Brazil issues new transfer pricing rules seeking alignment with arm's length principle

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In brief

The Brazilian Government on December 29 issued Provisional Measure (MP) 1.152/22 seeking alignment with the arm's length principle (ALP) in accordance with the OECD Transfer Pricing Guidelines. The MP is effective immediately with the force of federal law. In order to remain effective, Congress must ratify the MP within 60 days from the date of publication (discounting Congressional recess, the initial deadline is April 2023), and convert it into ordinary law. This term may be extended for an additional period of 60 days (i.e., by June 2023). Congressional amendments to the provisions of the MP may be proposed by February 3, 2023.

MP 1.152/22 represents a complete overhaul of Brazil's transfer pricing system, and would be mandatory for taxpayers starting January 1, 2024. Taxpayers may opt into the new rules with retroactive effect starting January 1, 2023. The MP is consistent with the terms announced by the Brazilian Tax authorities in public consultations, which took place from February through September 2022, and incorporates feedback and input provided by taxpayers during the public consultations.

While the new law is extensive, it is mostly principles-based and delegates substantial authority to infralegal regulations to be issued by the Federal Revenue of Brazil (*Receita Federal do Brasil* (RFB)). The rules follow the general provisions of the OECD Transfer Pricing Guidelines. Specific details will be fleshed out in the regulations, which may have some Brazilian nuances.

Observation: Certain issues and terms that raise questions, such as specific anti-avoidance rules (SAAR) limiting royalty and service deductions for remittances from Brazil that benefit from low-tax regimes in the recipient jurisdiction, as defined by the Brazilian regulations yet to be issued. The substantial authority delegated by the law to the regulations currently being drafted by the RFB also could raise the question as to whether the new Brazilian corporate tax system would be deemed compliant with the arm's length standard as referenced in the US foreign tax credit (FTC) regulations.

Observation: Brazil's MP is likely to be approved by the National Congress, as it represents both an improvement in the Brazilian business environment for foreign investors, and eliminates disparities that may lead to non-taxation. It is not yet clear whether the new rules provide a basis to conclude that Brazilian corporate income tax is a creditable tax under the Final US FTC regulations. An in-depth analysis of the new Brazilian rules is warranted to determine whether the new Brazilian rules are consistent with US and international standards.

This Tax Insight presents a summary of the main changes introduced by the MP, highlighting improvements not only vis-à-vis historical Brazilian rules, but other countries' applications of the ALP. Also highlighted are some issues that still may raise questions and demand caution and diligence in the analysis of the new Brazilian system for both TP and US FTC purposes.

In detail

Background

In February 2018, a joint OECD and RFB project was publicly launched regarding needed changes to the Brazilian transfer pricing (TP) rules, which is one requirement for Brazil's accession to the OECD. After the conclusion of the 'joint project,' in December 2019, the OECD and the RFB jointly issued a final report (see PwC's Tax Insight for more details).

Following the publication of the joint study by the OECD-RFB, changes to the rules gained momentum separate and apart from the OECD accession process. Convergence to the ALP became broadly viewed by the Brazilian government and by the technical bodies of the RFB as an opportunity to improve the Brazilian business environment through elimination of situations or cases of double taxation, which both discourages foreign investment in Brazil and limits Brazil's participation in global value chains. Moreover, through cooperation with the OECD Secretariat and other tax authorities involved in the joint OECD-RFB project, the RFB concluded that the new rules would have a revenue-raising effect in circumstances involving export-oriented groups, especially Brazilian multinationals.

In 2022, discussions intensified in light of the finalization of the US FTC regulations governing, *inter alia*, creditability of foreign taxes (Final US FTC regulations). One of the key issues with respect to Brazil's residence-based corporate income taxes (IRPJ and CSLL) is their historical nonalignment with the ALP.

The new Brazilian TP system, therefore, raises two fundamental questions:

(1) Does it fully align with the ALP?

(2) Would it currently allow Brazil's corporate taxes IRPJ and CSLL to be deemed creditable foreign income taxes in the United States, particularly in light of the transition rule (optional adoption in 2023, mandatory in 2024)?

