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Transfer Pricing in Brazil: Practical Aspects in the Adaptation of the Arm's Length Standard

Brazilian taxpayers need to comply with new OECD-based transfer pricing rules as of financial years starting on or after 1 January 2024. They are also allowed to apply the new rules for financial years starting on or after 1 January 2023, if they choose for "early adoption" later this calendar year. This article outlines the practical impact of the new rules for Brazilian taxpayers, based on its underlying concepts and a case study including intra-group transactions that Brazilian taxpayers are commonly engaged in. In addition, the authors aim to illustrate some key considerations, opportunities, and risks of the upcoming decision whether to adopt early.

1. Introduction

On 14 June 2023, Brazilian president Lula signed Law 14.596/2023, implementing provisional measure no. 1,152/2022 (hereinafter the New Rules). The bill of law implementing the New Rules ensures that Brazilian legislation as regards the tax treatment of transactions between related entities is substantially aligned with the latest version of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the OECD Guidelines).[1] The New Rules will be mandatory for Brazilian corporate taxpayers as of 1 January 2024 (i.e. for financial years starting on or after 1 January 2024). In addition, on 3 July 2023 the Federal Revenue Service Office (*Receita Federal do Brasil*, RFB) issued a public consultation on the draft of a Normative Instruction (NI)[2] (Draft NI) which aims to provide the regulations for applying the arm's length principle.

Law 14.596/2023 also allows taxpayers to apply the New Rules for calendar years starting on or after 1 January 2023 (the Opt-in). Taxpayers will need to inform the Brazilian tax authorities on their decision to Opt-in at the latest on 30 November 2023.[3] In this article, the authors (i) investigate the impact of the New Rules on an illustrative fact pattern commonly observed with Brazilian MNEs engaged in commodity transactions (the Case) and (ii) determine when an Opt-in decision may be beneficial.

2. Legal Framework

In view of the transition period of calendar-year 2023 (when the New Rules will be optional), situations will occur where taxpayers will need to analyse the two scenarios and decide whether to Opt-in. Therefore, in the sections below the authors will analyse each possibility (New Rules versus the Previous Rules) in light of the facts of the Case.

2.1. Previous Rules

The adoption of the bill of law marks a long-awaited shift from the "previous" safe-harboured and fixed margin-based regime (hereinafter the Previous Rules) to the arm's length standard aligned with the OECD Guidelines. As far as commodity transactions between related entities are concerned, Brazil followed suit with other Latin American countries, in changing its transfer pricing legislation to allow for the use of the so-called "sixth-method". In the case of Brazil, this comprised of two methods specifically geared towards related-party commodity transactions:[4] the "price under quotation in importations" (*Preço sob Cotação na Importação*, PCI),[5] mandatory for importations of commodities, and the "price under quotation in exportations" (*Preço sob Cotação na Exportação*, PECEX),[6] mandatory for exportations of commodities.

Unlike the arm's length principle, as reflected in the OECD Guidelines, which is centred around the "comparability analysis" (including a functional analysis based on functions performed, assets used and risks assumed), the Previous Rules determined the "market" price for these transaction as accounted for in the country. The Previous Rules

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1. *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (OECD 2022), Primary Sources IBFD [hereinafter *OECD Guidelines* (2022)].
2. For details, *see* the official Public Consultation Website (in Portuguese): https://www.gov.br/receitafederal/pt-br/assuntos/noticias/2023/julho/receita-federal-abre-consulta-publica-sobre-instrucao-normativa-rfb-que-estabelece-as-regras-de-precos-de-transferencia (accessed 24 July 2023).
3. NI 2.132/2023 has set the deadline for Opt-In at 30 Sept. 2023. However, the recent draft of the NI ("Draft NI") submitted to public consultation suggests that the deadline will be moved to 30 Nov. 2023.
4. According to BR: Law 9.430/1996, arts. 24 and 24-A, the dispositions of the Transfer Pricing Law (arts. 18-22 Law 9.430/1996 – current – and, after 1 Jan. 2024, Law 14.596/2023) also apply to transactions with low-tax jurisdictions or privileged tax jurisdictions. Those jurisdictions are included in a list provided by NI 1.037/2010.
5. According to art. 18-A Law 9.430/1996, the PCI is defined as the daily average mean of quotations of goods or rights subject to public pricing in renowned future and commodities exchange markets of import operations.
6. As per art. 19-A Law 9.430/1996, the PECEX is defined as the daily average mean of quotations of goods or rights subject to public pricing in renowned future and commodities exchange markets for export operations.

