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TRANSFER PRICING PERSPECTIVES IN LATIN AMERICA

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BRAZIL

Adoption of the arm's length principle

Published on December 29th 2022, Brazil’s Provisional Measure (PM) 1,152/2022 amended the Brazilian transfer pricing rules aligning them to the standards adopted by the Organization for Economic Cooperation and Development (OECD), expressly adopting the Arm's Length Principle (ALP) in Brazil in transactions between related parties resident abroad and unrelated parties resident in tax havens or that benefit from privileged tax regimes resulting in total corporate income tax burden less than 17%.

It is important to provide some context on this relevant change. Due to the express intention of the previous government to access the OECD, Brazil has started assessing the economic, regulatory and fiscal requirements it would need to comply with to be able to join the organization – one of them was the adoption of the ALP for transfer pricing purposes. Starting on 2018, the Brazilian tax authorities and OECD officials reviewed the gaps of the Brazilian transfer pricing rules comparing them against the international practice and establish a solid pathway for convergence.

According to the report issued by the OECD and the Brazilian Government in 2019, the Brazilian transfer pricing rules, among other implications:

(a) Could be exploited through tax planning, creating base erosion and profit shifting (BEPS) opportunities;

(b) Fail to properly address more sophisticated and complex transactions, including transactions involving intangibles (currently, royalty streams are not subject to transfer pricing rules but have strict deductibility thresholds depending of the remitting company’s activity – this limits date back to the 1950s);

BRAZIL

(c) May create double taxation issues, which may cause Brazil to miss out on investment and trade opportunities; and

(d) Are conducive to ease of tax administration and tax compliance at least at a domestic level due to its fixed margins.

In short, as mentioned above, the PM expressly adopts the ALP principle and indicates as available methods the ones used internationally, with some peculiarities for transactions with commodities (in line with the sixth method based on the Argentinian experience). Specific sections of the PM deal with transactions with intangibles and hard-to-value intangibles, intragroup services, cost sharing agreements, business structuring and financial transactions.

Aiming at keeping the ease of tax administration and lower the compliance burden, Brazilian tax authorities may (i) simplify comparability analysis or demand simplified documentation on controlled transactions, (ii) issue additional guidance on specific transactions such as business structuring, cash pooling structures and other financial transactions; and (iii) provide alternatives in case of limited information on the controlled transaction, the related party or comparable.

PM 1,152/22 states that the ALP will be valid for calendar-year 2024, however, taxpayers would be allowed to make an election to anticipate its adoption for calendar-year 2023. The PM must go through both Houses of Parliament and must be approved in a maximum 120-day period, otherwise, it would be deemed void.

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Although the timing of the actual congressional procedures is uncertain, in anticipation for its approval, tax authorities issued on February 24th, 2023, Normative Instruction 2,132/2023, allowing the taxpayer to apply the ALP to controlled transactions carried out in 2023. Such election would be irrevocable and cover all transactions with related parties abroad and unrelated parties located in low-tax/subject to privileged tax regimes and must be formalized up to September 30th, 2023, by filing the adoption form electronically.

Taxpayers should review their transfer pricing policies aiming at evaluating, according to the peculiarities of each business and corporate structure, whether the adoption of the ALP in Brazil for calendar-year 2023 would be advisable.

Another important point worth raising is the indirect impact for American multinationals with presence in Brazil due to the U.S. Foreign Tax Credit (FTC) Regulations issued in 2021, imposing new restrictions broadly requiring that taxes paid abroad derive from a system meeting certain defined conditions (generally resulting in a system reasonably comparable to US rules) in order for a foreign levy to be considered eligible for an FTC. A key condition of the American FTC rules for taxes on resident taxpayers is that the relevant system utilize arm’s length principles for allocations of items between the resident taxpayer and nonresident controlled entities.

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Many taxpayers and advisors believe that because of this condition, certain corporate income taxes under the current Brazilian system are not eligible to be used for an FTC in the US. It is anticipated that the adoption of ALP in Brazil's tax laws could permit US taxpayers to utilize applicable Brazilian corporate income taxes as an FTC—e.g., in the case of income arising from Brazilian subsidiaries of US entities treated as controlled foreign corporations (CFCs) or entities that have elected to be treated as a branch for US tax purposes.

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COLOMBIA

Adjustments for portfolio provision and transfer pricing.

The highest tax court in Colombia issued a favorable ruling in a case where the taxpayer applied a comparability adjustment when analyzing an inventory purchase operation for production and distribution.

