‘Global Transfer Pricing Standard and Brazilian Approach: The Way Forward’

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On 11 July 2019, the event “*Global Transfer Pricing Standard and Brazilian Approach: The Way Forward*” took place in Brasilia, in which the Organization for Economic Cooperation and Development (OECD) and the Brazilian Federal Revenue Office (RFB) presented the main discrepancies between the OECD Transfer Pricing Guidelines (TPG) and the Brazilian transfer pricing rules, an assessment of the strengths and weaknesses of each approach for taxing intercompany transactions and options for future alignment.
The conclusions presented during the event derive from the project “*Transfer Pricing in Brazil*” launched in 2018, with the political and financial support from the United Kingdom’s Foreign and Commonwealth Office (FCO). In the high-level opening of the event, Marcos Cintra, Secretary of the Tax Administration in Brazil, highlighted that the alignment of Brazilian transfer pricing rules with the OECD TPG is an essential step toward improving Brazil’s legislation and encouraging foreign investments, with a focus on the creation of an environment conducive to business, in line with the best regulatory practices and macroeconomic policies. In addition, the alignment of transfer pricing rules fits into the agenda of Brazil’s new government and the request to kick-start the accession process to the OECD.

During the project, several discrepancies in the Brazilian transfer pricing rules have been identified by the OECD, such as the following:

- a broader *personal scope* in comparison to the concept of *associated enterprises*, since the Brazilian transfer pricing legislation also reaches parties in low-tax jurisdictions or preferential tax regimes, exclusive agents and members of consortiums;
- a *narrow material* scope of transactions covered, because Brazil does not apply transfer pricing rules to royalties, fees for technical assistance and scientific and administrative fees;
- *territorial scope* limited to cross-border transactions, given the fact that Brazilian transfer pricing rules are not applicable in a domestic setting;
- *predetermined profit margins* are not in line with the arm’s length principle, since they do not reflect profits that would have been made between independent enterprises in comparable transactions and comparable circumstances;
- lack of implementation of new guidance resulting from BEPS Actions 8-10, despite the Brazil’s participation as member of the Inclusive Framework on BEPS;
- absence of *transactional profit methods*, such as the profit split method and the transactional net margin method (TNMM);
- non-permission to use *other methods*, while the OECD authorizes the application of other methods not described in the TPG if they satisfy the arm’s length principle;
- *freedom to select any transfer pricing method*, even if it is not the most appropriate;
- lack of an *appropriate functional* and *comparability analysis*, which are at the core of the transfer pricing control based on the arm’s length standard, because attributes of the transactions, business models and enterprises affect conditions in arm’s length dealings;
- strict application of an “*item-per-item approach*”, in which taxpayers must control the transfer price of each product, service or right, as Brazil’s transfer pricing legislation does not allow the use of “*package deal*” or “*basket approach*”;
- limited use of *comparables* based on “*similar*” and “*identical*” products, services or rights, with delimited comparability adjustments only for the Brazilian versions of the CUP method (PIC/PVEx- PVA-PVV and PCI/PECEX methods);
- use of c*omparables* for the determination of the arithmetical average of sales price of goods, services or rights, either identical or similar, but not for margins;
- no guidance on aggregation of transactions, use of multiple year data, arm’s length range, use of statistical tools and databases, effect of government interventions (*e.g.* price controls in certain industry sectors);
- non-implementation of the *simplified approach for low value-adding intragroup services*, which allows a standard profit mark-up of 5% on cost base, without requiring a separate benchmarking analysis;
- no specific considerations for *high value-added services*, such as research and development services, manufacturing and production services, purchasing and distribution activities, among others;
- absence of a *benefit test* to determine whether intra-group services have been rendered;
- no legislative guidance on *cost contribution arrangements* involving intangibles and only limited administrative guidance on *cost sharing arrangements*;
- misuse of *safe harbour rules*, which generally lead to under-taxation of export transactions, misprice and potential tax arbitrage;
- restricted application of transfer pricing rules to *other types of financial transactions* (apart from loans), such as cash pooling, hedging and guarantees;
- mandatory application of specific TP methods for commodities (PCI/PECEX), while in the OECD the “*sixth method*” is a variation of the CUP, which allows the use of quoted or publicly available prices;
- limited *comparability adjustments* under the specific TP methods for commodities (PCI/PECEX), which prevents the elimination of material differences between quoted or publicly available prices and controlled transactions;
- no *functional analysis* for the specific TP methods for commodities (PCI/PECEX) to account for all relevant characteristics of the controlled transaction, such as contractual terms, functional and risk profiles of the parties and other relevant economic circumstances;
- absence of transfer pricing rules or special measures for *hard-to-value intangibles*, aimed at preventing base erosion and profit shifting by moving intangibles among group members;
- lack of guidance on the application of transfer pricing rules to *business restructurings*;
- limited room for *administrative consideration* and *flexibility* in relation to transfer pricing compliance and examination practice;
- non-implementation of *master file* and *local file*, thereby deviating from the three-tiered approach to transfer pricing documentation;
- absence of *tax rulings* and *advance pricing agreements* (APA) to prevent double taxation and improve legal certainty;
- lack of *corresponding adjustments* to avoid economic double taxation derived from transfer pricing adjustments, due to the absence of article 9(2) of the OECD Model Convention in tax treaties signed by Brazil;
- limited experience with *mutual agreement procedures* (MAP) in transfer pricing cases, despite the commitment under BEPS Action 14 minimum standard;
- lack of rules on the *attribution of profits to permanent establishments*.

