Client Alert

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Brazil: Transfer pricing developments — the arm's length standard within reach

Tax News and Developments February 2023

In brief

On 29 December, 2022, the Brazilian Federal Government published Provisional Measure No. 1,152/22 ("**Provisional Measure**"), which implements the full alignment of the Brazilian domestic transfer pricing legislation with the transfer pricing standards laid out by the Organisation for Economic Co-operation and Development (OECD). Although the Provisional Measure will come into effect January 1, 2024 and must be converted into law by June 1, 2023, taxpayers will be able to opt for the early application of the Provision Measure for calendar year 2023. If the Provisional Measure is not converted into law, it will not have any effect at all and the currently applicable rules will remain in existence.

Applicable Rules

Currently, Brazil's transfer pricing methodology does not resemble that of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines"). Brazil applies statutorily defined transfer prices depending on the type of transaction and by industry − sometimes known as a formulary approach. These Brazilian methods are similar to the transactional methods under the OECD Guidelines − namely the comparable uncontrolled price (CUP) method, the resale price method and the cost plus method, but for the most part without an underpinning of third-party evidence. Generally, under the statutory rules, Brazilian taxpayers need only set their intercompany prices by selecting one of the methods provided for in the law, which the taxpayer can freely choose, and apply the appropriate statutorily defined transfer price.

For example, where goods or services are imported, and where the taxpayer chooses the resale price less profit method (the equivalent to the resale price method), generally a profit margin of 20% is mandatory. Certain industries, such as for chemicals and pharmaceutical products, machines, apparatus and equipment for dental, medical and hospital use have to generate an operating margin of 40%, whereas chemical products, glass and glass products, metallurgy, pulp, paper and paper products have to realize a profit margin of 30%. Where the Brazilian equivalent of the cost plus method was chosen, the costs of production plus taxes and duties have to be increased by a gross profit margin of 20%. Commodities that have a quotation on a commodities exchange have to be imported at a price equivalent to the average quotation price adjusted by an average market premium on the day of the transaction.

The export of services and goods follows similar statutory margins. If a taxpayer applies the resale price method, a profit margin of 15% calculated on the wholesale price in the country of destination or of 30% calculated on the retail price in the country of destination has to be realized. Where the cost plus method is chosen, a mandatory profit margin of 15% applies. Similar to the importation of commodities, also the export of commodities has to be priced in accordance with the average commodity exchange quotation price adjusted by an average market premium on the day of the transaction.

Royalties paid by a Brazilian taxpayer to a related foreign party for the use of patents, trademarks and know how, as well as fees for technical, scientific or administrative services are only deductible up to a fixed percentage limit of 1% - 5%, depending on the underlying industry, product or royalty involved. The applicable percentage limit is set by the Ministry of Finance. In addition, for royalties and technical services to be deductible, the underlying agreement has to be approved by the National Institute of Industrial Property and registered with the Brazilian Central Bank.

Contrast with OECD Guidelines

Brazil's current rules starkly contrast with the OECD Guidelines. The OECD Guidelines require an accurate delineation of intercompany transactions, a most appropriate method analysis that relies on evaluating numerous factors with the availability of reliable data, and, generally, an economic benchmarking analysis that looks to third-party evidence for setting prices. Brazil's transfer pricing setting process essentially combines all three steps into one step that does not look to third-party pricing evidence, with the exception of commodity pricing. Even in applying safe harbor markups on cost, the OECD Guidelines require taxpayers delineate the intercompany transaction, assert the application of the method is reasonable, and do not prescribe a specific markup rate.

In addition, Brazil does not acknowledge profit-based methods. The most commonly applied method under the OECD Guidelines for relatively straightforward operations, the transactional net margin method (TNMM), is not allowed. Neither is the profit split method (PSM) allowed, which in contrast to the TNMM, is commonly applied for more complex transactions involving contributions by multiple parties.

