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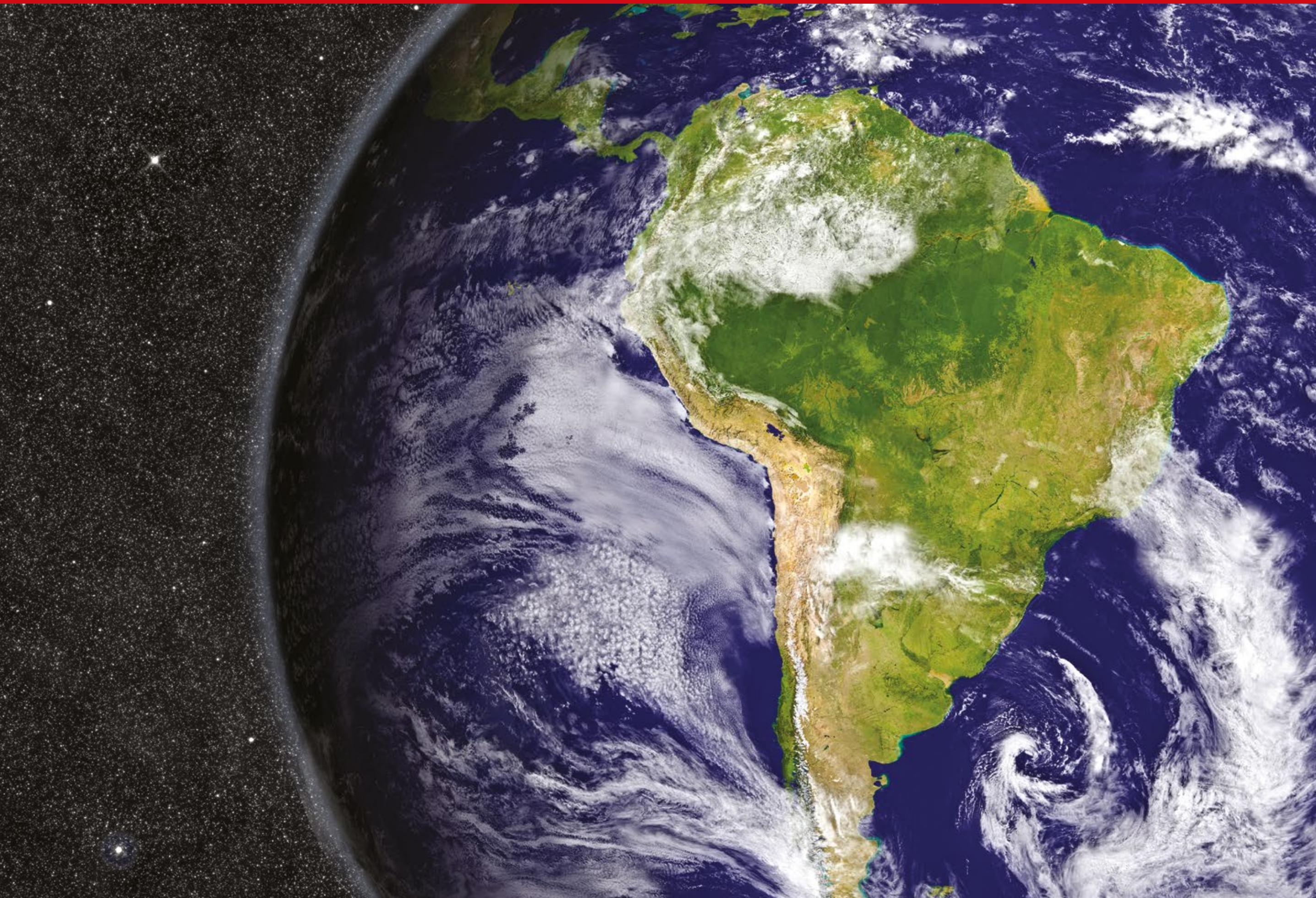

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Stepping up and bouncing back

Lorraine Yardley
Commercial editor
ITR

Latin America is expected to make a 'moderate recovery' following the global impact of COVID-19, according to the World Bank, with reports of a forecasted growth of 5.2% for 2021. Economic conditions are improving – the rebound may be slower than hoped but progressive steps are being taken in the right direction.

ITR brings you exclusive coverage from experts across Latin America on the most significant tax and TP-related developments.

Baker McKenzie's practitioners provide an insight on the general anti-avoidance rules and the potential the rules have to strengthen the tax system across Latin America.

Deloitte's TP experts report on the mandatory disclosure regime obligations in Mexico and the trends in TP audits across Central America. The Deloitte Brazil team focus on why local entities in Brazil continue to be affected by an increase on taxable adjustments arising from TP matters. As Colombia, Peru and Venezuela take steps to advance their TP models, the Deloitte team explain the approach each country is adopting.