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were mandatorily applicable to transactions of products included in a list provided for in the Normative Instruction issued by the RFB.[7] The prices for the "commodities" included on the list were based on (i) public commodities and future exchange prices or (ii) public research institutions.[8] In general, the PCI and PECEX methods allow for the public pricing on a specific date. This date generally is the transaction date, i.e. the date included in the contractual agreement or the purchase order. If the date of the transaction cannot be determined, the price has to be calculated using the average quotation of the shipment date of the imported or exported goods.

The following price adjustments were permitted under the Previous Rules: payment terms, quantities, climate influences in the exported good, intermediation costs charged by the commodities and future exchanges, warehousing, insurance and freight, unloading costs, internal transportation costs,[9] storage costs and customs release costs.

Another point to highlight is the possibility of transferring intangibles to a related party under the Previous Rules. For such cases, the cost-plus method is normally applied, as it may be used for goods, services and rights, according to NI 1.312/12, using the capitalized cost plus a 15% markup. This is also favourable, as capitalization of formation costs of intangibles is extremely difficult under the IFRS rules (Brazil Accounting Pronouncement – CPC 04), which will reduce the taxable basis of the asset to be transferred. An attention point is that normally such situations would entail a profit stripping from the Brazilian entity, and under the New Rules would need to be reviewed under the Business Restructurings provision (article 26 of Law 14.596/2023).

Although the Previous Rules allowed for the benefits of simplicity and legal certainty, the absence of "OECD-aligned" arm's length pricing resulted in increased likelihood of double taxation[10] and allowed for unintended planning opportunities. As regards the latter, the Previous Rules allow for planning opportunities by using (i) transaction date arbitration, which can differ in timing or use derivatives to obtain a profit from the date of the actual sale to the final costumer;[11] and/ or (ii) the imputation of risks, assets and functions to the Brazilian entity, which under the OECD Guidelines aligned rules would require more profits to be booked there.

2.2. New Rules

The New Rules align Brazil's legislation with the most recent version of the OECD Guidelines, published by the OECD in 2022. Although one may question to what extent the Brazilian legislator intended for the New Rule to be applied dynamically[12] (which is not yet clear), the fact that OECD Guidelines evolve means that certain "new" concepts (hereinafter sometimes collectively referred to as the Concepts), such as "actual conduct" (Actual Conduct), the "risk assumption" (Risk Assumption) framework (including DEMPE functions[13]) and "options realistically available" (ORA), were introduced in the 2017 and 2022 versions of the OECD Guidelines, will need to be used when applying the New Rules. The authors note that the Concepts were already used in discussions between taxpayers and tax authorities in jurisdictions such as the Netherlands regarding financial years prior to the publication of the 2022 (and 2017) OECD Guidelines and that their application often leads to disputes with tax authorities. Considering that the Concepts are expected to continue to cause uncertainty, we expected them to also cause discussions between Brazilian MNEs and the RFB on transfer pricing matters.

As a "2022 OECD Guidelines analysis" revolves around two phases: (i) delineation of the controlled transaction and (ii) the comparability analysis – both are discussed in more detail below with an emphasis on the Concepts.

2.2.1. Delineation of the controlled transaction

The "delineation phase" attempts to establish what a third party would have agreed on as regards the controlled transaction (or transactions[14]) under review. For this purpose, delineating the transaction, the five comparability factors need to be considered.[15] The analytical framework included in this article focuses on the new concepts of Actual Conduct (part of the "Contractual terms"