The benefit of Brazil's formulary transfer pricing methodology has been simplicity in its application, its documentation, and its support during tax audit. The cost of these generally fixed transfer pricing returns has been, oddly, volatility of results. In an evolving economy, transfer prices that are not set to market conditions lead to non-market commercial results for multinationals (MNEs) that operate in Brazil. The inability to access profit-based methods that tie to market conditions creates unusual results for companies that can be benchmarked using the TNMM, such as trapped losses, unusually high returns, and difficulty to manage operations in an economically efficient manner, which might all happen across a handful of years. Similarly, more complex enterprises that generate intangibles or are highly entrepreneurial may not be able to expand internationally as effectively if unable to set transfer prices like other MNEs in non-Brazilian markets.

Perhaps more meaningful for some MNEs, Brazil's non-compliance with arm's length principles can make operating in Brazil even more inefficient. For example, because of these statutory rules and because there is no Double Tax Treaty between the United States and Brazil, US taxpayers generally cannot credit Brazilian taxes under section 901 because Brazilian law does not comply with the arm's length principles as required under Treas. Reg. §1.901-2(b)(5)(i)(B)(2) (see further discussion below). A recent decision from the *US Tax Court, 3M v. Commissioner*, 160 T.C. No. three (9 Feb., 2023), makes Brazil's current royalty deductibility limits less palatable to US-parented MNEs.

New Rules under the Provisional Measure

Brazil's new transfer pricing regime greatly changes the tax landscape and Brazil's position within the international tax system. The methodology under the Provisional Measure complies with the OECD Guidelines by applying a "most appropriate method" and its pricing methods, but for a few notable differences.

First, the new law adopts a framework to select a "most appropriate method" akin to the OECD Guidelines, and include an abbreviated framework for comparing a potential comparable with a tested transaction, including:[1]

- the economically relevant characteristics of the controlled transactions and of the transactions with unrelated parties;
- the date when the controlled transaction and the transactions between unrelated parties were conducted, in order to ensure that the economic circumstances of the transactions that are intended to be compared are comparable;
- the availability of information on transactions between unrelated parties, which allows the comparison of its economically relevant characteristics, aiming to identify the more reliable comparable transactions conducted between unrelated parties;
- the selection of the most appropriate method and of the financial indicator to be examined;
- the existence of uncertainties in the existing pricing or assessment at the moment of the execution of the controlled transaction and if such uncertainties were addressed as unrelated parties would have done under comparable circumstances, considering also the adoption of appropriate mechanisms in order to ensure the compliance with the principle set forth in article two; and
- the existence and relevance of the group synergy effects, pursuant to the provisions of Article 10.

[1] Chapter II, Section V, Subsection III, Article 9.

Although similar, the legislation includes specific language on group synergy that precludes compensation for synergistic activity that does not involve a "direct action"[2] pursuant to the "head provision"[3]. This is akin to rules disallowing the benefit of passive association, but as currently stated is broader than the United States' rule under Treas. Reg. § 1.482-9 (2)(iv), in that a sole effect test is not applied.

Overview of New Transfer Pricing

Second, the new methods proposed in the Provisional Measure are more aligned with the methods in the OECD Guidelines, including new profit-based methods:

- **Comparable Independent Price - PIC**, which consists in comparing the price or amount of the consideration of the controlled transaction to the prices or amounts of the considerations of comparable transactions conducted between unrelated parties;
- **Resale Price less Profit - PRL**, which consists in comparing the gross margin that an acquirer of a controlled transaction obtains from the subsequent resale made to unrelated parties to the gross margins obtained from comparable transactions conducted between unrelated parties;
- **Costs plus Profit - MCL**, which consists in comparing the gross profit margin obtained on the supplier's costs in a controlled transaction to the gross profit margins obtained on the costs in comparable transactions conducted between unrelated parties;
- **Transaction's Net Margin - MLT**, which consists in comparing the net margin of the controlled transaction to the net margins of comparable transactions conducted between unrelated parties, both calculated based on an appropriate profitability indicator;
- **Profit Division - MDL**, which consists in the division of profits or losses, or of part thereof, in a controlled transaction in accordance with what would be established between unrelated parties in a comparable transaction, considering the relevant contributions provided in the form of functions performed, assets used and risks assumed by the parties involved in the transaction; and
- **other methods** provide that the alternative methodology adopted produces a result consistent with the one that would be reached in comparable transactions conducted between unrelated parties.