Overview of the main changes introduced by the MP

The arm's length principle

The ALP was specifically referenced in the law as the cornerstone of the new system. However, in contrast to the US Internal Revenue Code Section 482, the only US statutory language on the matter, or its treaty equivalent (article 9 of the OECD Model Convention), there is more language in the Brazilian law, with substantial authority given to the RFB to define and interpret statutory terms.

Observation: Even though some of the terms used in the MP on the surface would appear consistent with what is observed in other countries within Latin America, and more broadly in other regions, the combination of the substantial authority delegated to regulations yet to be issued, and some specific issues of nonalignment with international standards (as discussed herein) that are already noted in the Brazilian approach, could raise issues. It remains to be seen whether Brazil will administer the rules similarly to OECD and non-OECD countries. It is expected that the regulations currently being drafted will offer more clarity in this respect.

Still, in broad alignment with the standards as interpreted by the OECD TP Guidelines, the new Brazilian law determines that in order to ascertain whether the terms and conditions established in controlled transactions are in accordance with the ALP, it is necessary to:

- delineate the controlled transaction, considering (1) contractual terms and conditions, (2) functions, assets, and risks, (3) characteristics of goods and services, (4) economic circumstances of the parties and the market, and (5) companies' business strategy; and
- undertake a comparability analysis.

The law also provides broad definitions of associated enterprises (or related parties) and controlled transactions, as well as methods, certainty measures, and other matters.

Associated enterprises vs. related parties: Influence standard (not control)

Brazil continues to use a broader net to include in local studies transactions that are not under common control, diverging from the US standard. Brazil's rule is also broader than — albeit not inconsistent with — the OECD TP Guidelines in this respect.

Brazil's prior rules applied to transactions involving resident entities and nonresident "related parties," as well as transactions involving third parties (e.g., commercial dealings involving "exclusivity" in cross-border trade and transactions with "tax havens" and "privileged tax regimes"). The "related party" hypotheses were listed in article 23 of Law 9.430/1996.

The new law determines that parties are related when at least one of the parties is subject to "influence," exercised directly or indirectly by another party, which may lead to the establishment of terms and conditions in their transactions that differ from those that would be set between unrelated parties in comparable transactions. The term here is not "control," and the law provides some hypotheses of related parties in a non-exhaustive list that includes, for example, certain firms with common minority shareholders.

Observation: In the OECD TP Guidelines and generally under the US regulations (the US rules do include some broader concepts regarding control), the term used to define "associated enterprises" is based on principles of "common control" and not "influence"; therefore, an economic approach to ascertain whether "common control" exists is warranted. Brazil will undertake an economic approach to ascertain whether "common influence" exists, thus reaching more transactions than the international standard.

The provisions of the MP also apply to transactions carried out with any entity resident or domiciled in low-tax countries referencing a corporate tax rate of 17% (in prior law, a 20% standard was used), or considered beneficiary of a "privileged tax regime" to be defined in the regulations of the RFB. In using 17% as the rate to define low-taxation triggering anti-avoidance rules, Brazil diverges from the 15% global minimum taxation standard under the OECD Pillar Two.

Controlled transactions

The scope of transactions subject to TP analysis has broadened, and now is consistent with international standards. Previously, Brazil's TP scope was limited to imports and exports of goods, services, and rights, as well as interest; a separate body of rules imposed formulary deductibility limitations to royalties. The new rules provide that a controlled transaction comprises any commercial or financial relationship between two or more related parties, established or carried out directly or indirectly, including contracts or arrangements in any form and series of transactions.

In the previous regulations, royalties, technical, scientific, administrative, or similar assistance were subject to specific deductibility rules with statutorily defined thresholds and "valuation" and were not tested as such for Brazilian TP purposes. Now that these historical deductibility limitations have been revoked, the new general rule is that royalties are deductible under the ALP as legislated and regulated in Brazil.

Nonetheless, a new limitation was established determining that not only payments to entities located in countries with favored taxation or considered a beneficiary of a privileged tax regime will be nondeductible (in full), but also payments to related entities in cases of double nontaxation. All these terms are yet to be further defined in

infralegal regulations. Remaining to be determined are whether the US foreign-derived intangible income (FDII) regime will be deemed privileged, and other cases of double nontaxation.