7. NI 1.312/2012 arts. 16 (Imports) and 34 (Exports).
8. If the price could not be determined based on these sources, a price at cost plus 15% could be applied. In the notorious *Cellulosis* case (BR: Administrative Court, 15 Oct. 2019, Decision 1302-003.989), the Administrative Court decided that the taxpayer was not obliged to apply the PECEX method, as the product was not included in the list of commodities under Annex I of NI 1.312/2012, thus opening the window to apply a sales price based on cost + 15% for the export of raw material to a trading company of the group.
9. Transportation costs can be adjusted using the "BDI index".
10. With its advent as a global economic powerhouse, Brazil has moved from a heavily source-oriented international tax policy, realizing that double taxation provides for an increasing burden on the profitability of its own foreign direct investments.
11. This possibility was noted by Daniel Prates, who explained in his article the possibility for arbitration of the transaction date in situations where the transaction date offered a market quotation of, say, USD 100, and on the actual shipment date the price would drop to USD 90. The documentation could be amended to reflect the lower quotation, at least in theory damaging the expected profitability of the seller. *See* D. Prates, *A data da Precificação e as Metodologias Especiais Para Commodities. A Experiência Internacional e o Padrão Brasileiro*, in *Transfer Pricing in Brazil: Towards Alignment With the OECD Standard* pp. 271-306 (T. Balco & F. Cavalcanti et al. eds., Quartier Latin 2023).
12. If further concepts are introduced in later versions of the OECD Guidelines, does that mean that these concepts form an integral part of the Brazilian legislation on related-party transactions and to what extent would these concepts be applied to financial years before such update of the OECD Guidelines? The draft of NI 1.312/2012 specifically mentions that the *OECD Guidelines* (2022) and its amendments will serve as secondary guidance, unless contrary to the spirit of Law 14.596/2023 (i.e. the New Rules).
13. When dealing with TP aspects of intangibles, the "DEMPE" concept, first published in the *OECD Guidelines* (2017), refers to the relevant framework of functions: development, enhancement, maintenance, protection and exploitation.
14. If feasible, transactions are analysed on an aggregated level.
15. The *OECD Guidelines* (2022) identify five "comparability factors". These are (i) the characteristics of the property or services transferred; (ii) the functions performed by the parties (taking into account assets used and risks assumed), in relation to the controlled transaction; (iii) the contractual terms of the controlled transaction; (iv) the economic circumstances of the parties; and (v) the business strategies pursued by the parties in relation to the controlled transaction.

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comparability factor), the Risk Assumption framework,[16] ORA[17] (both part of the "functional analysis" comparability factor) and DEMPE.[18] These concepts are used to establish whether for transfer pricing purposes the controlled transaction can be analysed based on (i) the terms and conditions of the written contract or (ii) adjusted terms and conditions aligned with the actual conduct of the parties. In exceptional circumstances, tax authorities may disregard the controlled transaction. However, with the new concepts, tax authorities have more room to recharacterize transactions, and even use these concepts – although arguably this was not the OECD's intention – to flat out disregard certain transactions.[19]

2.2.1.1. Actual Conduct

The starting point of the delineation phase is the contractual terms and conditions of the controlled transaction. However, where there is a deviation between the actual conduct of the parties and the economically significant terms of the contract, the actual conduct of the parties will generally be the starting point of the delineation analysis. Such actual conduct can be based on functional interviews, email correspondence or other sources of evidence available within the parties to the transaction (such as board resolutions).

It is worth noting that the Draft NI, in article 61, requires that transactions concerning *commodities* to be imputed in a system (to be made available by the RFB) within 10 days of the transaction. This is likely a response to the tax authorities' concerns about arbitration of the transaction date by taxpayers.

2.2.1.2. Risk Assumption

The six-step Risk Assumption framework, as included in the OECD Guidelines, needs to be applied to determine which parties actually assume significant risks in a controlled transaction. Only parties that exercise (i) "control over risk" and have (ii) sufficient financial capacity, can assume risks.

Exercising control over risk requires that the risks identified as "economically significant" are effectively managed. There are different forms of risk management functions: (i) decision-making to take or decline a risk-bearing opportunity; (ii) decision-making on whether and how to respond to risks; and (iii) risk-mitigating functions. However, assumption of risks does not necessarily require that all these risk management functions are performed by the party assuming the risks. The OECD Guidelines explicitly note[20] that some functions can be outsourced to another party without transferring risk assumption to the insourcing party. For example, if a risk-assuming party hires another party to perform day-to-day risk-mitigating functions (e.g. administrating or monitoring), while the risk-assuming party has the authority and capability to, and effectively does, determine and review the performance of that other party and continue or terminate underlying contracts, the control over risk and thereby the risk assumption is maintained at the level of the outsourcing party under the OECD Guidelines.[21]

Furthermore, in addition to the practice of placing more relevance on functionality (to the detriment of the contractual allocation of asset and risk), tax authorities of certain OECD member states[22] apply a too restrictive interpretation of the term "functions". The limited interpretation does not allow for the possibility of a related entity to be represented by anyone other than an employee. In our view, the performance "functions" are not restricted to employees of the company but can also be undertaken by statutory directors of the company or by capable staff hired under a contracting agreement.