The method of transactional profit margins was applied and for the accuracy of the analysis a comparability adjustment was applied which consisted of eliminating a proportion of the expense for portfolio provision, associated to the account receivable with the most significant independent client of the taxpayer that entered into a business reorganization process, a circumstance that was not taken into account by the tax administration, which focused on adjusting the taxpayer's income tax return, on account of the operating result before the comparability adjustment.

It should be noted that the tax administration did not admit the adjustment arguing that the portfolio provision was a general or usual expense applicable to all commercial companies, since this was allowed by the Colombian accounting standards, a statement that, in the opinion of the highest court is not sufficient to rule out the analysis.

This position is consistent with the OECD guidelines, which indicate that:

"Also, there may be differences between companies in the treatment of operating expenses and other expenses affecting net margins, such as depreciation and amortization, reserves and provisions, which should be addressed to achieve an acceptable level of comparability" (OECD Guidelines).

COLOMBIA

And since the entity showed negative results when compared with the results obtained by the companies considered as comparable, it was evident that they were not in the same conditions and therefore it was appropriate to make extraordinary adjustments to the taxpayer's financial information.

This ruling supports the technical analysis performed by taxpayers to increase comparability and enriches the trend in jurisprudence, in terms of incorporating multidisciplinary elements in the verification of the arm's length principle.

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MEXICO

Transfer Pricing Adjustment Rule

In Mexican legislation, there are mechanisms in place to prevent economic double taxation resulting from transfer pricing adjustments, regardless of the existence of a double taxation treaty between Mexico and the counterparty's resident country. The Mexican Income Tax Law (MITL) mandates that transactions with related parties be conducted on an arm's length basis, applying methods consistent with the OECD Guidelines. If the transactions deviate from what would have been agreed upon with independent third parties, adjustments must be made based on the results of the analysis. It is worth nothing that the MITL specifies that these adjustments should bring the analyzed transaction in line with the median of the sample.

The Mexican tax authority, through the Miscellaneous Tax Resolution, has introduced rules since 2018 that provide taxpayers with a certain level of certainty when applying transfer pricing adjustments. As expected, implementing a transfer pricing adjustment that increases the taxable base has fewer requirements compared to executing an adjustment that reduces the taxable base.

In this document, we present a simplified flowchart outlining the steps involved in applying a transfer pricing adjustment that reduces the taxable base through deduction, in accordance with the aforementioned rule.

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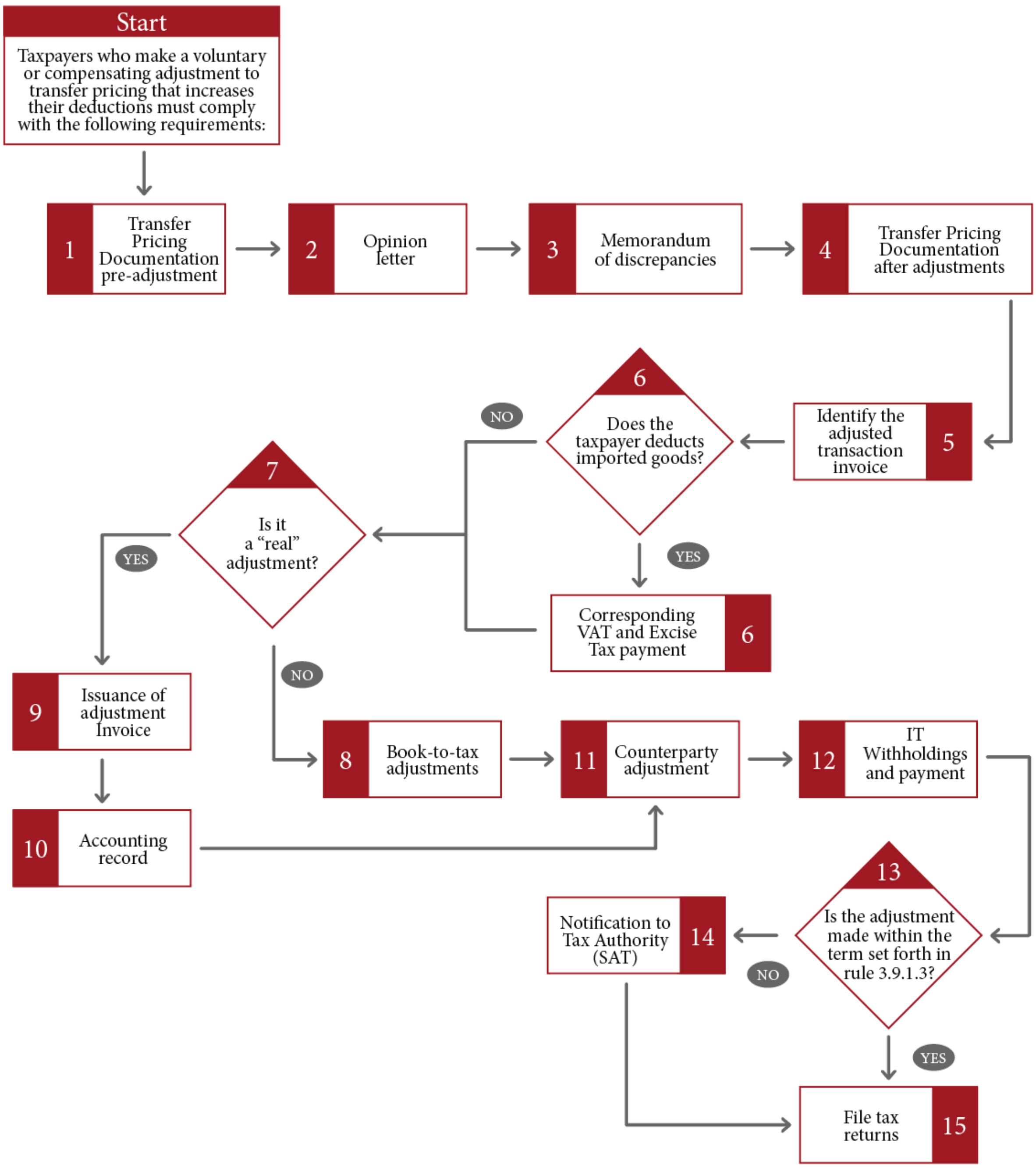