The first five methods are nearly identical to a corresponding OECD transfer pricing method, respectively: (1) the Comparable Uncontrolled Price; (2) Resale Price Method; (3) Cost Plus Method; (4) TNMM; and (5) the PSM. However, unlike the OECD methods, Brazil adopts an additional method that allows for method flexibility. This method is more aligned with the unspecified method found in the US Transfer Pricing Regulations.[4] When selecting comparables[5], Brazil's comparability criteria are arguably more rigid than under the OECD Guidelines as either comparables must have no differences to materially affect financial indicators or adjustments may be carried out to eliminate the material effect of these differences.[6] The methods under the Provisional Measure also specifically point out when to use different intervals, such as the inter-quartile interval or the full interval, when multiple financial indicators are available and after the comparability criteria are met.[7]

Importance of the CUP

Lastly, unlike the OECD Guidelines and the US Transfer Pricing Regulations, the draft legislation explicitly says that the PIC method, the Brazilian equivalent to the CUP method, is the most appropriate method unless there is a more appropriate method. This puts greater weight on disproving the application of the PIC, before applying another method. In some ways, this is not dissimilar to historical treatment of the CUP under earlier versions of the OECD Guidelines, or the generally observed notion that comparable uncontrolled transactions are viewed more favorably by US courts. However, it is meaningful that the current version of the OECD Guidelines does not have this language, and that the

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[2] Chapter II, Section V, Subsection III, Article 10.
[3] Chapter II, Section III, Article 4, Para 1.
[4] Treas. Reg. § 1.482-3(e), Treas. Reg. § 1.482-4(d).
[5] See The arm's length principle in Brazil: A first glance to domestic publicly traded companies as potential comparables | Insight | Baker McKenzie for helpful information on Brazilian companies as comparables.
[6] Chapter II, Section V, Subsection VII, Article 5.
[7] Chapter II, Section V, Subsection VII, Article 16.

US Transfer Pricing Regulations generally restrict the use of the CUP to relatively strict circumstances. This inclusion could reflect the inclination to view commodity pricing as more important even in setting the level of income, due to Brazil's natural resource economy, or a view toward pricing simplification in the presence of even imperfect CUPs. This concern is also supported by Chapter II, Section V, Subsection III, Article 12 and 13 of the Provisional Measure, which specifically refer to the quotation price of commodities as one parameter to consider when determining the transfer price based on the PIC method. Given that the legislation currently in force provides for the quotation price of commodities as the applicable price, it would not be surprising if in the future the Brazilian tax authorities placed emphasis on this pricing element when determining the transfer price based on the PIC method. It would also not be surprising if adjustments made to the quotation price to account for differences in transaction conditions, though allowed under the new legislation[8], would be met by the authorities with skepticism and require substantive discussions.

These differences lead to several potential implications the least of which being that CUPs, which have arguably been under assault in the US Courts, become substantially more meaningful in Brazil. This change could lead to future disagreements between Competent Authorities. In some cases, the preferred use of CUPs may lead to greater profit variability in Brazilian entities depending on business cycles, but it remains to be seen whether this would be any more variable than the current Brazilian transfer pricing methodology. Where CUPs are not as common, e.g., outside of natural resources or for pricing transactions of start-up technology, the presence of an unspecified method could lead to more commercially-driven transfer pricing approaches that could make entry into Brazil more attractive.

Special Provisions

Brazil also includes a section on special provisions relating to the treatment of intangibles, services, restructuring, and financial transactions that are all relatively similar to, though more abbreviated than, the OECD Guidelines.