In essence, a party has sufficient financial capacity for a risk if it has – on a standalone basis – access to funds to deal with financial consequences if that risk materializes.[23] When testing financial capacity, available assets, (forecasted) cash flows and ORAs of a party to attract additional liquidity should be considered. Although this guidance implies that a party's ability to attract funding (i.e. in practice often assessed via determination of the party's creditworthiness[24]) is key for testing financial capacity, tax authorities also focus on capable functionality and not merely on financial ratios relevant for the creditworthiness.

If a party contractually bears a risk (because it is allocated the risk under the contract) but that party does not (i) exercise control over that risk; or (ii) has insufficient capacity to incur that risk, it should not be allocated for tax purposes the consequences (upside or downside) of that risk. Rather, these consequences should be allocated to the party exercising control over risk and having sufficient financial capacity to assume the risk.

2.2.1.3. ORAs

As part of the delineation process, the ORAs from a two-sided perspective need to be analysed. This concept is based on the notion that third parties, when evaluating the terms of a potential transaction, will compare that transaction to other potential (realistic) alternative transactions available to them. Independent third parties are deemed to only enter into the transaction if they expect that they will not attain their commercial objective with the potential

16. Consisting of six steps that are provided in para. 1.60 *OECD Guidelines* (2022).
17. Although references to this concept are only made in *OECD Guidelines* (2022) chapters about restructurings and financial transactions, it is in practice used and discussed in a broader context.
18. When delineating intangible-related transactions.
19. C. Silberztein & M. Guillaume, *Does Intangible Ownership Move with the People That Perform the DEMPE Functions?*, 29 Intl. Transfer Pricing J. 7 (2022), Journal Articles & Opinion Pieces IBFD.
20. *OECD Guidelines* (2022), para. 1.65.
21. *OECD Guidelines* (2022), para. 1.65 and *OECD Guidelines* (2010), para. 9.23.
22. NL: Decree of the State Secretary for Finance, July 2022, no. 2022/16685, p. 28, implying that the Dutch tax authorities are merely looking at functions performed by employees to determine which party(ies) exercises control over risk.
23. *OECD Guidelines* (2022), para. 1.64.
24. In this context, without the impact of financial guarantees as far as provided for the benefit of that party.

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alternative transactions. ORAs therefore need to be considered at the time of entering into the transaction under review.[25] If an ORA analysis is undertaken post-transaction, e.g. in the scope of a discussion with tax authorities, the taxpayer cannot make use of the benefit of hindsight (i.e. it will need to perform the analysis based on the facts that were known at the time of considering the transaction under review).

In the Medingo ruling (8 May 2022),[26] the Israeli court concluded that "realistically available alternatives" can only be recognized if these alternatives "clearly" nullify the business logic of the transaction undertaken. In the view of the court, this means that the ORA threshold will also be considered to be passed by the taxpayer if several alternatives are available and it is not necessarily possible to prefer one alternative over the others, as all alternatives can potentially give rise to both positive and adverse consequences.

2.2.2. *Comparability analysis*

The second phase of the transfer pricing analysis attempts to establish an arm's length price for the controlled transaction with reference to the comparability analysis. The latter compares the controlled transaction with uncontrolled transactions based on the five comparability factors mentioned earlier. Contractual agreements – if available – provide the starting point of a comparability analysis.[27] However, where inconsistencies exist between the transaction (i) as reflected in the contracts and (ii) based on the Actual Conduct of the parties, the latter prevails for tax purposes.[28] The assessment of Actual Conduct requires an analysis of functions,[29] assets and risks (FAR Analysis), based on agreement, board resolutions, minutes of board meetings, or fact-finding interviews (e.g. with key staff).[30] The FAR Analysis aims to "characterize" the parties involved in the controlled transaction under review, based on their functions performed, assets used and risks assumed.

The possible outcomes of a FAR Analysis range between two extremes: (i) low-risk or routine companies or (ii) full-risk or standalone companies. Ultimately, the FAR Analysis will allow the parties to substantiate the selection of the appropriate transfer pricing method used to price the controlled transaction.

