TP Minds Brazil 2022

Session: Transfer Pricing in Primary Products: Commodities
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Challenges in benchmarking the commodity transactions:

Various nuances regarding the manner in which deal is structured, variations in supply chain factors, difference in reference price etc.

#	Type	Variables for structuring a deal
1	Regulatory	Jurisdiction in which the market is being regulated
2	Regulatory	Contract security
3	Financial	Availability of financial instruments for certain commodities
4	Financial	Deal currency
5	Financial	Settlement type of futures contract i.e., physical delivery vs cash delivery
6	Financial	Financing of deal (finance recovery)
7	Trading/ Physical	Different exchange markets for same type of commodities
8	Trading	Trading hours differ per exchange market
9	Trading	Type of commodities
10	Trading	Quality variation per type of commodities
11	Trading	Volume
12	Trading	Deal delivery zone
13	Trading	Price quotation (spot vs forward prices)
14	Trading	Settlement price/Daily margin
15	Trading	Timing of the deal closure
16	Trading	Liquidity of trade, i.e., existence on a certain number of deals per timeslot
17	Operational	INCOTERMS
18	Operational	Deal delivery date
19	Operational	Availability of listed contracts
20	Operational	Expiration date

Variables for structures for structuring a deal, Source - Katerina Miari and Steef Huibregtse, Top Transfer Pricing Challenges for the Agricommodities Industry
BNAI European Tax Service Monthly Digest, 18 ETS 25, (October 2016)

Factors which add-up costs to the original reference price
1. Processing costs, e.g., blending, packaging, etc.
2. Local logistics, e.g., based on incoterms such as ex-works, CIF, etc.
3. Payment to 3rd party broker
4. Warehousing
5. Other (e.g. local market premium due to better product quality, discount based on high volumes etc.)

Supply chain and the factors which add-up costs to the original reference price , Source - Katerina Miari and Steef Huibregtse TPA GlobalTop Transfer Pricing Challenges for the Agricommodities Industry
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CUP OR SIXTH METHOD? – BEFORE GOING INTO THIS DISCUSSION LET´S HEAR BRAZILIAN PERSPECTIVE FIRST

Transfer Pricing in Primary Products: BRAZILIAN PERSPECTIVE

» Brazilian Transfer Pricing Methods for Commodities:

- PECEX – Export quotation Price Method;
- PCI – Price under quotation on Import Transactions

» Brazilian Transfer Pricing Legal Basis:

- Commodities methods were introduced in the Brazilian Transfer Pricing legislation through Law #9430/96 in September 2012;
- Normative Instruction (NI) #1312 was enacted only in December 2012 bringing more detailed guidance on the new procedures for commodities as well as other updates for the current fixed margins methods.

Commodity methods used to be considered as the most similar to OECD transfer pricing methods ... Is that true?

Transfer Pricing in Primary Products: BRAZILIAN PERSPECTIVE

» Mandatory Methods for Commodities:

- ✓ there is no “search for most apropriate method” when a commodity is being traded between related parties;
- ✓ The statement of reasons of Law #9430/96 evidences that the main purpose of the Brazilian standard would be to avoid “harmful practice” or “pricing manipulation” rather than the effective pursuit of arm´s lenght conditions for transfer pricing control purposes.

Is there any prejudment from lawmakers that the transaction carried out between related parties would have irregularities, fraud or tax evasion?

Transfer Pricing in Primary Products: BRAZILIAN PERSPECTIVE

» **Commodities definition :**

- ✓ there is a proper and exhaustive list of Commodities defined in Annex I of NI 1312;

» **Benchmark price:**

- ✓ quoted prices of the good listed on internationally recognized **commodity and futures exchanges** (Annex II) **or** public prices at internationally recognized **sectoral research institutions** (Annex III) **or** prices defined by **Regulatory agencies** or bodies and published in the Brazilian Official Gazette (not listed in the NI);

Attention: not all listed commodities have **frequent trading** activity in commodity future exchanges and players in different positions in the production and distribution chain may have **different margins** and it cannot be considered by the prices published by research institutions. Same concern applies to **different terms** on contracts for same goods.

Transfer Pricing in Primary Products: BRAZILIAN PERSPECTIVE

» Calculation Methodology:

- ✓ per transaction and per type of goods instead of “**basket approach**”;
- ✓ average quote on the transaction date or on the date of shipment/import declaration of the exported/imported goods;
- ✓ different perspective related to other Brazilian TP methods that follows the **Income tax calculation period - annual basis** -> transactions will be compared one by one, and not on an average basis
- ✓ safe harbour rules are **not** applicable;
- ✓ divergence margin of **3%** - up (to imports) or down (to exports).

