends on being able to find 'comparable' prices as a guide to establishing the right price for transactions - whereas in many cases, these 'comparable' prices simply do not exist (for example in the extremely common situation where a company produces a product that is unique in the global marketplace). As FalcÃ£o notes:

The search for comparables is one of the main concerns of developing countries . . . Brazil has developed an objective method that allows the taxpayer to mathematically determine and prove its pricing benchmark without having to go through a search for comparables.

Developing countries' tax laws can be quite bureaucratic and tangled and inconsistent, so an objective method for determining pricing is potentially very useful for them. What is more, the Brazilian rules are broader in scope than the OECD's guidelines, allowing a lot of other corporate entities to be brought into the equation than would normally be permitted:

In this regard, the Brazilian transfer pricing rules are broader and more effective at combating tax evasion and intercompany profit shifting than the OECD trans- fer pricing guidelines.

The Brazilian system does, at times, mean that companies might occasionally suffer double taxation - that is, being taxed twice on the same income - but that "Brazil cost" is a price Brazil seems willing to pay in exchange for the system's many other benefits.

The Brazilian system aims to do several things, including to prevent entities from artificially inflating costs (which can be deducted against tax); to prevent them from under-reporting export revenues (which affect taxable profits,) and to prevent excess interest payments (which can be used to shift profits from one jurisdiction to another, affecting taxable profits.) Essentially, it tackles these abuses by providing benchmark methods and formulae, above which the relevant deductions and payments are not allowed.

The article contains plenty of detail on exactly how this is done, and it ends with a dramatic suggestion. Not only should developing countries study the Brazilian system, but:

"*Now that developing countries have become significantly more important because of their economic capacity and their economic potential, the OECD could consider modifying its transfer pricing guidelines to ac- cept Brazil’s system as an alternative for other develop- ing countries that have not yet been able to implement the OECD’s more complex transfer pricing guidelines due to a of lack of resources, qualified personnel, or comparables.*

As a second alternative, the Brazilian system could be marketed as a stepping stone: an initial, simpler, and more objective approach for developing countries to get acquainted with the transfer pricing regulations and build domestic capacity on the subject. Developing countries then could decide, on a more definitive basis, which transfer pricing system they want to adopt."

A reminder: this article is posted on our Transfer Pricing page, where you will also find an earlier article by FalcÃ£o for TJN.

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