Brazil reinforces commitment to align its TP rules with OECD Guidelines; taxpayers requesting more clarity

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In brief

Brazil's Ministry of the Economy reaffirmed on April 12 its commitment to 'fully converge' its transfer pricing (TP) rules to the arm's length standard (ALS), bringing the rules in line with the OECD TP Guidelines. Specific draft legislation has not yet been released. This announcement is of increased significance to taxpayers in light of the recently adopted final regulations (TD 9959) (the 'Final Regulations') by the US Department of Treasury (Treasury) and Internal Revenue Service (IRS) addressing various aspects of the US foreign tax credit (FTC) regime, as well as BEPS 2.0 developments.

Takeaway: Taxpayers should continue to remain engaged, particularly since more clarity is needed as to whether any provisions might still raise concerns particularly for US FTC purposes, when draft provisions will be published or if the debate will remain high-level and conceptual.

In detail

Background

Following years of participation as a 'key partner' of the OECD, including a prominent role in the International Forum of Tax Administrations, and after taking an influential role in the OECD/G20 BEPS Project, Brazil changed its long-standing position of rejecting OECD membership and applied for accession to the OECD in May of 2017. Accordingly, the alignment of the Brazilian TP system with the ALS and with the OECD TP Guidelines was raised by OECD member countries in Working Party 6 as the first critical step to address in the process of Brazil being confirmed by the OECD as a candidate for accession. Thereafter, a taskforce was organized and funded by the UK, involving Brazilian tax officials along with the OECD Centre for Tax Policy and Administration, and in cooperation not only with tax authorities from the UK, but also from other countries such as the United States, Canada, France, Mexico, and Spain, to pursue Brazil's convergence to the ALS.

In February 2018, the joint OECD and *Receita Federal do Brasil* (RFB) project was publicly launched. Significant progress was made in 2018 and 2019, which included public consultations. After the conclusion of the 'joint project,' in December 2019, the OECD and the RFB jointly issued a final report, affirming that Brazil had identified "a clear pathway for aligning its transfer pricing framework with the OECD standard" — i.e., the full adoption of the ALS in Brazilian law, specifically, with full alignment of Brazilian TP rules to the OECD TP Guidelines.

The RFB indicated the next steps would be the drafting of the legal and infra-legal provisions, or a blueprint of the actual norms that would be put in place. The two pending issues were (1) how much content would be legislated (i.e., included in ordinary law) versus regulated (i.e., governed by a Presidential Decree and by Normative Instructions equivalent to US Treasury Regulations); and (2) how exactly the infra-legal safe harbors for routine functions and activities would work.

TP reform was delayed by the impact of the pandemic and by other domestic tax reform proposals until mid-2021, when the income tax reform bill (Project of Law – PL 2.337/2021) was submitted by the Ministry to Congress. That bill included a preamble where Brazil's intent of alignment with the tax practices of OECD Member Countries was again affirmed, in the context of lowering Brazil's corporate tax rate, and reintroducing a dividend withholding tax, among other measures.

Note: The US Treasury and the IRS on December 28, 2021 released Final Regulations addressing various aspects of the US FTC regime. The Final Regulations, published in the Federal Register on January 4, 2022, became effective on March 7, 2022, with certain provisions applicable to periods beginning before that date. The Final Regulations affect taxpayers that claim credits or deductions for foreign income taxes and include guidance on the definition of a foreign income tax and a tax in lieu of an income tax, including a new attribution requirement.

Observation: The Final Regulations raise a number of questions around the creditability of corporate taxes, including whether Brazilian taxes on corporate income (e.g., IRPJ and Social Contribution of Net Income (CSLL)) may be deemed to satisfy the new attribution requirement. The Brazilian business community commented in February-March 2022 that Brazil transfer pricing rules consistent with the ALS may alleviate some of the concerns of Brazilian corporate tax creditability, if the draft provisions are indeed consistent with the ALS and also satisfy the 'cost recovery' test under the Final Regulations.

On January 25, 2022, the OECD extended a formal invitation for Brazil to start the accession process, effectively 'accepting' Brazil's status as a key candidate for accession — an invitation which would not have happened without Brazil's prior commitment to fully converge to the ALS. In February 2022, the RFB and the OECD announced that an event would be held on April 12, 2022 to unveil Brazil's new transfer pricing system; instead, the Brazilian Government again reinforced its commitment to fully converge to the ALS and demonstrated that it intends to bring into the proposed law key features of the OECD TP Guidelines. The text of the law will be presented to the National Congress only after discussions with stakeholders and the main sectors involved are carried out. Such discussions are underway, yet without information on the text of the new law and new regulations.

New Brazilian rules

The new Brazilian rules, as expected, and necessarily as a result of the December 2019 announcement and publication, will include topics explicitly covered in the OECD TP Guidelines, such as:

- Explicit reference to the ALS as the guiding transfer pricing principle;
- A definition of related parties and a list of situations that will give rise to the application of TP rules;
- Reference to comparability factors, involving (a) contractual terms and conditions, (b) functions, assets, and risks, (c) characteristics of goods and services, (d) economic market circumstances, and (e) business strategy of the companies;
- Introduction of the profit-based Transactional Net Margin Method (TNMM) and Profit Split Method (PSM), in addition to the acceptance of other methods, such as the valuation method in the case of unique and valuable intangibles;
- Adopting the 'most adequate' method according to the facts and circumstances of the operation and availability of information for documentation;

- 'More flexible rules' for commodities, with the stated objective of capturing market values;
- Acknowledging Cost Contribution Agreements (CCAs) and addressing business restructurings;
- Introduction of new rules related to financial operations — e.g., adopting the OECD standards relating to debt, cash-pooling, guarantees, and insurance;
- New documentation format, adopting three elements in line with the OECD BEPS Action 13 — in addition to the Country-by-Country (CbC) reporting already provided for in the current legislation, the Master file and Local file will be introduced; and
- Introduction of Advance Pricing Agreements (APAs).