Basham Ringe & Correa's article discusses Mexico's Income Tax Law, the US–Mexico tax treaty and the provision that requires foreign residents to pay a 10% tax on dividends paid to Mexican companies.

Chile has experienced several tax reforms, which have substantially changed the tax scene in Chile. EGB Abogados describe how the reforms are promoting growth in this most developed Latin America country. The Deloitte team provide a valuable insight on changes to tax planning reporting in Argentina and the new transfer pricing obligations in Chile.

We hope you enjoy this year's edition of the Latin America guide.

Latin America

ITR

Brazil

The increase of TP adjustments and the alternatives available to taxpayers

Carlos Ayub and Daniel Macedo of Deloitte Brazil take a closer look at the alternative options that companies in Brazil can apply to reduce tax effects, which are not always outlined in the TP legislation.

It is well known among global transfer pricing (TP) practitioners that Brazil has its own rules that significantly deviate from international standards. It is not news either that in recent years, Brazilian tax authorities have been discussing with the OECD issues involving the alignment of the current standards with international rules to obtain a place in the so-called group of rich countries.

In the meantime, local entities continue to be affected by an increase on taxable adjustments arising from TP matters, especially when it comes to imports with significant devaluation of the Brazilian currency, such as the one in 2020. The fact is that these high exchange rates variations affect the bottom line in 2021, when companies must settle their accounts with the tax authorities.

In this context, companies must be aware of the alternatives that can be applied to reduce the tax effects, which are not always outlined in the TP legislation itself but in other related tax or accounting statutes. This article addresses three of these alternatives, which are keen to an adjustment optimisation.

Cost of inactivity

It has been reported by several media outlets that, among major social and economic impacts, the COVID-19 pandemic resulted in high levels of idleness in several segments of the manufacturing industry.

Considering this fact, it is key that an entity follows the appropriate accounting treatment to reflect the effects of this idleness in its bottom line and, as a result, in its TP calculations.

Thus, in order to understand how the adverse impacts of this idleness can be eliminated in the TP calculations, first one must grasp its accounting aspects.

As the cost of the full production capacity used under normal circumstances is prorated to the individual cost of each item produced and, therefore, the larger the production scale, the lower the unit cost of each good. However, if for reasons beyond a company's control – such as the pandemic – companies may be operating below its usual production capacity, even for a short period, in which the unit cost of the manufactured items is affected since each individual item absorbs a greater share of fixed cost and overhead expenses.

In order to avoid such distortions, the best accounting practices suggest that "from the time when idleness ceases to be within normal thresholds, the cost referring to this excess idleness should be allocated directly to nonoperating expenses, as a nonrecurring item" (Securities and Exchange Commission of Brazil, or CVM in local acronyms, Guidance Opinion No. 24/1992).

Likewise, Accounting Pronouncements Committee's standard CPC 16, which sets the Inventories recognition standards, provides for the following:

> "13. The allocation of fixed production overheads to the costs of conversion is based on the normal capacity of the production facilities. Normal capacity is the production expected to be achieved on average over several periods or seasons under normal circumstances, taking into account the loss of capacity resulting from planned maintenance, collective vacations, and other similar events considered usual for an entity. The actual level of production may be used if it approximates normal capacity. The amount of fixed overhead allocated to each unit of production is not increased because of low production or idle plant. Unallocated overheads are recognised as an expense in the period in which they are incurred."

Once the importance of properly recognising idleness in an entity's accounting records is understood, one must now address the aspects concerning TP matters, while bearing in mind that in Brazil the methods most used to calculate the comparison benchmark prices by taxpayers and the tax authorities themselves are those based on predefined fixed margins, which are the resale price less mark-up (PRL) method for imports and the cost of purchase or production plus taxes and profit (CAP) method for exports. The current focus is on import transactions; therefore, the CAP method is not addressed in this article.

Focusing the PRL method application, it is imperative to remind that its formula requires taxpayers to test, on a product-by-product approach, a minimum gross profit margin earned by the resale of imported items, being for distribution or manufacturing purposes, against the fixed margins of 20, 30 or 40% given the tax payer economic sector, as provided by Law 12715/12.

Since in some segments, companies' output is below their regular production capacity, compliance with the accounting policies discussed here is paramount to ensure that the cost of each unit of production is not unduly increased by the cost of idleness.

Consequently, since the PRL method comprises of the net revenue and cost of goods sold, the taxpayer will be able to report to the tax authorities a realistic profit margins per product resold, free from the spill-over of idle-plant costs, and thus reduce or even eliminate the taxable adjustments arising from transfer pricing.

ICMS added to the PIS and COFINS tax base

On May 13 2021, the Brazilian Federal Supreme Court (STF) closed yet another key chapter in the so-called 'Thesis of the Century', concerning the calculation of the social integration program tax on revenue (PIS) and social security funding tax on revenue (COFINS), which had dragged on for more than four years and has now been celebrated by the Brazilian productive sector.