Transfer Pricing in Primary Products: BRAZILIAN PERSPECTIVE

» **Price adjustments limited to (and in case of transactions carried out with non-related parties.**

- payment term
- negotiated quantities
- climate influences on the characteristics of the exported/imported good
- intermediation costs
- Packaging
- insurance and freight (incoterms)
- storage, internal transport costs, customs clearance, including taxes and fees levied on imports

In the absence of proper transactions by the legal entity domiciled in Brazil with unrelated persons, research carried out by a company or institution with notable technical knowledge based on technical publications or databases may be used - **if existent<u>internationally recognized</u>**

Transfer Pricing in Primary Products: BRAZILIAN PERSPECTIVE

» Brazilian TP approach X OECD TP approach

- ✓ there are no "**functions and risks**" to be analyzed, it means that there is an absence of an analysis of complete comparability and consequent of strict use of comparables;
- ✓ All the price adjustments are made based on a **limited list** of adjustment natures defined in the NI;
- ✓ Brazilian TP model has put in place effective mechanisms to curb abusive tax planning arrangement as the ones that intend to shift taxable profits to jurisdiction with favorable taxation and focus in simple, fast and effective manners to obtain that, reducing costs and litigation

- ✓ OECD model assumes active relationship, most of the time, between tax authorities and taxpayers in exchanging information or even in negotiating APAs and MAPS, however it usually results in relevant expenses in the control, execution and enforcement of APAs and MAPs

Transfer Pricing in Primary Products: Commodities (OECD Transfer pricing guidelines*)

From OECD Transfer pricing guidelines:

- *'The term 'commodities' refers **to physical products for which a quoted price is used as a reference by independent parties in the industry to set prices in uncontrolled transactions**' (Para 2.18)*
- *'The term 'quoted price' refers to **the price of the commodity in the relevant period obtained in an international or domestic commodity exchange market. Quoted price also includes prices obtained from recognised and transparent price reporting or statistical agencies, or from governmental price-setting agencies, where such indexes are used as a reference by unrelated parties to determine prices in transactions between them**' (Para 2.18)*
- *Price for the commodities being transacted would be determined by reference to **the average quoted price on the shipment date, subject to any appropriate comparability adjustments based on the information available to the tax administration** (Refer Para 2.22)*

**OECD (2017), OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017,* https://doi.org/10.1787/tpg-2017-en

Per the OECD, CUP is the appropriate transfer pricing method for establishing the arm's length price for the transfer between associated enterprises of commodities for which a quoted or public price is available

Transfer Pricing in Primary Products: Commodities (Definition)

Schoueri stresses that such concept is not limited to tangible assets but also comprises services, rights and interests referring to the concept of commodities introduced by the Commodity Exchange Act which regulates the trade of commodities and futures in the United States (See Commodity Exchange Act (USA), L.E. Schoueri, Preços de Transferência no Direito Tributário Brasileiro, 3rd edn. (Dialética 2013)).

Should definition include both goods and services?

Transfer Pricing in Primary Products: Commodities (BEPS ACTION 8-10)

- Final Reports on *BEPS Actions 8-10 Aligning Transfer Pricing Outcomes with Value Creation (https://www.oecd.org/tax/beps/beps-actions/actions8-10/)*
  - In order for the CUP method to be reliably applied to commodity relations, **reasonable comparison adjustments must be made in order to ensure that the economically relevant characteristics of transactions between related parties are sufficiently comparable to the ones happening on the market.** Such characteristics include, among others, physical attributes and commodity quality, the contractual terms of the transaction between related parties, the volumes transacted, the delivery time and terms, transportation and insurance of the goods and the change in the exchange rate. For some commodities, such relevant economic features may represent a premium or a discount.

Transfer Pricing in Primary Products: Commodities (UN Transfer pricing guidelines*)

From UN Transfer pricing guidelines: (Sixth method Commodity Rule: 4.7)

"The less arbitrary the sixth method and its criteria for application can be, the more legal certainty may result and the more efficient and successful audits of transactions and taxpayers subject to the method can be. Clarifying the definition of intermediaries subject to the sixth method (if and when it refers to intermediaries), specifying the transactions subject to the sixth method and specifying the criteria for its application will assist in reducing uncertainty and potential tax disputes. To the extent taxpayers can provide evidence as regards to the necessary substance of intermediaries and what would constitute an arm's length price, and the legislation includes provisions for adjustments to the publicly available commodity prices to assure improved comparability, the sixth method becomes more sophisticated and in line with the arm's length principle. Taxpayers may benefit from (improved) access to avoidance of double taxation in that event as well" (Para 4.7.5.7)