The Provisional Measure introduces hard-to-value-intangibles[9] and "DEMPE" functions, and looks to the conduct of unrelated parties with regard to the remuneration of intangibles, otherwise defined as transferred non-tangible, non-financial assets[10]. Usefully, the Brazilian rules clearly provide that an intangible holder is whomever is identified as the holder in agreements, records, or applicable legal provisions (excluding mere legal ownership), or whomever exercises control over the exploitation of the asset when ownership cannot be identified[11]. Similar to the OECD Guidelines, the definitions limits the intangible return of "cash box" arrangements[12].

With regard to intragroup services, cost sharing, business restructuring, and various financial transactions, the Provisional Measure takes a similar approach to the OECD Guidelines. For services, the Brazilian rules say that services have been rendered when a related party benefits, or has a reasonable expectation of benefit, and that the payment is akin to what unrelated parties would be willing to pay for[13]. The rules provide several situations where services do not provide a benefit and are deemed to not give rise to compensation, such as if the activity is a shareholder activity or if duplicative. Allocation keys also explicitly define allocation criteria that seem aligned with the OECD's accurate delineation framework[14]. The Brazilian rules also include abbreviated versions of both the cost contribution rules[15] for cost sharing and business restructuring rules, which consider costs borne by restructuring as well as the transfer of profit potential[16].

Documentation

The Provisional Measure also includes a short statement about new transfer pricing documentation rules that, in principle, align with the OECD Guidelines (with a requirement to provide a value-chain-like analysis). Notably, the Brazilian rules grant tax authorities the power to determine a *de facto* deemed profit regime, by allocating to the Brazilian

[8] Chapter II, Section V, Subsection III, Article 13 Paragraph 1.
[9] For such intangible transactions, a 20% band is applied on the compensation at the time of the intangible transaction. Chapter III, Section II, Article 23.
[10] Chapter III, Section I, Article 20.
[11] Chapter III, Section I, Article 21.
[12] Chapter III, Section I, Article 22.
[13] Chapter III, Section III, Article 24.
[14] Chapter III, Section III, Article 25.
[15] Chapter III, Section IV, Article 26.
[16] Chapter III, Section V, Article 27.

entity the activities, risks, and assets in the lack of reliable evidence, and adopting a reasonable estimates themselves in the absence of appropriate transactional delineation and comparability analysis[17].

Additionally, penalties for lack of transfer pricing documentation are onerous, equivalent to 0.2% per month on gross revenue upon failure to file on a timely basis; 5% of the amount of the transaction or 0.2% of the consolidated revenue of the MNE group for the year prior to which the information refers in the event of an inaccurate, incomplete, or omitted information; 3% of the amount of gross revenue if ancillary obligation requirements are not met; and for lack of timely presentation during a tax procedure or other prior inspection measure, 5% of the corresponding transaction.

Implications for TP Planning

Brazil's deviation from the statutory system and the alignment with the OECD Guidelines opens up many options for transfer pricing planning, but also closes some previously utilized opportunities. For example, Brazilian exporters of goods who structured their distribution through low risk distributors in Europe may need to rethink their distribution structures or at least accept that certain structures no longer yield the same benefit. In the past, Brazilian companies were often able to obtain a unilateral ruling on the compensation of the European low risk distributor, which was often based on a transaction method, such as the TNMM. Because of the divergence of the Brazilian statutory rules from the arm's length principle, applying the TNMM would usually result in a different compensation amount than the statutory Brazilian rules would have yielded, which often led to a tax arbitrage that in effect lowered the effective tax rate of the group. This tax arbitrage will likely no longer be available when the Brazilian rules align with the OECD arm's length principle. However, Brazilian taxpayers might use this opportunity to negotiate (bilateral) APAs[18] (unavailable for the United States, for lack of a double tax treaty), an option that has been introduced by the Provisional Measure and that is new to the Brazilian administrative landscape. While APAs can be a very helpful measure for taxpayers to gain certainty, the novel character of the transfer pricing rules and the potential lack of resources will likely make the negotiation process interesting (see more considerations on APAs below).

