The Transfer Pricing Law Review

Fourth Edition

Editors
Steve Edge and Dominic Robertson

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PREFACE

It has been a great pleasure to edit this fourth edition of *The Transfer Pricing Law Review*. This publication aims to give readers a high-level overview of the principal transfer pricing rules in each country covered in the *Review*. Each chapter summarises the country's substantive transfer pricing rules, explains how a transfer pricing dispute is handled, from initial scrutiny through to litigation or settlement, and discusses the interaction between transfer pricing and other parts of the tax code (such as withholding taxes, customs duties, and attempts to prevent double taxation).

Other than Brazil, all the countries covered in this *Review* apply an arm's-length standard and adhere, at least to some extent, to the Organisation for Economic Co-operation and Development Transfer Pricing Guidelines (the OECD Guidelines); and Brazil itself has recently launched a project to align its transfer pricing rules with the OECD norm. However, as the chapters make clear, there remains significant divergence, both in countries' interpretation of the arm's-length standard (e.g., the transactions it applies to, the pricing methods preferred and whether secondary adjustments are imposed) and in the administration of the rules (e.g., the documentation requirements imposed, and the availability of APAs). Transfer pricing practitioners, therefore, cannot simply assume that the OECD Guidelines contain all the answers but must in fact engage with their detailed application within each country.

As we have said in earlier editions of the *Review*, transfer pricing rules will be high on the corporate tax agenda for many years to come, and they are continuing to evolve at a rapid pace. Over the next year or so, we expect the following to be among the main areas of focus.

First, as in so many other areas of endeavour, the covid-19 pandemic raises new challenges for transfer pricing, and may in some cases invert the 'normal' argument between taxpayers and tax authorities. For example, will tax authorities which have previously argued that a company is not a routine service provider, and should be rewarded through a profit split, now accept that the company therefore needs to bear a share of the group's covid-19 losses? Looking further forward, the experience from the 2008 financial crisis suggests that, in the medium term, the need for tax revenues is likely to push tax authorities towards a more assertive approach in transfer pricing cases.

Second, a number of countries may see disputes over the extent to which transfer pricing can be used to recharacterise transactions, rather than merely to adjust the pricing of transactions. For example, the German courts held last year that transfer pricing rules are not limited to pricing adjustments alone; and Ireland introduced rules that enable the Irish Revenue to impose a 'substance over form' principle.

Third, the long-awaited OECD Transfer Pricing Guidance on Financial Transactions was published in February 2020. Although its immediate impact has been rather overshadowed

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by the covid-19 situation, many taxpayers, and tax authorities, will need to get to grips with the potential impact of this guidance on them.

Finally, the OECD/G20 project to address the tax consequences of digitalisation continues to work towards its target of presenting an agreed solution by the end of 2020. The current Pillar One and Pillar Two proposals would, if enacted, be the most far-reaching change to transfer pricing principles in close to 100 years, and would mark a significant shift away from the arm's-length principle. The desire to shore up tax revenues in light of covid-19 may well encourage the countries that expect to be 'winners' from the proposals to push for an agreed outcome. It is worth noting, however, that the reforms will not be a silver bullet for public finances. The OECD expects the reform to increase corporate tax revenues by 4 per cent; in the UK, for example, that would raise enough money to fund the National Health Service for only one week.

We would like to thank the authors of all of the country chapters for their comprehensive and illuminating analysis of each country's transfer pricing rules; and the publishing team at Law Business Research for their diligence and enthusiasm in commissioning, coordinating and compiling this *Review*.

Steve Edge and Dominic Robertson
Slaughter and May
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Chapter 3

BRAZIL

Marcos Ribeiro Barbosa and João Victor Guedes Santos[1]

I OVERVIEW

Brazil only introduced transfer pricing regulation in the mid-1990s. The concern to properly tax profits from transnational businesses emerged immediately after Brazil began taxing Brazilian companies on income derived from activity carried out abroad, in a clear move from territorial to worldwide taxation.

Inspired by international practices, Brazil enacted transfer pricing control through Law No. 9,430 of 1996, with the aim of assessing whether the prices applied in transactions with certain foreign parties corresponded to market parameters. The Law's main purpose is to avoid Brazilian companies improperly reducing the amount of their returns subject to Brazilian corporate income tax, which comprises corporate income tax and the social contribution on profits (collectively CIT).