Observation: The anti-avoidance rule in the new law seems to diverge from the ALP. Under the principle of combating tax avoidance and base erosion, the new rule could arrive at disproportionate results — e.g., a Brazil 34% tax is effectively collected on a full nondeduction, while a foreign recipient pays another level of tax where the same royalty revenue is subject to a nexus-compliant, nonharmful tax regime reviewed and greenlighted by the OECD. It remains to be seen whether the RFB, when issuing the regulations, references the tax rate in the recipient's country simply to impose a full disallowance of deduction without applying a proportion that allows collection of a minimum tax of 15% (and not more). If it does, Brazil would be diverging not only from the ALP but from global anti-base-erosion standards.

Comparable transactions

Here the Brazilian rules are consistent with international standards. The transaction between unrelated parties may be considered comparable to the controlled transaction when (1) there are no differences between the economically relevant characteristics of the transactions, including their terms, conditions, and circumstances, which may materially affect the financial indicators examined under the most appropriate method or (2) adjustments can be made to eliminate the material effects of any differences.

TP methods

Regarding TP methods, the new rules fully converge with the OECD TP Guidelines. Taxpayers no longer will have the option of choosing the method that results in the lowest adjustment to the IRPJ and CSLL calculation bases. Instead, the most appropriate method must be selected considering the facts and circumstances of the transactions and the availability of reliable information of comparable transactions, among other factors.

Brazilian law now includes the traditional transactional methods without statutorily fixed formulae — i.e., Comparable Independent Price Method (PIC); Resale Price minus Profit (PRL); Cost plus Profit (MCL) — as well as the profit-based methods — i.e., Transactional Net Margin Method (MLT); and Profit Split (MDL). A combination of methods is allowed.

The PIC method must be considered the most appropriate method when there is reliable information on prices or amounts arising from comparable transactions carried out between unrelated parties, unless it can be established that another method (listed above) is more appropriate in order to comply with the ALP.

Note: Other methods may be considered as long as they can produce a result more consistent with the ALP.

The tested party

In cases where the application of the method requires the selection of one of the parties to the controlled transaction as the tested party, the one in relation to which the method can be most appropriately applied and for which more reliable data is available will be selected. Foreign parties and foreign data can be used, and adjusted.

Range of comparables

Regarding comparables, the new rules bring a welcome innovation, allowing not only the use of an interquartile range in a panel of comparables, but also the full range of comparables when the data collected is deemed reliable. In case of uncertainty regarding the reliability of such comparable indicators (margins, prices), the taxpayer would need to use the interquartile range. In the absence of a study prepared by the taxpayer, the median will be used by the tax authority.

TP adjustments to the IRPJ and CSLL calculation bases

Brazil legislated the types of adjustments it will allow or impose, noting only corporate taxes IRPJ and CSLL are in scope (not income withholding taxes IRRF). Primary (dubbed "spontaneous" for taxpayer-initiated) adjustments and corresponding adjustments are allowed, while secondary adjustments can be imposed by the authority.

Observation: In the case of secondary adjustments, the law sets a yearly interest rate of 12%, which itself is not an approach consistent with the ALP (instead an arm's length interest rate should be imputed).

Primary adjustments will not be permitted to reduce IRPJ and CSLL (or increase tax losses). However, corresponding or compensatory adjustments carried out according to the conditions and within the terms established by the RFB, or deriving from results agreed to in the dispute resolution mechanism, can reduce Brazilian corporate taxes or increase tax losses.

Again, in cases where a primary (or spontaneous) adjustment materializes, the secondary adjustment will be determined considering this adjusted amount as a credit granted to the relevant related parties of the controlled transaction, remunerated at an interest rate of 12% per year, until the date when the credit is fully refunded to the Brazilian entity. The interest rate will be reduced to zero if the stated credit is fully refunded to the Brazilian taxpayer within 90 days.

Commodities

The MP sets forth the concepts of "commodities" and "quotation price" and determines the application of the PIC method as the most appropriate, except if it is possible to determine that another method would be more appropriate considering the characteristics of the transaction.