25. The lack of a clear regulation on a GAAR in Brazil is likely to give rise to several disputes, as the broad concept of ORA may fit the taxpayer, but not necessarily the tax authority. On this subject, *see* R. Tomazela, *Transfer Pricing Reform in Brazil and 'Options Realistically Available': New Tax Disputes Ahead?*, TPNews (4 July 2023), available at https://transferpricingnews.com/transfer-pricing-reform-in-brazil-and-options-realistically-available-new-tax-disputes-ahead/ (accessed 7 July 2023).
26. IL: Tel Aviv-Jaffa District Court, 8 May 2022, 53528-01-16, *Medingo, Ltd. v. Afula Assessing Officer*.
27. *OECD Guidelines* (2022), Ch. I, D.1, para. 42.
28. *OECD Guidelines* (2022), Ch. I, D.1. para. 46.
29. In the authors' view, a party's functions may also be performed by others (e.g. board members) than the party's personnel.
30. D.R. Wright et al., *The BEPS Action 8 Final Report: Comments from Economists*, 23 Intl. Transfer Pricing J. 2, p. 102 (2016), Journal Articles & Opinion Pieces IBFD.

3. The Case

OILBRAZ is a publicly traded Brazilian MNE. It extracts and procures crude oil in Brazil and other locations around the world and subsequently distributes these products globally. OILBRAZ's ultimate parent and operating company OILBRAZ SA (SA) concluded an agreement with a third-party Brazilian oil exploration company (EXBRAZ). Under the agreement (the Mandate), EXBRAZ commits itself to sell part of its excess production to OILBRAZ and the latter commits itself to purchase that production under beneficial conditions. OILBRAZ also has a trading company located in Switzerland (TradeCo) that is engaged in the trade of oil procured from OILBRAZ and third parties. TradeCo's staff consists of employees as well as independent contractors.

TradeCo was incorporated for trading crude oil to third parties on the global market. OILBRAZ chose Switzerland as the location for TradeCo because of the (i) availability of qualified trading personnel, (ii) ease of attracting external financing from third-party banks and financial institutions to finance its trading activities, and (iii) Switzerland's friendly business climate. The relevant flow of goods, services and invoices is included in Figure 1.

4. Analysis

In the following sections, the facts of the Case based on the Previous Rules and the New Rules are analysed.

4.1. Previous Rules

Under the previous rules, OILBRAZ would sell to TradeCo at market prices determined at the transaction date. At this date, oil companies in Brazil use the National Oil Agency (*Agência Nacional do Petróleo, Gás Natural e Biocombustíveis*, ANP) reference price,[31] which is used for computation of the government takes,[32] but also for calculation of the parameter price under PCI/PECEX methods. This is because the ANP reference price also qualifies for the independent sectorial pricing requirement of the Law. In addition, when the parameter price (i.e. the reference price) differs with up to 3% of the actual intercompany price, no adjustment would be required ("divergence margin"). In practice, the divergence margin created a regime where one could sell at 97% of the reference price without adjustment.

The Previous Rules also allowed for a premium based on quality, characteristics or contents of the oil exported. Adjustments to the price between OILBRAZ and TradeCo would account for: (i) payment timing; (ii) quantities sold;

31. According to the ANP Glossary, "the Oil Reference Price (PRP), used for calculation of the government takes, is calculated by ANP on a monthly basis, having as basis the monthly average quotations for the oil (Brent-reference) and of sub-products (light, medium and heavy oil), to which you incorporate a quality differential due to physio-chemical characteristics of each current".
32. Government takes are financial compensations due by companies who have been granted the rights to exploit and produce oil and gas in the Brazilian Territory. The ANP performs the calculation of the amounts to be paid by states and cities under BR: Law 9.478/1997 and BR: Law 7.990/1989.