Over the years, several pieces of legislation on this topic have been introduced by federal authorities, resulting in a thorough, almost exhaustive legal framework, aspects of which have faced legal challenges in the courts.

Brazilian transfer pricing rules are mainly focused on Brazilian corporations. Trusts do not exist under Brazilian law and, although resident individuals fall within the scope of the rules governing persons, in practice there are no rigid filing requirements to make the rules enforceable for individuals. The exclusion of Brazilian individuals from any tight transfer pricing control may derive from the complexity of the rules and the fact it is not common practice to have individuals directly carrying on substantive, high-level international activities.

The rules apply to transactions between Brazilian persons and foreign directly or indirectly related parties, as well as to foreign deemed-related parties (entities resident in tax havens or that make use of privileged tax regimes). There is a separate set of rules dealing with transactions between Brazilian corporations and other parties domiciled in Brazil (in relation to disguised distributions of profits).

There are several situations in which persons abroad are considered related to a Brazilian entity, including the following:

a the entity has its head office or branch abroad;
b the parent company or controlling individuals are resident abroad;
c the entity has subsidiaries or associated companies abroad;
d where any company under common corporate or administrative control, or with at least 10 per cent of the capital held by the same person, is resident abroad;
e its exclusive agents or distributors are resident abroad; and

1 Marcos Ribeiro Barbosa and João Victor Guedes Santos are partners at L O Baptista Advogados.

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f the person that granted the Brazilian entity exclusive agency or distribution rights in Brazil is resident abroad.

As well as having a legally defined concept of tax havens or low-tax countries (mainly jurisdictions that tax income at rates of up to 20 per cent), Brazil also applies a blacklist to countries actually considered tax havens. A couple of years ago, Ireland was listed as a tax haven, while Switzerland was recently excluded from this list. The inclusion of a country on the Brazilian blacklist may trigger an impact on tax far beyond that of transfer pricing rules.

On top of that, foreign entities are deemed to make use of privileged tax features if incorporated under certain (tax) regimes in Austria, Costa Rica, Denmark, Iceland, Malta, the Netherlands, Portugal, Singapore, Spain, Switzerland, the United States and Uruguay. The privileged tax regime classification has implications mainly only for transfer pricing.

In a deviation from the international practices followed in Organisation for Economic Co-operation and Development (OECD) countries, Brazilian transfer pricing legislation sets objective parameters to regulate the prices used with foreign related or deemed-related parties. In some circumstances, the methodology formulated to implement the arm's-length principle may not be considered totally at arm's length according to international best practice. For example, Brazilian legislation does not regulate the deduction limits of transactions concerning royalties and technical, scientific and administrative assistance, which are subject to specific, restrictive parameters. Also, there is no provision in law for transactional profit methods, secondary adjustments, settlements or advanced pricing agreements (APAs).

Furthermore, the best-method rule is not applicable, meaning that Brazilian taxpayers may freely choose a suitable method, namely the one that results in making the least transfer pricing adjustment. Brazilian legislation also provides for safe harbours to exclude either the application of transfer pricing rules themselves or the need for adjustments under certain circumstances. This affords Brazilian transfer pricing rules a high level of administrability, simplicity and feasibility, compared with practices in more developed countries.

The OECD TP Guidelines are not used or accepted by Brazilian tax authorities and courts, although the intensification of the movement of Brazil towards the OECD is forcing rule makers to rethink transfer pricing legislation and its compatibility with OECD standards. The launch in December 2019 of the joint report *Transfer Pricing in Brazil: Towards Convergence with the OECD Standard*, by the Brazilian tax authorities and OECD, constitutes a major step towards a near-future convergence with the TP Guidelines.

The legislation is not applicable to corporate transactions such as dividend distributions, or Brazilian unique interest on equity payments and capital contributions. However, in view of the recent decision by the tax authorities that capital contributions through the assignment of rights by foreign shareholders are subject to tax, the extension of the transfer pricing regime to this kind of transaction may be considered in the near future.

Given that there are restrictive methods in place and several types of major transaction are excluded from the transfer pricing regime, multinational groups must be careful to devise the most suitable planning strategy to distribute returns abroad, otherwise several constraints may apply. The accounting positions that they adopt will play an important role in determining the tax consequences for Brazilian corporations.

Brazilian transfer pricing rules present various peculiarities, which makes them complex and somehow unclear. Over the years, the tax authorities have contributed to creating this uncertainty by issuing regulations aspects of which have been challenged before the administrative and judicial courts as being legally deficient.

