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Appropriate Adjustments of Transfer Pricing through Mutual Agreement Procedures

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It is common to face resistance in MAP application, which is essentially based on misconception of Double Taxation Conventions (DTCs). As Article 9(1) establishes the arm's length standard, which presents a range of possible prices, that misunderstanding may imply more economic double taxation. Given the Brazilian position on recent transfer pricing changes, these problems become more complex to address.

Within the context of transfer pricing on BEPS Project, Brazil expressed on Note 1 of BEPS Actions 8-10 Final Report a dual position. On the one hand, Brazil will continue to apply the fixed margins system in order to ensure practicability as such method sets a profit margin for all transactions in a deemed economic sector. On the other hand, Brazil will adopt the content of that report in the context of fixed margins system. Although this commitment seems to be a pure diplomatic language, Brazil also ensures in Note 1 that it will provide access to MAP on transfer pricing cases as below:

[…] 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.

Both commitments are not incompatible with each other. If one considers that internal legislation and DTCs are to be interpreted and applied independently, than one may conclude that the fact that Brazil, for internal law purposes, shall maintain its predetermined margins, does not jeopardize the possibility that upon interpreting its DTCs, Brazil would apply the arm's length standard. Keeping this in mind, one can understand that Brazilian authorities may enter into MAP notwithstanding what may have been established in its internal law.

Accordingly, since all 33 Brazilian DTCs in force contain a provision equivalent to Article 9(1) of the OECD and UN Model Tax Conventions, Brazil shall grant access to MAP on transfer pricing issues, despite such position has not been obvious given the reservation to adopt Article 9(2) and the lack of information regarding the use[1] of MAP. An evidence of such commitment may be exemplified by the provision below that was inserted in the Protocol of the DTC between Brazil and Switzerland, concluded on May 3, 2018:

5. *With reference to Articles 9 and 25*

It is understood that the absence of a clause providing for an obligation of a Contracting State to make an appropriate corresponding adjustment cannot be construed so as to hinder a Contracting State to make such an appropriate adjustment if it has been agreed to in the course of a mutual agreement procedure.

Taking into account such considerations, the question that emerges for Brazilian tax authorities is the application of Article 9(1) along with MAP, considering Brazilian domestic legislation.

The apprehension would be grounded in possible violation of Article 142 of the National Code, which states that tax assessment is not disposable and cannot be relinquished by tax authorities. Based on the prohibition of waiver of tax revenues, tax authorities would not be entitled, within the ambit of a MAP, to refrain from charging a tax created by law.

However, this understanding is not appropriate. As already mentioned above, internal law and tax treaties are interpreted and applied independently.

Article 9(1) represents the adoption of arm's length standard to measure transactions between related parties. This provision does not choose any method. As the arm's length standard presents a range of valid results, the price used by the taxpayer may be at arm's length irrespectively whether the method adopted is not similar to a Brazilian one. In order to understand this, one may explain the role of DTCs.

When States sign DTCs, their jurisdiction are limited. DTCs establish a 'retaining wall' to the power of domestic legislature to regulate situations referred to in those treaties. Given that the contours of the jurisdiction are delineated by DTCs, the tax legislator is allowed to operate only within such limits. It is the DTC that determines how, when and to whom the national laws of the sovereign States may be enforced. As the jurisdiction is a requisite of the enforcement of the law, only after setting the jurisdiction, the States are able to enforce their own laws.

According to Klaus Vogel, DTCs may be conceived as a mask, which is put over domestic legislation, blocking parts of it. The portions of domestic law which remain uncovered, visible, represent the domain in which they are applicable. On the other side, the domestic law provisions covered by the mask are not applicable, since the DTC removed the jurisdiction that underlay them[2].

In this sense, under the MAP, the Brazilian tax authority shall verify whether the operation was realized in conditions that would be made between independent enterprises. No criterion of the Brazilian domestic law shall be considered. The issue is related to ambit of possible application of domestic provisions, but not its proper application.

As more than one price satisfies the arm's length standard envisaged by Article 9(1), not only Brazilian methods comply with it, but also other methods such as those established by TP Guidelines as modified by BEPS Actions 8-10 Final Report are sufficient. That is why Brazilian tax authorities shall not question all prices adopted. The question is only related to the fulfilment of the conditions required by the arm's length standard. Beyond such analysis, the contours of the jurisdiction established by the DTC are disrespected.

Each Contracting State applying its domestic law may result economic double taxation to address transfer pricing. The problem, however, is which one has the jurisdiction according to the DTC. If both Contracting States consider that they are competent to apply their transfer pricing rules, the MAP is important in order to reach which one has the jurisdiction under the DTC; the "loser" Contracting State will not be allowed to tax it. At the same time, the MAP defines the range of prices that satisfy the arm's length standard. A price that, at first sight, would be adjusted under the domestic law of a Contracting State, may be at arm's length because the criterion of the other Contracting State is in accordance to this standard.

The mask of the Article 9(1) only will cover the part of domestic law that demands tax base adjustment if the transaction, which is object of the MAP given potential economic double taxation, complies with the arm's length standard as established by the competent Contracting State. In such context, the Brazilian commitment to provide access to MAP in line with the minimum standard of Action 14 may be explained. Brazil shall, on a MAP, agree on the arm's length standard range. Provided a price is within the range fixed through the MAP, than the only question is whether, or not, a concrete price falls therein. Should this be the case, than Brazilian predetermined margins are not applicable, since the price falls beyond Brazilian jurisdiction.

[1] M. C. Barbosa, Mutual Agreement Procedure on Brazilian Double Taxation Conventions ("*O Procedimento Amigável nos Acordos de Bitributação Brasileiros*"), Série Doutrinária, vol. XXIII, São Paulo, Quartier Latin, 2018, pp. 113-114.

[2] K. Vogel, *Doppelbesteuerungsabkommen der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen*, Kommentar auf der Grundlage der Musterabkommen, 3.

ed., Munich, Beck, 1996, p. 121.

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