The new rules also present ample tax planning opportunities for companies. For example, the Provisional Measure explicitly introduces the concept of Cost Sharing[19], which is currently unavailable in Brazil. In the future, a Brazilian IP holder could cost share certain IP with a US NewCo, who is responsible for the US market and with a European NewCo, who is responsible for EMEA. Tax efficient restructuring options for transferring the IP out of Brazil into the United States and/or Europe might be available prior to the new Business Restructuring Rules[20] under the Provisional Measure taking effect and would need to be analyzed.

Further, the new rules also largely eliminate the limitations to royalty payments currently in effect and explained above. This means that IP licensed to a Brazilian related party may now carry a royalty charge just like any other related party licensing transaction. Note that payments remain non-deductible if the recipient benefits from a privileged tax regime[21]. It is unclear, if the US FDII rules qualify as a privileged tax regime. Additionally, payments are non-deductible if (i) the same amount is treated as a deductible expense for another related party, (ii) the amount deducted in Brazil is not treated as taxable income for the recipient, or (iii) the amounts (in)directly finance deductible expenses of a related party to which (i) or (ii) apply[22].

When deciding on whether to charge a royalty, Brazilian withholding and ancillary taxes have to be considered carefully. Absent a double tax treaty, royalties generally trigger withholding tax of 15%. The payment might also trigger 0.38% IOF, PIS/COFINS and/or 2%-5% ISS. Applicable double tax treaties might reduce the applicable withholding tax and a credit should be available in the country of the recipient subject to the regular credit limitations. For a US taxpayer, the foreign tax credit rules would need to be considered. Because there is no tax treaty between the United States and Brazil, a separate analysis under Treas. Reg. §1.901-2 is required to determine the credibility of a Brazilian withholding tax. A foreign royalty withholding tax satisfies the US attribution requirement only if foreign law imposes the withholding tax based on the **place of use of**, or the right to use, the intangible property (consistent with US royalty sourcing

[17] Chapter IV, Section 1, Article 35, Para 1.
[18] Chapter V, Section II, Art. 39.
[19] Chapter III, Section IV, Article 26.
[20] Chapter III, Section V, Article 28.
[21] Chapter VI, Article 45 I.
[22] Chapter VI, Article 45 II a)-c).

principles under Treas. Reg. §1.901-2(b)(5)(i)(B)(2)). The Brazilian domestic tax law does not follow the US sourcing rules but rather applies withholding tax to any royalty paid, irrespective of where the IP was used. Therefore, withtholding tax imposed by Brazil might be partially or fully non-creditable. For a detailed analysis of the new Brazilian rules under the US Foreign Tax Credit regulations please see the article,The Arm's Length Principle Comes to Brazil – Does Creditability Come With It?, by our colleagues Julia Skubis Weber, Connor Mallon, Ethan Kroll and Stewart Lipeles in the March 2023 edition of TAXES - the Tax Magazine. However, the proposed regulations under section 903 introduce a single-country license exception[23], which allows for creditability of the foreign tax under the following conditions:

- There is a written agreement in place between the licensor and the licenses on May 17, 2023 that characterizes the payment as a royalty; and
- The agreement limits the territory of use of the IP to Brazil or the agreement separately and accurately states the portion of the royalty attributable to use of the IP in Brazil.

Therefore, for taxpayers who wish to charge a royalty to a Brazilian related party, immediate action is warranted given the 17 May 2023 deadline. In addition, the Brazilian company will likely have to opt for the new rules to apply as of 2023. The advantages and disadvantages of this election should be analyzed in detail, especially where transfer of IP or other assets, functions or risks is to occur in 2023. The Business Restructuring Rules, which require a transfer at fair market value, will only apply in 2023 if opted in, while without the application of these more restrictive rules tax efficient restructuring options might be available. Further, as always, changes in the transfer pricing system have to be considered and implemented carefully, especially where only the pricing terms change but not the underlying facts.

