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Global Tax Alert

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OECD and Brazilian Revenue Authority issue joint report on convergence of Brazilian transfer pricing rules with OECD standard

Executive summary

The Organisation for Economic Co-operation and Development (OECD) and the Brazilian Revenue Authority (RFB) issued a joint report on 18 December 2019, *Transfer Pricing in Brazil: Towards Convergence with the OECD Standard (the Joint Report)*, which outlines two potential options for aligning Brazil's transfer pricing rules with the OECD standard. Alignment of Brazil's transfer pricing rules with the OECD standard is part of the process for membership in the OECD and is described as providing the benefits of increased tax certainty and prevention of double taxation. While no timeline has been set for such alignment, taxpayers should consider performing an initial assessment of the risks and opportunities associated with the potential changes to Brazil's transfer pricing rules.

Detailed discussion

Background

In 2017, Brazil expressed interest in initiating the process for membership in the OECD. Because Brazil has unique transfer pricing rules that do not align with the OECD standard and given the significance of transfer pricing in international tax standards, the transfer pricing topic is one of the key elements of Brazil's potential accession to the OECD.

Accordingly, in February 2018, Brazil and the OECD launched a joint project to examine the similarities and divergences between the Brazilian and OECD transfer pricing approaches. The objective of the study was to assess the strengths and weakness of Brazil's transfer pricing framework. The 15 months of work carried out by the OECD and the RFB included an in-depth analysis of the Brazilian transfer pricing legal and administrative framework, as well as its application.

A highlights document accompanying the Joint Report includes a diagram on page 3 depicting the three-stage work program carried out by the RFB and the OECD.

As part of the third stage of the project, the Joint Report prepared by the RFB and the OECD outlining the gaps and divergences associated with the Brazilian transfer pricing rules was published. The Joint Report was discussed by officials from the RFB and the OECD at an event held in Brasilia on 18 December 2019, with participation by representatives of Brazilian taxpayers. The purpose of the event was to present the options for aligning Brazilian transfer pricing rules with the OECD standard.

Reasons for launching the project

When Brazil's transfer pricing rules were enacted in 1996, their purpose was to provide simplification for both taxpayers and the Brazilian authorities. Given the nature of the Brazilian economy at the time the rules were developed, the Brazilian transfer pricing rules were designed mainly for tangible goods.

The Brazilian transfer pricing rules do not fully align with the international standard based on the "arm's-length principle" described in Article 9 of both the OECD Model Tax Convention and the United Nations Model Tax Convention. The application of the arm's-length principle as defined in the OECD Transfer Pricing Guidelines is one of the OECD Committee on Fiscal Affairs' requisite Core Principles for assessing accession candidate countries.

On 29 May 2019, Brazil sent a formal request for initiation of the accession process to the OECD. Because adherence to the arm's-length principle is required of OECD member countries, changes to Brazil's transfer pricing rules, with a view to aligning the current rules with the OECD standard, will need to be contemplated in connection with a future accession process.

Key findings of the project

During the project, many gaps and divergences between the Brazilian transfer pricing rules and the OECD standard were identified, with the potential for Base Erosion and Profit Shifting (BEPS) risks. The Joint Report includes the following:

- Absence of special considerations for more complex transactions (i.e., intangibles, services, business restructuring, cost contribution arrangements, etc.)
- Absence of restatement of the arm's-length principle in the domestic law
- Use of a fixed margin approach
- Taxpayer flexibility to select the transfer pricing method to be adopted
- Limitations on the deductibility of royalty payments
- Potential under the current system for some categories of taxpayers to benefit to the detriment of others
- View of current system as practical, predictable, and providing certainty for domestic purposes, but creating significant tax uncertainty from an international tax perspective
- No functional and risk analysis requirement
- Use of an item-by-item approach
- Weakness in safe harbors on exports
- Absence of advanced pricing arrangements and corresponding adjustments
- Absence of profit-based methods, such as the transactional net margin method and the profit split method
- Requirement of only country-by-country reporting but not the master file or local file as provided under BEPS Action 13

Many of these gaps and divergences can lead to either double taxation or double nontaxation because Brazil has a different transfer pricing regime than other countries, most of which follow the arm's-length principle.

Options for alignment with the OECD standard

After identifying the gaps and divergences of the Brazilian transfer pricing rules, the RFB and the OECD agreed on two potential options for alignment described in the Joint Report:

- **Full and immediate alignment**: The first option would immediately align the Brazilian transfer pricing rules with the OECD standard, including the arm's-length principle and the guidance for its application contained in the OECD Transfer Pricing Guidelines.
- **Full and gradual alignment**: The second option would involve the same full alignment, but the process would be structured in stages for gradual implementation. This alternative would allow the RFB to prioritize its needs and receive training and assistance from the OECD.

