The Future of Transfer Pricing in Brazil

Kluwer International Tax Blog
December 10, 2019

Sergio André Rocha (Rio de Janeiro State University, Sergio André Rocha Advocacia & Consultoria Tributária)

Please refer to this post as: Sergio André Rocha, 'The Future of Transfer Pricing in Brazil', Kluwer International Tax Blog, December 10 2019, http://kluwertaxblog.com/2019/12/10/the-future-of-transfer-pricing-in-brazil/

In 2017, Brazil sent a formal request to the Organisation for Economic Co-operation and Development ("OECD") to become one of its members. It seems that this decision — made by the economic team of former president Michel Temer — was not preceded by relevant discussions with areas potentially impacted by the occasional accession of the country to the OECD. Therefore, they had to deal with the consequences of this initiative without having taken part in the original decision or having had an opportunity to alert relevant parties regarding the potential outcomes of Brazil joining the OECD.
Because of my ongoing research on international taxation, I am usually questioned about whether Brazil should become an OECD member or not. My answer is always the same: joining the OECD is not a tax decision *per se*. It is a political decision with tax consequences.

From a tax standpoint, Brazil already has an active participation in the main working groups of the OECD. This puts the country in a more comfortable position to follow its own path whenever it is more advantageous. Even the more multilateral approach of the works of the Global Forum on Transparency and Exchange of Information for Tax Purposes and the inclusive framework of the BEPS project do not require Brazil's entry into the OECD. Indeed, in both cases groups were created that include more non-OECD countries than OECD members. Therefore, participation in these groups as a non-OECD member is not necessarily a disadvantage.

However, as I previously pointed out, joining the OECD is not a tax decision. Since it is a political decision with tax consequences, the question is: what are these tax consequences?

Since the beginning of this association between Brazil and the OECD, it was clear what the main tax issue was going to be: Brazil's transfer pricing regulations and their more distinctive feature, predetermined fixed margins, which have generated a relevant deviation from OECD standards.

I have long argued that the globalization of principles, rules, and practices adopted by developed economies must always take into account the institutional capacities of other countries, especially those less developed.[1] It makes no sense to establish a sophisticated set of rules in the law if countries do not have knowledgeable personnel and technological infrastructure to apply them.

Law No. 9,430, which currently establishes the basic structure of Brazil's transfer pricing rules, was enacted in 1996. In my opinion, at that moment Brazil did not have the necessary infrastructure to adopt an open and sophisticated methodology for transfer pricing control. It took some time for tax authorities to start applying even the country's simplified rules. Therefore, the option for simplification over a more accurate application of the arm's length standard was a reasonable decision, even if it triggered two negative externalities: double taxation and double non-taxation.

This scenario has certainly changed over the years. The study of international taxation in Brazil is at another stage when compared to what we had when transfer pricing rules were first enacted. Back in 1996, one could count using the fingers of his/her hands the number of books on the topic. (Maybe the fingers of one hand.) Currently, however, on transfer pricing alone we have numerous books, articles, dissertations, and doctoral theses.

The understanding of international taxation by Brazilian tax authorities has also improved significantly. Their participation in the working parties of the OECD has certainly played an important role in this improvement. Without setting aside the starting points of Brazil's international tax policy,[2] the auditors of Brazil's Tax Administration ("Receita Federal do Brasil") have clearly evolved – most notably those who are engaged in the country's representation in the discussions at the OECD.

From 1996 to 2019, there was not only a significant change in the level of the discussions regarding international tax topics, but also during this same period there was no significant modification in the legislation to adapt it to changes in the economic environment – notably the digitalization of the economy. It was quite the opposite. Brazilian rules dealing with transactions with intangibles were enacted back in the decades of the 1950's and 1960's. Change was inevitable.

It was in this context, on February 18 and March 1, 2018, that the joint work of Brazil's Tax Administration and the OECD to review the country's transfer pricing rules started.

On July 11, 2019, they presented a partial result of this joint work. As a matter of fact, the main objective of this meeting was to make public their conclusions about the gaps of Brazil's transfer pricing rules taking into account OECD Guidelines. In this event, the joint task force announced that the shift of Brazil's transfer pricing standards to a more OECD-like approach had been decided.