The RFB indicated that these elements are to be included in detail in the text of the statute. The RFB did not accept the suggestion by the business community to include in the statute a more succinct provision such as that of Articles 9(1) and 9(2) of the OECD Model Convention, or the regulations under US Internal Revenue Code Section 482. That suggestion would have simply imposed the ALS as the rule, and left most of the language from the current version of the OECD Guidelines, which interprets the ALS, to the Income Tax Regulation (Income Tax Decree, which is not fully controlled by the RFB but requires Ministerial and Presidential enactment), and operational details, as well as ALS-compliant safe harbors, to Treasury Regulations (Normative Instructions). From the RFB's viewpoint, infra-legal norms would only govern a new system of safe harbors for routine functions and activities, such as a specific provision for low-value-added intra-group services, aside from operational details of provisions included in ordinary law.

Issues

The April 12 announcement introduced new references in the RFB slide deck to issues that may be problematic vis-à-vis the ALS and the creditability of Brazilian corporate taxes under the US FTC Final Regulations, such as:

- The RFB still intends to keep royalty deductibility limitations as an 'anti-avoidance' rule (noting Brazil also will have interest limitations such as those used by OECD members and not viewed as conflicting with the ALS, and treating royalty limitations as equivalent). Key concerns that can be raised have to do with the definition of 'avoidance' by the RFB. For example, could the RFB legislate that royalties paid to a 'genuine' entity, yet subject to a 'low tax rate' while not carrying Development, Enhancement, Maintenance, Protection and Exploitation (DEMPE) functions (that are performed, for instance, by a US Parent), would be nondeductible in full or in part? Would a 'low tax rate' serve as a proxy for 'avoidance,' irrespective of beneficial ownership or DEMPE?
- The RFB suggests legislating the use of 'rebuttable presumptions' in the context of 'penalties' (i.e., cases where taxpayer studies are nonexistent or disregarded). This notion (derived from Brazilian academics) theoretically could, for example change the burden of proof back to taxpayers if the RFB discredits a comparability analysis. Instead of demonstrating an alternative (adequate, viable, transparent) set of comparables, the RFB perhaps could impose 'presumptions' (e.g., statutorily fixed margins) based on opaque comparables collected under taxpayer secrecy from Brazil's sophisticated electronic filings systems (e.g., SPED, ECF), which taxpayers would have to 'rebut' (albeit without penalties), that is, enter into an administrative dispute proceeding.

Observations

Introducing into an ordinary federal law (requiring Congressional approval) language and terms from the current version of the OECD TP Guidelines that typically are brought into local rules by other countries as infra-legal regulations could introduce rigidity and risks in case the OECD TP Guidelines materially change in the future. Legislating in detail on TP may increase certainty, but could detract from the dynamic nature of the OECD TP Guidelines and Commentary to the OECD Model Tax Convention, and might create distortions in the future, as legal constructs under domestic law could deviate from future interpretations of the ALS.

A more flexible approach, as suggested by the Brazilian business community, could be to include in the law as little as possible, perhaps the same language contained in the OECD Model Tax Convention Articles 9(1) or in the U.S. IRC sec. 482. The Income Tax Regulation (a Presidential Decree, not fully controlled by the Tax Authority) instead could contain most of the provisions, interpreting the meaning of the ALP fully aligned with the current version of the OECD TP Guidelines. However, if in the future the OECD TP Guidelines change, it would be more efficient to update the decree than to amend the statute. Infra-legal, infra-decree, treasury rulings (‘normative instructions’) could provide further operational guidance, and further details, including safe harbor provisions that are appropriate for Brazil.

A system of safe harbors (supposedly opt-in) still is being developed and would come in the regulations, fully governed by the ALS. It is still to be determined whether any such safe harbors will be common and comparable with what already exists in the OECD rules, aimed only at routine or low-value-adding functions, whether they will include or embody Pillar One (specifically, amount B), or whether they will be more advanced or innovative. Perhaps Brazil’s specificities (large, closed economy, highly regulated, with relative cross-sector prices affected by unique transactional-level taxation), including the large volume of financial statements and transactional microdata available to the local tax authorities due to Brazil’s specific electronic filing systems, could support the development of RFB safe harbors that taxpayers could safely opt into, even in fact patterns where local functional profiles are beyond ‘routine.’

Finally, the Brazilian system should not be over-reliant on unilateral APAs or administrative dispute proceedings within the RFB (be it with a system of ‘rebuttable presumptions’ or not). The RFB remains understaffed (particularly in the international division) and arguably underfunded as stated by the RFB Union itself in the ongoing strike currently affecting taxpayers’ international trade adversely. Questions as to whether the RFB would have the installed capacity to handle and process a high volume of APAs that may be quite complex, also given the peculiarities of the Brazilian market and law, lacking a main risk mitigation framework such as a wide treaty network (comparable to the average network of OECD member countries), and treaties in force consistent with the OECD Model Tax Convention, with Articles 9(1) and 9(2), and including Mutual Agreement Procedures (MAP) with binding arbitration.

Let’s talk

For a deeper discussion of how Brazil’s commitment to align its TP rules with OECD Guidelines might affect your business, please contact:

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