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MÉXICO

Flowchart for deducting transfer pricing adjustments:

1) Obtain and keep TP documentation determining that the transaction was not agreed at market values.

2) Obtain and keep a written opinion signed by the TP documentation preparer (referred to in point 4) explaining why the transaction was not agreed at a market value.

3) Obtain and keep a written document signed by the TP documentation preparer, explaining the year-toyear consistency/inconsistency in the application of TP methodologies, as well as in the search for comparables.

4) Obtain and keep all the documentation with which it is possible to verify that, by means of the adjustment to transfer pricing, the transactions were agreed as they would have been with or between independent parties in a comparable transaction (including its computation).

5) Keep the original invoice for the transaction that meets all the deduction requirements.

6) In the case of deductions associated with the acquisition of imported goods, document the proper payment of the corresponding VAT and excise tax

7) In case that the adjustment only impacts the tax computation, it is considered a “virtual” adjustment. However, if the adjustment also affects books, then it is considered a “real” adjustment.

8) Proceed to apply a book-to-tax adjustment.

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9) Concerning real adjustments, an invoice must be issued covering all the deduction provisions including, at least, the following information: i. description of the transaction adjusted in a voluntary or compensating manner, ii. original transaction value, iii. gross or operating profit derived from the adjustment, iv. fiscal year in which the adjusted transaction was declared as taxable income or authorized deduction, v. description of the Transfer Price Adjustment.

10) Record transfer pricing adjustments in memoranda accounts and recognize them in the tax reconciliation for IT purposes.

11) Confirm that the counterparty has recognized the income derived from the adjustment, or the corresponding deduction in the same tax year in and for the same adjusted amount, as well as that the adjustment it is not income subject to a preferential tax regime.

12) If applicable, withhold and pay IT pursuant to tax provisions

13) Voluntary or compensating transfer pricing adjustments shall be reflected in returns or in the opinion, as appropriate, not later than the date the annual return is due. If the taxpayer has chosen to request for a tax opinion issued by a CPA, adjustments should be reflected not later than the corresponding due date.

14) Taxpayers who intend to make Transfer Pricing adjustments after the deadlines established (accordingly to Rule 3.9.1.3, third paragraph), may take the deduction if they first submit a notice complying with the requirements established by the tax authorities.

MEXICO

15) Duly comply with filing of income tax return that include or expressly state the TP adjustment.

Once these requirements are met, taxpayers may only be allowed to take the deduction in the fiscal year in which the income or deduction was originally recognized.

It is also important to consider the Mexican tax authority's non-binding opinion (40/ISR) stating that adjusting a transaction that it is already within the accepted range to the median represents an improper tax practice.

It is crucial, considering the current situation and the changes in markets, costs, and economic conditions, that taxpayers in Mexico review and adjust their transfer pricing policies to ensure compliance with the arm's length principle and accurately reflect the current economic and commercial conditions. This will enable them to comply with the applicable regulations and avoid tax contingencies.

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