Perhaps the communication during this meeting between the OECD and Brazil's Tax Administration was not as clear as it was intended. The perception that Brazil would simply adopt the OECD Transfer Pricing Guidelines triggered opposition from industry sectors, practitioners, and academics. Together with professors Heleno Torres, Luís Eduardo Schoueri, and Romero Tavares, I published a position paper on this Blog in which we argued against the pure and simple adoption of the OECD standards without taking into account the potential advantages of the Brazilian experience.[3]

It is possible that the expectation about what would be disclosed at this meeting was out of place. Some expected the presentation of Brazil's new rules when, in fact, Brazil's Tax Administration and the OECD were merely making public the results of their joint work during the past year as well as the direction they intended to follow from there on.

We are now close to the end of this initial phase of their joint transfer pricing project. This December will mark the shift to a next stage with the publication of a detailed study on Brazil's transfer pricing rules – specifically, its gaps and mismatches compared to the OECD standards. Together with this assessment, the reasons why Brazil should change its rules will be made clear. No one should expect Brazil's Tax Administration and the OECD to present a new design for the country's transfer pricing rules. Instead, it will be an x-ray of Brazil's rules when compared to the OECD Transfer Pricing Guidelines. Accordingly, this study will be the starting point of a new stage of this joint work, in which new rules – which do not exist at this moment – will begin being drafted. The report – which will formalize the preliminary results presented last July – will be, on its own account, the object of studies, analyses, and commentaries, which will certainly be of the utmost importance to advance the necessary debates.

There is, then, a relevant question: what are the basic pillars of this new phase of Brazil's transfer pricing rules' reform?

As previously mentioned, up to this moment all paths are open. There is a lot of room for Brazil's Tax Administration, the OECD, the impacted companies, academics, and professionals who work with transfer pricing to contribute to the design of the new rules. However, if there are open spaces, there is also a basic structure matter that will have to be taken into consideration.

On November 14, I had the opportunity to meet with Brazil's Tax Administration and the OECD to discuss the next steps of the project. I comment below on the four main pillars of the work to come.

1. **Avoiding double taxation and double non-taxation:** One of the main features of current international taxation, notably in the post-BEPS era, is the consolidation of the avoidance of the double non-taxation as something as relevant as the avoidance of double taxation. In other words, the international tax regime must be designed to avoid unintended spaces of non-taxation.

Brazil's methodology for transfer pricing control has shortcomings in both areas. Indeed, the fixed margins, the lack of corresponding adjustments, and the incipient use of the mutual agreement procedure generate situations of double taxation. Today, these same features are being explored by multinationals engaging in aggressive tax planning schemes.

Therefore, one of the objectives of the reform of Brazil's transfer pricing rules is to reduce the space for situations of double taxation as well as opportunities for double non-taxation.

2. **One single regime:** On launching the of OECD/Receita Federal do Brasil joint transfer pricing project last year, there was a perception that one possible way forward would be the adoption of a dual system. This would mean keeping Brazilian current rules and enacting new rules that follow OECD standards. In this case, the taxpayer would be allowed to "check the box" and opt for the set of rules they would be applying.

This option is currently off the table, which seems to be the right choice.

Indeed, one of the virtues of the Brazilian model is its simplicity, both for the taxpayer and the Tax Administration.[4] The existence of two sets of rules, with different starting points, principles, and objectives, would definitely make the system more complex – especially for the Tax Administration but also for taxpayers.

This fact – the super complexity of a dual system – should be enough for the idea of two coexisting systems to be abandoned. However, this might not even be the most relevant reason.

As a matter of fact, as mentioned previously, one of the main assumptions of the new model is to prevent both double taxation and double non-taxation.

Keeping two regimes would result in the following situation: those multinationals that suffer with double taxation as a result of Brazil's fixed margins would most likely opt for using the OECD standards. On the other hand, those multinationals that manage to use the fixed margins to shift profits to low-tax jurisdictions would probably continue using the current rules, thereby generating asymmetry in the system.