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II FILING REQUIREMENTS

Transfer pricing regulation is carried out annually (the tax period is generally the calendar year). On 31 December of each year Brazilian entities are required to make the necessary tax adjustments to the prices and costs registered in their accounting books in connection with transactions performed with foreign related and deemed-related parties.

Relevant information on methods used and corresponding tax adjustments, if any, are rendered in the corporate tax return (ECF) filed in July of the following year. In the ECF, taxpayers are obliged to present preliminary information concerning parties, transactions, prices, methods and tax adjustments.

There is, however, no requirement to file beforehand a thorough, detailed report demonstrating all calculations and supporting documentation. Evidence that taxpayers are fully compliant with transfer pricing rules is only required during a tax inspection, when competent authorities scrutinise the documentation supporting the companies' position.

In the context of concessions made to the OECD Base Erosion and Profit Shifting (BEPS) Action Plan, Brazil introduced country-by-country reporting a few years ago, with country-by-country reports (CBCRs) having to be included in the ECFs filed by certain entities. The CBCR mainly concerns information rendered by controlling Brazilian companies about their group, profit allocation and activities undertaken in countries where the group has a material presence. Groups with a global gross income below the threshold of €750 million are generally excused from the CBCR filing requirement.

Further, corporations whose gross income from foreign related and deemed-related parties is not lower than 90 per cent of the transactions concluded domestically with unrelated parties are also excused from this obligation once no transfer pricing adjustment applies to them. This safe harbour is not applicable to the negotiation of commodities. Also, when controlled export revenues are not representative, or demonstrate a certain level of profitability, there is no transfer pricing adjustment; in these situations, there is no filing requirement.

Although resident individuals are theoretically included in the personal scope of Brazilian transfer pricing rules, they are not required to submit any specific transfer pricing-related information in their annual individual tax return (DIRPF). Individuals must file their DIRPF for the previous year by the end of April.

III PRESENTING THE CASE

i Pricing methods

Four methods apply to import transactions and five methods cover export transactions of goods, rights and services. Methods are conceptually similar to traditional methods within OECD practice, despite their several particularities. No transactional methods (transactional net margin or profit split) are provided or allowed under Brazilian transfer pricing rules.

There is no best-method rule under Brazilian legislation. With exceptions for transactions with commodities (for which there are specific import and export methods) and royalties, and technical, scientific and administrative assistance (where restrictive deduction limits apply under a separate set of rules), taxpayers are free to choose transfer pricing methods, and may opt for an applicable method that generates the lesser adjustment, or even no adjustment.

The method chosen by taxpayers shall be used throughout the tax year for the same type of transaction (product by product).

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Methods derive from three distinct elements aimed at achieving arm's-length pricing: uncontrolled or independent price, cost, or resale price.

The import parameter price to be compared with the acquisition cost of imported goods, rights and services consists in the following:

a Compared independent price (PIC): the average of uncontrolled transactions with identical or similar goods, rights or services between unrelated parties under similar payment conditions.

b Quotation price on imports (PCI): the daily average of the quotation of commodities listed in internationally recognised exchanges.

c Production cost plus profit (CPL): the average production cost abroad, plus taxes and charges imposed by the foreign country, and a profit margin of 20 per cent.

d Resale price less profit (PRL): the average resale price for transactions with unrelated purchasers, less unconditional discounts granted, taxes and contributions on sales, commissions and brokerage fees, and a profit margin of between 20 per cent and 40 per cent depending on the business developed.

The export reference price to be considered against the revenue obtained from the sale of goods, rights and services is determined as follows:

a Export sales price (PVEx): the average sales price on exports to unrelated parties in connection with identical or similar goods, rights or services during the same tax year and under similar payment conditions.

b Quotation price on exports (PECEX): the daily average of the quotation of commodities listed in internationally recognised exchanges.

c Purchase or production cost plus taxes and profit (CAP): the average price of acquisition or production costs of exported goods, rights or services, plus taxes charged in Brazil and a 15 per cent profit margin.

d Wholesale price in the destination country, less profit (PVA): the wholesale market price of identical or similar goods sold in the wholesale market of the country to which the product is exported under similar payment conditions, less sales taxes in that country and a 15 per cent profit margin.

e Retail price in the destination country less profit (PVV): the average price of identical or similar goods sold between unrelated parties in the retail market of the country to which the product is exported under similar payment conditions, less sales taxes in that country and a 30 per cent profit margin.