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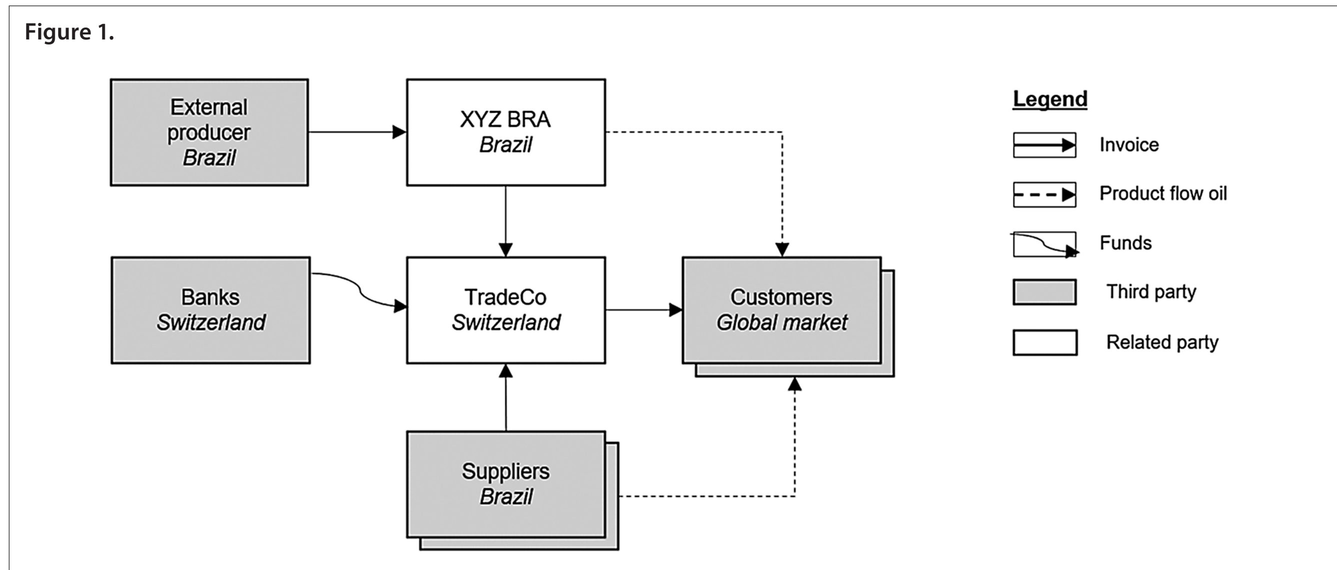

(iii) climate conditions to the oil exported; (iv) intermediation costs paid to unrelated parties; (v) conditioning; (vi) insurance and freight; and (vii) unloading and transportation, warehousing and customs release costs.

In principle, the use of the ACC/ACEs[33] does not require adjustment to pricing conditions – as the financing is offered by an independent, unrelated party, and interest rates are, at least in theory, at arm's length, though this must be evaluated on a case-by-case analysis. In a normal transaction, the financing component would be considered in an application of the profit split method or the transactional net margin method (TNMM).

4.2. New Rules

The analysis in this section consists of the following two phases: (i) a delineation of the controlled transaction and (ii) the comparability analysis.

4.2.1. Delineation

As a first step in the transfer pricing analysis, the controlled transactions between SA and TradeCo, i.e. the sale of crude oil, need to be accurately delineated.

4.2.1.1. Actual Conduct and Risk Assumption

SA and TradeCo concluded a contract under which the terms and conditions of the transaction, the sale of crude oil by SA to TradeCo (the Transaction) takes place. To analyse the Actual Conduct and Risk Assumption, the authors primarily focus on TradeCo, as SA is the main operational company of OILBRAZ and as such would itself be capable of performing all relevant functions and controlling all relevant risks.

TradeCo's staff performs functions such as pre-financing of purchases, price management via hedging, and negotiation of sales conditions with customers. With the performance of these "risk management" functions, TradeCo exercises control over key risks[34] in relation to the Transaction, and it also has sufficient financial capacity to assume these risks as it is able to attract funding from third-party banks. The fact that some of the risk management functions are performed by independent contractors[35] does not necessarily jeopardize TradeCo's capability to assume the risks, for transfer pricing purposes, as these independent contractors are supervised by capable employees and/or the management of TradeCo.

The analysis of TradeCo's Actual Conduct and Risk Assumption points out that (i) Actual Conduct is consistent with the terms of the Transaction laid down in the contract and (ii) Risk Assumption is in line with how risks are contractually assumed.

4.2.1.2. ORAs

In terms of substantiating ORAs, SA could not have established TradeCo (and therefore not have initiated the trading activities at all), or SA could have instead performed the trading activities itself. Not initiating trading activities at all is not considered a viable option for SA taken into account that it has specifically identified this business opportunity and that it is willing to invest in obtaining these commercial objectives. At the same time, engaging itself in the trading activities would neither be clearly more beneficial than engaging in the Transaction given that SA lacks experienced staff in Brazil capable of handling global trading activities. In addition, this alternative has as a disadvantage that financing local trade, i.e. in Brazil, is more expensive compared to the cost of funding of trading activities in Switzerland.

33. ACC stands for advancement of exchange contract, in which the seller can borrow against the receivable, with a banking institution. ACE stands for advancement over foreign currency delivered, and is of a similar nature.

34. Such as financing risks and market risks (including price volatility risk).
35. Logically, contractors that have functional profiles similar to those of the company's employees (i.e. quasi-employees) would be considered to be capable of assuming risk. Arguably, also independent contractors with "more distance to the company" would not jeopardize the risk assumption for the company where employees or the management of the company determine the objectives of their activities, monitor performance and decide to extend or terminate the contracting agreement.