Hence, it is clear that from a tax system design perspective, it would be inefficient to have two different sets of rules in place. This is the main reason why the implementation of a dual system, which would open up room for tax arbitrage and aggressive tax planning, is not being considered.

3. **Inspired by the Brazilian regime but looking beyond the national experience:** The fact that a dual system is off the table does not mean that the Brazilian experience with simplified methodologies will be discarded. The pursuit for legal certainty and simplification transcended Brazil's experience and has been included in the OECD's works. There are also other countries' experiences with simplified methodologies that might also be considered in the future. Therefore, one of the assumptions of the work ahead is that the "full OECD standard" – at least as it stands today – will be used only when necessary. The new safe harbors that will be included in Brazil's regulations are under development. In principle, the idea is not just to replicate current rules. Rather, one of the objectives of the joint project is avoiding unnecessary complexities, with the development of safe harbors that might apply to certain sectors and transactions.

4. **Institutional capacity and dispute resolution are of the utmost importance:** There is a clear perception that the change in the regime cannot come without large investments in training for Brazil's Tax Administration team. A relevant change in the Brazilian regulations, without such an investment in training and systems would have dire impacts on the legal certainty of multinationals operating in Brazil. In the transition period, it is very important that Receita Federal do Brasil provides quick and clear guidance answering ruling requests from taxpayers, and that authorities make public their interpretations of the new legislation, thereby allowing taxpayers to properly organize their affairs.

However, it is not only in the field of tax administration that investment will be needed. Dispute resolution will be a key area. Since the workshop that launched the OECD/Receita Federal do Brasil joint project, I have insisted that Brazil does not have courts with the technical capacity to review transfer pricing assessments based on the OECD standards. One of the pillars of the next stage of the work will certainly be the design of dispute resolution mechanisms, domestic and international, which will be essential for the development of the new regime in an environment that provides legal certainty and stability.

Outside the scope of transfer pricing, there are other topics not at center stage right now that will have to be debated. For instance, it is well known that Brazil has an important and consolidated policy of taxing at source the gross income of non-residents at a very high rate. Does it make sense to keep this policy unaltered when there is shift in the transfer pricing rules, with the aim of a fairer distribution of taxing rights? This is a debate that we will require.

Conclusion

This article is only meant to provide the reader with an overview of what might lay ahead in the future of Brazil's transfer pricing. I think that the underlying message of this text is that all of us who deal with this topic in Brazil should assist with the work to be developed beginning in 2020. The report assessing the current rules will be a great source of critical study, and I hope that society and academia will have the chance to contribute to the next phases of the work.

We live in complicated times, with tax reforms all over. Pillars 1 and 2 of BEPS' Action 1 unified approach might, at last, change the basic grounds of the international tax regime. In Brazil, all relevant taxes are under threat of reform, from indirect taxes to the income tax. The change in the country's transfer pricing rules is something tangible, possibly with a higher chance of approval than other intended reforms. Notwithstanding, it will require a great effort in its design and future implementation. I hope the launch of this OECD/Receita Federal do Brasil report will be a meaningful advance in the direction of the new Brazilian regime for transfer pricing control.

****

[1] See: "International Taxation, Epistemologies of the South, and Institutional Capacities: Transfer Pricing and the Universalization of the OECD Standards", published on the Kluwer International Tax Blog. Available at http://kluwertaxblog.com/2018/05/07/international-taxation-epistemologies-south-institutional-capacities-transfer-pricing-universalization-oecd-standards/.

[2] See: Sergio André Rocha, *Brazil's International Tax Policy* (Rio de Janeiro: Lumen Juris, 2017). Available at: http://www.sarocha.com.br/livros/BRAZIL-INTERNATIONAL-TAX-POLICY_Final.pdf.

[3] The text is available at this link: http://kluwertaxblog.com/2019/07/30/brazilian-tp-missed-opportunities-ahead/.

[4] See: Sergio André Rocha, *Brazil's International Tax Policy* (Rio de Janeiro: Lumen Juris, 2017) p. 155-165. Available at: http://www.sarocha.com.br/livros/BRAZIL-INTERNATIONAL-TAX-POLICY_Final.pdf.