On March 15 2017, the STF had already acknowledged that adding back the state value added tax (ICMS) to the tax base PIS and COFINS would not be correct by setting the following thesis in stone: "ICMS is not an integral part of PIS and COFINS tax base."

It is worth noting, however, that the federal government appealed against this decision by filing a motion for clarification, where it requests, among other issues, that this decision only takes effect on future transactions, i.e. after the decision date, and that the ICMS amount to be deducted from said tax base is the tax amount actually paid to the states and not the tax amount separately disclosed in invoices.

The confirmation of the thesis outlined in 2017, recognising that there is no ambiguousness, omission, or contradiction in the awarded decision, and reaffirming that the ICMS amount to be deducted from the PIS and COFINS tax base is the ICMS amount separately disclosed in the invoice, was a victory for taxpayers celebrated on May 13 2021. It is worth mentioning that the effects of the court's decision may vary depending on some assumptions, including the date each individual lawsuit was filed by a company.

It is not our intention to break down the details of this Supreme Court's decision specifically as regards PIS and COFINS levies in this article, but rather to address the impacts of the decision on TP calculations.

To this end, this should be explained by recalling the provisions of Regulatory Instruction (IN) 1312/12 regarding the formula of the method most used both by taxpayers and the tax authorities themselves to support the import prices, namely, the PRL:

> "Article 12. The determination of the cost of goods, services or rights, acquired abroad, deductible from taxable income and the tax base of social contribution on net income (CSLL), may also be made using the resale price less mark-up (PRL) method, calculated, beginning January 1, 2013, using the following approach:
>
> "I – net selling price: – the weighted arithmetic mean of the selling prices of the good, right or service sold, less:

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Carlos Ayub is the TP partner leader of Deloitte Brazil. He has more than 31 years of professional experience, which besides TP services includes accounting audits and corporate tax.

In the TP area, where he has been working since 1999, Carlos provides services to local, European, Asian, Latin American and North American clients operating in various industries, such as automobile, chemical, pharmaceutical, and electronics. He has authored various articles on TP for reputable magazines, newspapers and other publications with national and international circulation. He is a member of the Brazilian TP group, which has been recognised by different institutions for several years as having the best TP team in Brazil.

Carlos has a bachelor's degree in accounting from *Faculdade de Ciências Econômicas de São Paulo – Fundação Álvares Penteado*, a bachelor's degree in law from *Universidade Paulista* and an MBA from *Fundação Getulio Vargas*. He has been recently quoted as one of the best references in TP in Brazil by Euromoney's Expert Guides.

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Daniel Macedo is a TP partner at Deloitte Brazil. His practice focuses on the development and implementation of TP policies for multinational groups. He has previously participated on a secondment programme from August 2012 to November 2014 at Deloitte Calgary – Canada, working as a TP manager.

Having worked at Deloitte since 2002, Daniel has extensive experience in advising local and international clients on import and export operations, loans among related parties, services agreements and pricing policies. He provides assistance for international clients on pre-operational stage, in order to determine the best approach for the transactions in Brazil, regarding the local TP legislation and other relevant tax aspects. He has assisted on the development of the Deloitte calculation software in Brazil, for complying with TP legislation.

Daniel is a graduate of international relations from Pontifical Catholic University of São Paulo.

"a) the unconditional discounts granted;
"b) taxes on sales; and
"c) commissions and brokerage fees paid;
"II – percentage share of the imported goods, rights or services in the total cost of the goods, rights or services sold: – the ratio between the weighted average cost of an imported good, right or service and the total weighted average cost of a good, right or service sold, calculated according to a legal entity's cost sheet;
"III – share of the imported goods, rights or services of the sales price of a good, right or service sold: application of the percentage share of an imported good, right or service of the total cost, calculated according to number II hereof, on the net sales price calculated in accordance with number I hereof;
"IV – mark-up: the application of the percentages provided for in Paragraph 10, according to the industry of a legal entity subject to transfer pricing control, on the share of an imported good, right or service of the sales price of a good, right or service sold, calculated in accordance with number III hereof; and
"V – benchmark price: the difference between the share value of an imported good, right or service of the sales price of a good, right or service sold, calculated according to letter III hereof, and the "mark-up" calculated according to number IV hereof;"

In brief, the method requires that the net sales price be determined by using of the weighted arithmetic mean of the sales prices of the goods, rights or services sold, less unconditional discounts granted, taxes on sales, and commissions and brokerage fees paid. It is important to clarify that 'taxes on sales' comprise the taxes levied on each sale, which are an integral part of a taxpayer's gross revenue. As an example, the law mentions ICMS, PIS, COFINS, and ISS (Service Tax) as taxes on sales.