Without question, companies need to evaluate the pros and cons of such restructurings, whether to opt in, and how to structure the operations. Take for example the decision to enter into a CCA for a Brazilian operation creating intangible property. Under either cost sharing or a CCA, a balancing payment for the contributions of the parties to the arrangement must be calculated under arm's length principles. Entering a CCA requires a transfer pricing valuation between contributing jurisdictions that could move income into a lower tax jurisdiction than Brazil. This could require an OECD Guidelines business restructuring test depending on the nature of the restructuring, and potentially a Brazilian exit tax if not managed. Beyond the transfer of intangibles and potential transfer of functions, the domestic Brazilian tax system is complex and any meaningful restructuring should be evaluated for the net tax impact. Additionally, the ability to opt in to the Provisional Measure methods adds an additional wrinkle that cannot be ignored from a timing perspective.

Crystal Ball Gazing into 2024 and Beyond

Brazil is a historically litigious jurisdiction, and there is no indication that litigation activity would diminish by aligning its TP with the OECD Guidelines. Currently, among Brazil tax disputes, TP disputes are not as common, thus one would expect that domestic TP disputes will increase once the law is enacted. However, how the Brazilian tax authorities prioritize TP disputes and devote resources could greatly vary. When other countries have implemented new TP regimes, we typically see resources allocated between existing case resolution, enforcement effort, and dispute resolution.

Keeping an eye on governmental priorities and enforcement resource allocation will matter, the closer the law comes into effect. When other countries implemented TP rules, some prioritized resolving existing TP disputes as part of currency initiatives when they were still at an examination level. This may provide an opportunity for those in TP examinations to resolve them more quickly. However, cases already in the court system represent the last opportunities for the government to litigate an issue. Cases in litigation can face additional scrutiny depending, again, on where the government allocates resources.

Regarding enforcement under a new TP regime, we have seen jurisdictions increase their compliance enforcement in an effort to collect fines in the absence of documentation. This could be a realistic outcome if tax revenues are a priority, as the imposition of fines under the Proposed Measure is more straightforward than the application of transfer pricing adjustments. However, as it relates to adjustments made during a TP examination, countries vary greatly in their auditing practices. Countries that encourage foreign investment may be less eager to impose adjustments, and if and when they do so, the adjustments are typically infrequent and more compliance-oriented (e.g., adjustments into ranges). For those

[23] Proposed Treas. Reg. §1.903-1(c)(2)(iv).

countries that naturally attract foreign investment due to their location, language, or market importance, adjustments may be more common. In a handful of cases globally, we have seen more of a strategic and coordinated approach toward TP adjustments, which we may ultimately anticipate for a country like Brazil.

Lastly, Mutual Agreement Procedures (MAP) will be available, but how Brazil staffs up its Competent Authority (CA) departments can affect how useful MAP is for treaty jurisdictions. It remains to be seen what Brazil's hiring plans are and this affects how taxpayers use CA as part of their dispute resolution strategy. If Brazil adopts a robust hiring strategy at CA, this is likely a signal that the Brazil government wants to make this program work. This suggests that APAs, whether bilateral or unilateral, could become meaningful venues for resolution that should not be underestimated.

In many ways, Brazil's new TP regime is a welcome development – a sign of world continuing to integrate economically. However, the new TP rules generate a host of complexities for taxpayers from a tax planning perspective with regard to how to reprice, whether to restructure, and how best to undertake that restructuring if determined to be the best course of action. Brazil's commercial, regulatory, and treaty environment, must be taken in consideration holistically, which requires a strategic mindset, likely some modeling and country-by-country research. Tax litigation will likely remain a recurring theme, and a broader perspective may be necessary to facilitate future multilateral disputes and advocate for your position. Brazil will continue to be a complex jurisdiction, but one with the opportunity for longer-term commercial benefits as it continues to integrate into the OECD tax framework, and, between those in treaty jurisdictions, the potential for long-term transfer pricing certainty.

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