* United Nations Practical Manual on Transfer Pricing for Developing Countries 2021 (https://www.un.org/development/desa/financing/document/un-practical-manual-transfer-pricing-developing-countries-2021)

Transfer Pricing in Primary Products: Commodities (CUP)

CHALLENGES IN APPLYING CUP

- **Market conditions**
- **Price volatility**
- **Frequency of trade**
- **Risk profile**

Transfer Pricing in Primary Products: Commodities (SIXTH METHOD)

Applicability of sixth method:

Per the United Nations Transfer Pricing Manual (UN, 2017), and CIAT (2013), Latin American countries have implemented the Sixth Method for the valuation of commodities in international transactions

Concept / Country	Argentina	Bolivia	Brazil	Costa Rica	Ecuador	Guatemala	Paraguay	Peru	Dominican Republic	Uruguay
Only commodities	✓		✓	✓	✓	✓	✓		✓	
Exports	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
Imports		✓	✓	✓		✓		✓	✓	✓
Intermediary (Required)	✓					✓				
Price Date shipment (export) / unloading (Import)	✓	✓				✓			✓	

Source: https://www.ciat.org/transfer-pricing-and-commodities/?lang=en

SIXTH METHOD IS NOT APPLIED UNIFORMLY ACROSS COUNTRIES

Transfer Pricing in Primary Products: Commodities (SIXTH METHOD)

Different approaches to implementation of sixth method:

Aspect	Adopted approach
Transactions covered	• Only export transactions • Only import transactions • Import and export transactions
Nature of the measure	• A way of applying the CUP Method • A way to arrive to an arm's length price • A separate method
Products or goods subject to the measure	• Commodities • Renewable natural resources and / or non-renewable natural resources • Goods with known quotes in transparent market • Some regulations allow tax administrations to extend the measure to other goods provided that meet certain requirements. • The international intermediary does not have economic substance • And/ or the tax agency considers it appropriate
Relation condition	• Some countries define the condition by which the international exporter and / or intermediary trader and / or the exporter at origin and the importer at destination are related parties. • Some apply the method whenever the foreign company is resident in a listed jurisdiction (non-cooperative, low tax jurisdiction, or under a privileged tax regime), regardless of whether the companies involved are related enterprises.
Hierarchy of the method	• Mandatory if the conditions established in the regulation are met; • Optional, either this measure or the CUP method, or other OECD methods may be applied; • Not expressly established by the regulation

Aspect	Adopted approach
Prices to be considered	• Exports and imports are afforded different treatment: ◊ For exports: research on international prices in accordance with the terms agreed upon by the parties as of the last shipment date unless there is evidence that it was agreed on another date; ◊ For imports: the price may not exceed the price based on international parameters as of the date on which they were originally purchased • Multiple criteria in a single regulation: (i) price on the transparent market on the loading or unloading date; (ii) average price over a 4-month period or 120 days prior to unloading or after loading; (iii) price as of the date on which the agreement was executed; (iv) average price over a 30-day term after the agreement was executed; (v) quoted price on the transparent market on the loading date, that of the prior date in which a quoted price was available or that of the first day the goods are loaded (the criterion adopted varies by country)
Comparability adjustments	• Some countries allow for comparability adjustments to the publicly available price so as to take into account market circumstances, contract terms and conditions, and product quality and specifications whereas other countries do not accept comparability adjustments.
Exemptions to applying the rule	• Some measures provide the local taxpayer with the possibility to evidence that the intermediary has economic substance and thus be exempted from applying the rule, even though the criteria are not the same in every case. • Some countries exempt the application of the Sixth Method if an agreement is filed with the tax agency or with any other government agency a few days after it has been signed.

Source: Veronica Grondona, Transfer Pricing: Concepts and Practices of the 'Sixth Method' in Transfer Pricing, Tax Cooperation Policy Brief, No.2 (May 2018), South Centre Tax Cooperation

Transfer Pricing in Primary Products: Commodities

» International point of view

- ✓ Legal certainty in tax matters, however, it is also important from an international point of view, but due to existing divergences between the Brazilian system and systems compatible with the OECD around the world, taxpayers face the risks and uncertainties related to double taxation, as well as possible disputes and challenges arising from tax administrations in other jurisdictions
- ✓ **Need of appropriate documentation – Agreements and supporting documentations, price setting policy documents etc.**