As a result of the latest decision awarded by the STF, a taxpayer subject to TP rules on imports is now guaranteed the right to deduct part of the PIS and COFINS from gross price of sales, since ICMS is no longer added back to these taxes' calculation base, thus resulting in a higher net price and, consequently, also a higher profitability margin.

If a taxpayer meets the assumptions and circumstances necessary for the benefiting from the Supreme Court's decision on the taxes on revenue *per se*, such taxpayer may also benefit from this decision's impact on TP calculations.

In addition, the court determined that the prior ruling had retroactive effect as from March 15 2017, but taxpayers that filed a lawsuit up to March 15 2017 may recover amounts for the five-year period prior to the date of filing the lawsuit.

Regional ICMS tax incentive

The topic addressed below concerns the benefits that a taxpayer may also obtain by applying the PRL method, resulting from the allocation of ICMS-related tax incentives. In this endeavour, there is reference once again to Regulatory Instruction 1312/12, which in its of Article 12, paragraph 9, establishes that, for the purposes of the PRL method, the taxes and other charges levied by the government, on sales and included in the price, such as ICMS, ISS, PIS and COFINS, shall be considered as revenue reducers.

It is important to mention that even though the law sets forth objective criteria for the definition of the taxes that should be deducted from the gross sale price to calculate the net price, it does not provide any guidance on the tax treatment to be applied where there are tax incentives. Due to this omission on the part of the Federal Revenue Service, it is believed that such treatment should be based on relevant case law.

In this regard, Decision 1103000.672 is highlighted as awarded by the 3rd panel of the Administrative Council of Tax Appeals (CARF), which partially granted the voluntary appeal filed by a taxpayer, in order to determine the deduction of ICMS paid pursuant to the tax benefit granted by the State of Amazonas from the TP calculation:

"As to the merits, specifically regarding the deduction of ICMS from the calculation of the benchmark price in an amount higher than that the amount actually paid and due, I believe that the Appellant is correct. In fact, it is not appropriate to deduct the ICMS amount from the resale price at a 12% rate, when it is not actually due and paid at such rate. This is contrary to the spirit of the law."

Additionally, due to the lack of legal provisions in the law governing the scope of TP, it is necessary to use the definitions of net revenue outlined in other tax statutes. Notably, Regulatory Instruction 51/1978, which regulates sales and service revenue calculation procedures, for corporate taxation purposes, establishes that the ICMS and the IPI (tax on industrialised products, a federal VAT) bonus credits resulting from exports with tax incentives should be added to gross revenue in order to calculate net revenue. Even though the law does not specifically mention state tax incentives, one might construe, by analogy, that this definition can be extended to the stimulus tax credit earned by a taxpayer.

It is worth mentioning that understanding the requirements and methodologies set forth in the statutes that grant the benefit and the subsequent impacts of these same provisions, when allocating the benefits to said TP calculations, is key to minimise the possible risks related to the use of tax incentives in these calculations.

Even though there are several elements that must be observed in order to utilise the ICMS benefit in the TP calculations, there are sound arguments to support such utilisation.

This article is not intended to exhaust all the ramifications of the issues addressed above, but to provoke discussions regarding the possible resources that taxpayers may avail themselves of in light of the impacts of the exchange rate rise in Brazil and the devastating impacts that the COVID-19 pandemic has had on the economy.

In a subject that is a constant target of tax audits, as is the case of TP, appropriate technical advice is key to have a full understanding of all the aspects that are inherent to the alternatives presented here, as well as to maximise the tax results and minimise the tax risks.

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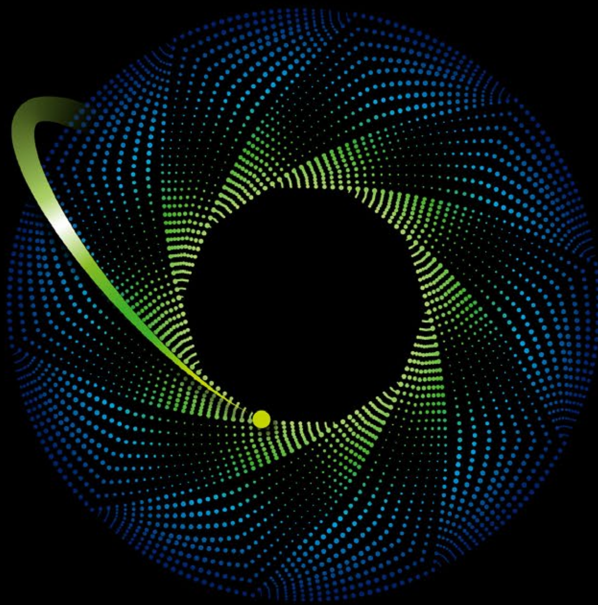

Transfer pricing
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