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From the perspective of TradeCo, an alternative option could have been for it to decide not to trade with SA. However, this alternative is not a viable scenario as TradeCo would be less likely to successfully initiate its activities without engaging in transactions with SA and without the possibility of obtaining the benefits of the Mandate.

The above-mentioned alternatives, taking into account the perspectives of both SA and TradeCo, cannot be considered to "clearly" nullify the business logic of the Transaction. When taking into account the framework presented in the *Medingo* ruling,[36] the ORA test should be deemed to have been passed without an in-depth quantitative analysis having been performed.

The delineation analysis points out that the Transaction can be further analysed based on the terms and condition reflected in the written agreement. Furthermore, reflecting the delineation analysis (specifically the ORA analysis) in TP documentation is essential for taxpayers to build a line of defense against potential challenges of tax authorities (i.e. if only because such documentation prevents tax authorities from preparing the analysis themselves and using the benefit of hindsight).

4.2.2. Comparability analysis

In scope of the comparability analysis, the FAR Analysis is essentially used to determine what contributions SA and TradeCo make to OILBRAZ' value chain. The analysis can be illustrated based on the two extremes of the range of outcomes of the FAR Analysis: TradeCo is either classified for transfer pricing purposes as (i) a low-risk or routine entity,[37] or (ii) as a full-risk or standalone entrepreneur. Based on either of these labels, one can (i) determine what TP method is appropriate (i.e. the TNMM or the comparable uncontrolled price (CUP) method) and, subsequently, (ii) actually perform the comparability analysis to compare (i) functions of the TradeCo (the "tested party") with those of comparable companies (i.e. for the "routine"[38] label) or (ii) the terms and conditions of the Transaction with those of market data (i.e. for the "full-risk" label).

In case of the "full-risk" label, the Transaction (or aggregated transactions[39]) can be priced on the basis of the CUP method[40] provided that sufficient reliable comparable data is available (i.e. which is typically the case for financial or commodity transactions). In contrast, the "routine" label would result in the selection of a one-sided profit-based method, i.e. the TNMM,[41] with the identification of the tested party (i.e. the party to the Transaction that exhibits the least complex functions and the party whose profit, or rather EBIT, tested against profit markup (on EBIT level), for example, on sales, total costs, or assets of comparable uncontrolled companies.

5. Case Expanded

To proactively manage opportunities and risks regarding the upcoming shift from the Previous Rules to the New Rules and the decision in September 2023 (or November 2023 under the Draft NI) for "early adoption", MNEs need to perform an opportunity and risk assessment. For Brazilian MNEs with standalone companies (e.g. full-fledged traders) located outside Brazil, it seems particularly worthwhile assessing opportunities and risks regarding (i) offshoring intangibles and (ii) intra-group financing for Brazilian business activities.

Based on the scenario in which TradeCo functions as a full risk-taking entrepreneur, the Case is supplemented with the following additional facts:

- although the Mandate is legally entered into by SA with EXBRAZ, all relevant functionality as regards the Mandate are currently performed by staff of TradeCo (i.e. such that there is no direct line of communication between SA and EXBRAZ and between TradeCo and SA as regards the performance of the Mandate);
- SA has transferred the Mandate to TradeCo (i.e. SA assigned its rights and obligations under the Mandate to TradeCo based on an assignment agreement with TradeCo);
- in the scope of its trading activities, TradeCo has attracted (USD) funding from a third-party commodity financing institution (the Bank) under a so-called revolving credit facility (the Facility). The terms of the Facility are such that TradeCo is allowed to drawdown amounts up to a certain maximum amount and that it can decide to make repayments of principal and interest from time to time. TradeCo is charged interest on the amount drawn under the Facility of EURIBOR + 600 basis points; and
- TradeCo also hired a treasury specialist, and that specialist has convinced TradeCo's management to extend a long-term intercompany loan (the IC Loan) to SA, rather than using the trading proceeds to repay principal amounts due under the Facility. The IC Loan is (i) denominated in Brazilian real, (ii) subordinated to external debt attracted by SA and (iii) bears an interest rate of 13.6% per annum.