In short, the overall conclusion of the OECD is that the discrepancies described above cause negative implications both for MNEs and for the Brazilian Tax Administration, such as double taxation, absence of legal certainty, and loss of tax revenues.

Indeed, the asymmetric application of Brazilian and international transfer pricing rules may easily result in *double taxation*, because the other country will not make a correlative adjustment where the profit allocated to the company in Brazil does not reflect the arm’s-length principle. According to the OECD, Brazilian transfer pricing rules often over-tax or under-tax the transactions carried out by the parties, mainly due to the predetermined profit margins and the freedom to choose transfer pricing method.

The *absence of legal certainty* takes place in a cross-border context, since the outcome deriving from the interaction between Brazil’s transfer pricing rules and the international standard is not accessible, clear and predictable. As a matter of fact, the much vaunted potential of predetermined profit margins to increase legal certainty and reduce tax compliance is only true from a pure domestic perspective, given the fact that, in a cross-border context, multinational enterprises have to deal with the interaction between different transfer pricing rules. This is an important conclusion of the OECD, since one of the main arguments of the Brazilian Tax Administration is that the arm’s length standard may be too complex and costly to be applied consistently by the Brazilian taxpayers.

The *loss of tax revenues* derives from the fact that the Brazilian transfer pricing legislation is prone to base erosion and profit shifting, which may put stress on government budget. According to the OECD, tax planning strategies may exploit gaps and specific features of the Brazilian transfer pricing rules, such as the lack of rules for hard-to-value intangibles, the freedom to choose transfer pricing method, the non-recognition of risks and intangibles as profit drivers, the absence of appropriate functional and comparability analysis, among others. Discrepancies between Brazilian and international transfer pricing rules may also give rise to reduced taxation, since predetermined profit margins may ensure only a minimum taxation in Brazil, while remaining profits are not entirely captured in the other jurisdiction based on the arm’s length standard. It would occur, for instance, due to the application of the same profit margin to high and low risk activities and to different types of assets. Simple examples would be the transfer of hard-to-value intangibles or the sale high-end products to a limited risk distributor based on the CAP (cost plus a profit margin of 15%). Thus, besides preventing double taxation, the alignment of the Brazilian transfer rules with the OECD TPG would contribute to enhance the allocation of tax bases to Brazil.

The result is that, despite the strengths and weaknesses of each approach, discrepancies in transfer pricing rules may have adverse impacts on international trade, investment flows and the integration of Brazil in global value chains. Despite its economic relevance, the participation of Brazil in the global value chain is somewhat limited, since it basically provides inputs and raw materials or offer the market demand. Obviously, transfer pricing rules play an important role in the implementation of global supply chains by MNE groups, so that the alignment with the arm’s length standard may contribute to a higher integration of the country in cross-border value chains in more sophisticated levels.

Finally, with regard to the future, the recommendation of the OECD is that the only way forward is a **full alignment** of Brazilian transfer pricing rules with the international standard. A hybrid system with rebuttable predetermined profit margins and limited functional analysis has been ruled out, since it would avoid double taxation, but at the cost of high tax complexity and increased potential for profit shifting and tax arbitrage. Thus, the alternatives proposed by the OECD are either (i) immediate alignment to the OECD TPG with a transitional period for adaptation; or (ii) gradual alignment to the OECD TPG based on the category of the taxpayer, in which the new rules would be initially applied to MNEs above certain threshold, as a basis for further extension to companies in general.

In conclusion, the result of the joint project between the OECD and the RFB is very comprehensive and reflect the limitations of Brazilian transfer pricing rules. It is clearly not a debate about which transfer pricing approach is better, as the structural flaws of the OECD TPG and the limitations of the arm’s length standard are widely known. The traditional dilemma *formulary apportionment vs. arm’s length standard* provides clear evidence that the OECD’s transfer pricing rules are very far from perfect. Thus, the focal point is that **the unilateral application of diverging transfer pricing rules may have negative consequences for businesses and, consequently, for economic development.** It is now time for a political decision in Brazil, which should consider the findings of this survey that collected inputs from several MNEs headquartered in 11 different jurisdictions, while also weighing the pros and cons of the full adoption of the OECD TPG.