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The Brazilian Mysterious position on Actions 8-10: a blank check for cherry picking?

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Brazil is known for its unique transfer pricing legislation. While in most countries the use of comparables is central for the application of the transfer pricing methods, the Brazilian system has conceived the "fixed margins", as means of ensuring practicability[1].

The Brazilian legislation adopts the predetermined profit margins under the equivalents of the resale and cost plus methods, deviating from the international standards. The fixed margins system is only concerned with the profits of the Brazilian entity, being irrelevant the amount of profits to be paid to the other entities of the group. It does not take into account the global profit of the MNE. Neither does it disregard the intra-group transactions. Hence, it should not be confused with Formulary Apportionment. The fixed margins approach is essentially a transactional approach, which implies a more "rough justice" in the detriment of the case-specific approach of the OECD Guidelines. Instead of comparability, the choice is to set a profit margin (*e.g.* 40%) for all transactions in a deemed economic sector (*e.g.* pharmaceutical).

This approach is considered by Brazilian tax authorities as compatible[2] with Brazilian international obligations under Article 9, being relevant to mention that Brazil has never agreed to include Article 9(2) of OECD Model in its tax conventions.

How is such system interacting with the BEPS Project? Brazil holds a very peculiar position with regard to Actions 8-10. In the executive summary of BEPS Actions 8-10 Final Report one reads that:

[This Report] represents an agreement of the countries participating in the OECD/G20 BEPS Project. For countries that formally subscribe to the Transfer Pricing Guidelines, the guidance in this Report takes the form of amendments to the Transfer Pricing Guidelines. Therefore this Report also reflects how the changes will be incorporated in those Guidelines.

The statement is then followed by a footnote ("Note 1"), according to which:

Brazil provides for an approach in its domestic legislation that makes use of fixed margins derived from industry practices and considers this in line with the arm's length principle. ***Brazil will continue to apply this approach and will use the guidance in this report in this context.*** *When*

Brazil's Tax Treaties contain Article 9, paragraph 1 of the OECD and UN Model Tax Conventions and a case of double taxation arises that is captured by this Treaty provision, Brazil will provide access to MAP in line with the minimum standard of Action 14.

Two main concerns arise as to the interpretation of Note 1.

Firstly, the purpose of Note 1 is not immediate. It seems to provide for an exception or a clarification to the paragraph of the main text. However, the main text refers to "*countries that formally subscribe to the Transfer Pricing Guidelines*", explaining how the Final Report is expected to affect the Guidelines. Curiously enough, Brazil is not one of those countries.

The obvious conclusion would thus be that, if the Final Report aims at providing amendments to the Transfer Pricing Guidelines and Brazil does not "formally subscribe" to the Guidelines, then the content of the Final Report is not relevant for the application of Brazilian transfer pricing legislation. As there is no further commitment to adhering to the OECD Guidelines in the BEPS Project, no exception or clarification regarding Brazil should be needed in this context. Hence, as Brazil does not subscribe to the Guidelines, a specific treatment should be provided to cover the Brazilian situation, and that is the purpose of Note 1.

Secondly, the very wording of Note 1 is troublesome. The statement that "*Brazil will continue to apply this approach…*" could be read as a concession or a commitment of the G20 on not bothering Brazil on the issue of its fixed margin approach. Conversely, the subsequent sentence ("*… and will use the guidance in this report in this context*") could be read as a commitment of Brazil on adapting its legislation to BEPS measures. The immediate interpretation would thus be that Brazil is committed to adapt its legislation as long as it does not imply abandoning the fixed margins regime.

However, the feasibility of adapting the Brazilian approach to the BEPS Project's measures on transfer pricing is doubtful. As most of these measures are related to the application of the functional analysis, it is shrouded in mystery how such changes should affect the fixed margins regime. It appears that adopting the fixed margins to the functional analysis is not even conceptually possible.

Therefore, a plausible conclusion seems to be that the wording of Note 1 is pure diplomatic language. Even though ambiguous language is not optimal for legal purposes, the ability to use sufficiently ambiguous terms so as not to be committed to an excessively rigid and perhaps undesirable position is deemed to be the quintessence of diplomacy. One refers to "constructive ambiguity"[3] to describe a situation where negotiating parties, foreseeing the impossibility of consensus, deliberately resort to ambiguous language, as to reach an agreement. By doing so, each party may claim to have obtained concessions on the contentious topic – even if, at the end of the day, no consensus is reached at all. On the other hand, the agreement on the empty expression is useful to enable progress in other items under negotiation.

In the concrete case, one may conclude that Note 1 was crucial for Brazil's adherence to the BEPS Project as a whole. Even if, at the end of the day, no significant progress on transfer pricing was achieved at all, Brazil has committed to many other significant measures set forth by the Project.

It is clear that the BEPS Project only managed to obtain a weak commitment from Brazil in Actions 8-10. Therefore, the adherence to TP measures is a much more challenging topic in Brazil than in other countries, as even the tax authorities' perception on the issue is unknown. While in other countries the adoption of the measures of Actions 8-10 is, in the worst scenario, a matter of democratic debate before the Legislature – with tax authorities defending the adoption of the measures of Actions 8-10 –, in Brazil, OECD’s value creation still lacks a sponsor in Congress.

Constructive ambiguity does not solve problems, but rather postpone them. It is still to be known how relevant the Brazilian divergences will be for the BEPS Project’s purposes and how significantly will the pressure over Brazil impact the Legislature to converge TP rules with OECD countries’.

For the future, one should expect controversy on the conceptual impossibility of Note 1. While G20/OECD’s intention is that Brazil adopts transfer pricing legislation in line with the international experience, Brazil is expected to defend the sufficiency its heterodox regime. In the short run the wording of Note 1 may well be read as a blank check for Brazilian tax authorities cherry picking BEPS Action 8-10 Final Report.

[1] See, for an analysis of the fixed margins systems, L. E. Schoueri, Arm´s Length: beyond the Guidelines of the OECD, 69 *Bulletin for International Taxation* 12, December 2015, pp. 690-716.

[2] See, *e.g.*, CARF, Judgment No. 108-09.763, decided on 11.13.2008; Judgment No. 1401-000.801, decided on 06.12.2012). However, the tax treaty concluded with Germany (27 June 1975) was denounced by the German authorities on 7 April 2005 due to disagreements that include also transfer pricing issues.

[3] The term is often credited to Henry Kissinger. See W. Isaacson, *Kissinger: a Biography* (Simon & Schuster, 2005), p. 556.

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