36. *Medingo* (8 May 2022).
37. This scenario would have led to a different outcome of the delineation analysis (i.e. that the analysis would have revealed that TradeCo would not be considered to assume key "trading" risks) because under this scenario would have lacked staff capable of managing these risks.
38. Entities that are part of a transaction with an entity (i.e. non-routine) that assumes key risks in relation to that transaction. On this subject, *see* G. Erdős, *Hungary Introduces an Annual Transfer Pricing Data Reporting System*, 30 Intl. Transfer Pricing J. 3, p. 7 (2023), Journal Articles & Opinion Pieces IBFD.
39. *OECD Guidelines* (2022), para. 3.9 prescribes that pricing on an aggregated basis is appropriate if transactions are "interlinked" to such an extent that pricing on a separate basis is impractical or even impossible.
40. Assuming that the facts of the Case are such that the parties to the Transaction do not (i) operate in an integrated manner, (ii) share the assumption of risks and (iii) both contribute to the development of the same unique and valuable intangibles and therefore cannot apply the profit split method.
41. The TNMM is often applied because its comparability requirements are less stringent than for other methods and because it is tolerant to accounting differences as compared to gross margin methods (e.g. because accounting standards differ between jurisdictions and comparable data does not provide the level of detail to be able to verify whether costs are consistently booked as "cost of goods sold" or "operating expenses").

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5.1. Mandate

Under the Previous Rules, the legal transfer of the Mandate would take place based on the accounting value of the Mandate increased with a 15% (gross) markup. However, as Brazilian GAAP may not require SA to capitalize the development cost of the Mandate on its balance sheet, lacking an accounting value the transfer of the Mandate could take place without consideration under the Previous Rules.

In contrast, a potential legal transfer of the Mandate under the New Rules would follow the guidance of the OECD Guidelines. That guidance, including an accurate delineation of the transaction, could allow the RFB to argue that the decision to enter into the Mandate by SA created value (assuming that SA had employees capable of making the decision to enter into the agreement) and that hence the transfer of the Mandate warrants a compensation at arm's length for SA.

In light of the above, SA would be in a more beneficial situation if it would decide not to Opt-in and hence transfer the Mandate under the Previous Rules. As regards the tax consequences of the Transfer for TradeCo, it would be able to (i) claim a step-up in the basis[42] to record the arm's length value of the Mandate for Swiss tax purposes and therefore (ii) use tax amortization expenses to (partly) offset taxable trading income.

5.2. IC Loan

Under the Previous Rules, interest rates on intra-group loans were determined on the basis of (i) the currency of the loan and (ii) the jurisdiction of the lender. In the case at hand, the benchmarked interest on the IC Loan would have been determined at Brazilian government bonds + 3.5%.[43]

Under the New Rules, the arm's length nature of the interest rate on the IC Loan needs to be substantiated based on a benchmarking analysis. The following characteristics of the IC Loan need to be taken into account when benchmarking the interest rate on the IC Loan: credit rating, country risk premium, currency, term and seniority. For the purpose of the Case, let us assume that, based on a proper benchmarking analysis, an interest rate on the IC Loan of 13.6% can be substantiated. This would mean that interest expenses on the IC Loan are deductible for Brazilian tax purposes in the hand of SA.[44] Corresponding interest income, in the hands of TradeCo, would be taxed at an effective rate (i.e. a combination of a federal and cantonal rate)[45] substantially lower than Brazil's CIT rate. Under this scenario, SA would likely decide to Opt-in.

42. In respect to a contribution in kind from a direct parent company, Swiss tax law allows for a step-up in basis. However, a stamp tax of 1% would be triggered on the (higher) value contributed.

43. Law 9.430/1996 determines that intra-group inbound debt denominated in US dollars with a fixed predetermined interest rate must be compared with the interest rate of the Sovereign Bonds issued by the Federal Republic of Brazil, and a *spread* of 3.5% must be added. Should the debt interest rate be variable, the six-month LIBOR would be used as benchmark (also with the 3.5% spread added).

44. Assuming that requirements (e.g. debt-to-equity ratios) are met and the interest deduction limitation do not apply. BR: Law 12.249/2010, art. 24, states that any debt assumed with related parties must also be tested for the thin capitalization rules, meaning that for each dollar of equity, the entity can borrow up to USD 2 with the related party (excess debt interest should not be deductible). Debt financing with any party resident or domiciled in tax havens or low-tax jurisdictions is subject to a reduced ratio of 0.3:1 debt-to-equity ratio (art. 25 Law 12.249/2010).

45. Under Swiss tax law, TradeCo may decide to apply safe harbour rules for interest rates on intercompany loans.

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