Observation: It is this exception to the general rule of PIC/CUP application that would enable consistency with the ALP, subject to infralegal regulations.

The RFB will regulate the choice of commodity and futures exchanges, research agencies, or government agencies, use of other sources of price information, as well as the form and deadline for the taxpayer to register controlled transactions of export and import of commodities.

Provisions for specific transactions

The new TP rules, in principle, are fully aligned with the ALP with respect to intangibles and royalties, putting an end to a historic divergence on the limitation to the deductibility of royalties. In relation to business restructuring, the new rules also are aligned with OECD TP Guidelines and the ALP.

Some of the main changes introduced by the MP include:

- Transactions with intangibles, including hard-to-value intangibles. ***Note:*** The mere legal ownership of the intangible asset will not give rise to the attribution of any remuneration resulting from its exploitation. Brazil thus is adopting the DEMPE standard, consistent with the latest version of the OECD TP Guidelines.
- Intragroup services. The activity must result in a benefit to the recipient parties. Partner activities or duplication of a service are not considered as services and shall not be entitled to remuneration.
- Cost sharing arrangements, where two or more related parties agree to share contributions and risks related to the acquisition, production, or joint development of services, intangibles, or tangible assets based on the proportional benefits that each party expects to obtain.
- Business restructurings, including taxing potential expected profits associated with the transfer of functions, assets, risks, or business opportunities, including the potential profit to a related party as a result of the renegotiation or termination of commercial or financial relationships with unrelated parties.

Specific rules for financial transactions also are included, mainly regarding guarantees, treasury functions, and insurance.

Documentation and penalties

The RFB will determine the format, timeline, and requirements to provide the TP documentation.

In the event of a tax audit, the taxpayer will be allowed to rectify the corporate return, exclusively to rectify the TP adjustments, provided that it complies with certain conditions established in the legislation and regulated by RFB.

Noncompliance or delay with TP documentation or ancillary obligation, as well as in the provision of information on TP audit, may subject the taxpayer to penalties between BRL 20,000.00 (20,000 Brazilian reais) and BRL 5,000,000.00 (5 million Brazilian reais). Other sanctions also may apply.

Simplification measures (safe harbors) and other provisions

The law allows the authority to establish "simplification measures for the application of the ALP," including safe harbors. These measures would serve to simplify the comparability analysis, including waivers or simplification of TP documentation, to provide additional guidance for specific transactions, and to provide specific treatment in case of limited availability of information for the application of the new rules. A new system of ALP-compliant, optional (opt-in) safe harbors has been supported by taxpayers and representative entities from multiple industries as a mechanism to reduce controversy and uncertainty in Brazil.

The law also authorizes the RFB to establish and regulate an advance pricing agreement (APA) program. APAs will be valid for up to four years and may be extended for two years, upon application by the taxpayer and approval by the competent authority.

Observations

The MP is limited in scope to transfer pricing and does not address withholding (and other) taxation of cross-border transactions. Therefore, Brazil's high tax burden on service fees and royalties may continue to be an issue for Brazil's integration into global value chains, and may keep Brazil at odds with international tax standards and the OECD Model Convention.

The sophistication of the new system may raise new challenges for taxpayers with complex (nonroutine) operations in Brazil, not only because interpreting and applying the ALP inherently is complex and uncertain, but also because Brazil is a large, closed, and complex economy, and the Brazilian tax system lacks similarly sophisticated dispute resolution mechanisms. The volume of taxpayer cases that will have complex comparability adjustments, complex choices or combinations of methods, and complex functional profiles may make APAs challenging to administer and negotiate, which could reduce the effectiveness and attractiveness of a Brazilian APA program. A new, improved dispute resolution program would be needed to enhance certainty. Brazil's tax treaty network also must be expanded, and Brazil treaties should include MAP Arbitration, which induces cooperation and mitigates risks to taxpayers and authorities in all jurisdictions involved.

Accordingly, it would be helpful for a transition rule to be in place, which allows taxpayers to have sufficient time to evaluate the new system and to revisit their functional profiles and value chains within Brazil.

Let's talk

For a deeper discussion of how Brazil's new transfer pricing rules might affect your business, please contact:

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