According to the Joint Report, the RFB and the OECD agreed that the full and gradual alignment seems to be the more reasonable option for alignment because it could allow taxpayers that are large multinational groups (i.e., as defined by reference to the group revenue threshold for the country-by country-reporting requirement) to move to the new transfer pricing system in the short term, while allowing small and medium-sized multinational groups to time their entry into the new system. The revenue threshold for required application of the new rules would gradually be lowered, with all taxpayers applying the new regime in the long term.

During the project, the possibility of partial alignment with the OECD standard also was analyzed. However, the Joint Report indicates that both the RFB and the OECD decided not to go ahead with further analysis of such an option given that significant gaps would remain, which would negatively affect tax certainty and risk double taxation or loss of tax revenue.

Finally, the analysis of the options for alignment also considered how to maintain some elements of simplification that ease tax administration, tax compliance and tax certainty. Therefore, it is expected that the options for alignment would maintain the existing simplification of the current transfer pricing system, such as by transforming the existing fixed margins into more tailor-made safe harbors in accordance with the arm's-length principle.

Benefits of alignment with the OECD standard

The Joint Report identifies the risk of double taxation arising from the lack of alignment as a factor in preventing multinational groups from making new investments in Brazil, with such double taxation considered to be an additional cost of doing business in Brazil.

The Joint Report also notes that the current Brazilian transfer pricing rules may lead to the reduction of the tax base and revenue collection in Brazil. This is because Brazilian taxpayers may report minimal or no income in Brazil by shifting their income to countries with lower tax rates, as Brazil does not require Brazilian taxpayers to allocate profit based on the value created in Brazil.

The Joint Report concludes that aligning the Brazilian transfer pricing rules with the OECD standard would increase tax certainty from an international perspective and would enable Brazil to be better integrated into global value chains.

Moreover, aligning the Brazilian transfer pricing rules with the OECD standard would facilitate Brazil's accession to the OECD.

Implications

It is our understanding that RFB and OECD officials and the participating taxpayer representatives at the event held in Brasilia agreed on the need to align the Brazilian transfer pricing rules with the OECD standard as a way of improving the business environment and tax practices in Brazil.

While there has been no official statement on when the alignment of the Brazilian transfer pricing rules with the OECD standard will occur, it is expected that a new transfer pricing law will be drafted by the RFB and could be voted on by the Brazilian Congress in the next few years.

Because the potential alignment of the Brazilian transfer pricing rules with the OECD standard may result in significant changes for foreign multinational groups with presence in Brazil and for Brazilian multinational groups, companies should consider performing initial assessments to identify the risks and opportunities associated with potential changes in the Brazilian transfer pricing system.

For additional information with respect to this Alert, please contact the following:

Ernst & Young Assessoria Empresarial Ltda, Brazil

- Orlando Veloci, *São Paulo* orlando.veloci@br.ey.com
- Caio Albino, *São Paulo* caio.albino@br.ey.com
- Janaina Costa, *São Paulo* janaina.costa@br.ey.com
- Daniel Biagioni, *São Paulo* daniel.biagioni@br.ey.com
- Marcio R Oliveira, *Rio de Janeiro* marcio.r.oliveira@br.ey.com
- Leandro Cassiano, *Campinas* leandro.cassiano@br.ey.com
- Soraia Steffens, *Curitiba* soraia.steffens@br.ey.com

Ernst & Young LLP (United States), Latin American Business Center, New York

- Gustavo Carmona Sanches gustavo.carmona1@ey.com
- Tiago Aguiar tiago.aguiar@ey.com
- Ana Mingramm ana.mingramm@ey.com
- Enrique Perez Grovas enrique.perezgrovas@ey.com
- Pablo Wejcman pablo.wejcman@ey.com

Ernst & Young LLP (United States), Global Tax Policy Leader, Washington, DC

- Barbara Angus barbara.angus@ey.com

Ernst & Young LLP (United Kingdom), Latin American Business Center, London

- Luciana Rodarte luciana.rodarte@uk.ey.com
- Jose Padilla jpadilla@uk.ey.com

Ernst & Young Tax Co., Latin American Business Center, Japan & Asia Pacific

- Raul Moreno, *Tokyo* raul.moreno@jp.ey.com
- Luis Coronado, *Singapore* luis.coronado@sg.ey.com

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