In summary:

Criteria	Import methods	Export methods
Uncontrolled price	PIC – compared independent prices PCI – quotation price on imports	PVEx – export sales price PCEX – quotation price on exports
Cost	CPL – production cost plus profit	CAP – purchase or production cost plus taxes and profit
Resale price	PRL – resale price less profit	PVA – wholesale price in the destination country less profit
		PVV – retail sale price in the destination country less profit

In general, a divergence of up to 5 per cent between the price used and the reference price determined using the foregoing methods is accepted. Adjustments are only required if the difference between prices exceeds 5 per cent. If the transaction concerns commodities controlled under PCI or PCEX, the maximum acceptable divergence margin is 3 per cent.

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When it comes to export transactions, it is important to add that no transfer price assessment is required in the following situations: (1) where the gross income from transactions with products other than commodities is not lower than 90 per cent of the price used with unrelated parties in the domestic market; (2) where the gross income derived from transactions does not represent more than 5 per cent of the total revenues registered by the company; or (3) where profitability from the transactions is not lower than 10 per cent, unless the total controlled export gross income is higher than 20 per cent of total revenues.

Although in theory it is generally feasible to opt for any one of the available transfer pricing methods, several practical restrictions on the taxpayer's choice usually arise in certain situations.

Methods that rely on the actual existence of identical or similar goods, rights or services are strictly limited to goods, rights and services that are also negotiated with unrelated parties. However, this level of comparison is often unfeasible in some multinational groups, especially in industries with patent-protected products. An example is the high-end technology industry.

For methods based on costs, a detailed description and breakdown of the costs and expenses involved is often not possible because of accounting differences and mismatches between countries, and more frequently on account of internal or external confidentiality reasons.

Resale price methods mandatorily require the existence of subsequent uncontrolled transactions concerning the goods, rights or services under scrutiny. This may create hurdles either because a resale does not occur or because a related party abroad is not able or willing to disclose information on subsequent transactions.

Because of difficulties related to the identification of comparables, and to the disclosure of foreign costs and complex costs information required by tax authorities, the most used method to assess import transactions in Brazil is PRL, which requires an actual resale to a third, independent party.

For exports, the most used Brazilian method is the cost-based CAP, which takes the Brazilian company's cost as the basis for the reference price to be compared with the transaction price. Other methods are less feasible because of the difficulty either in identifying comparables or in obtaining data on resale transactions carried out overseas by other parties.

Interest arising from financial agreements entered into between a Brazilian person and related or deemed-related parties are also subject to transfer pricing rules.

The control of interest through financial instruments is also based on strict, objective parameters. Nonetheless, following amendments introduced a few years ago, Brazilian legislation appears to achieve more accurate market parameters for financial transactions than for business and commercial transactions.

The established base interest rates are:

a for prefixed transactions in US dollars, the market rates of Treasury bonds issued by the Brazilian government abroad in US dollars;

b for prefixed transactions in Brazilian reais, the market rates of Treasury bonds issued by the Brazilian government abroad in Brazilian reais; and

c for other situations, the London Interbank Offered Rate (LIBOR) for six months.

A spread periodically fixed by the Brazilian government shall be added to the rate above to determine the maximum deductible financial expense, or the minimum taxable financial revenue in Brazil. Spreads currently in place are 3.5 per cent for interest expenses and 2.5 per cent for interest revenues.

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ii Authority scrutiny and evidence gathering

Considering that the Brazilian approach to transfer pricing is grounded in objective methods and predetermined margins, with no room for transactional methods, tax authorities are not concerned with scrutinising taxpayers' position in relation to foreign companies of the same group.

Except for situations where the adoption of a method requires the analysis of documents and supporting materials from other entities of the same multinational group, Brazilian tax authorities normally do not make requests connected to them. No powers are granted by law for tax authorities to discuss a situation with witnesses or third parties, or even to oblige taxpayers to produce witnesses or documentation outside Brazil. This includes the impossibility of discussing transfer pricing matters with tax authorities by using expert witnesses in a pre-litigation stage.

Unless fraud or dissimulation is alleged, the scrutiny generally concerns ordinary documents normally issued by corporations in connection with their businesses and commercial transactions. Besides, Brazilian rules allow taxpayers to rely on other documents to sustain their tax position, such as official publications and reports and research carried out by distinguished institutions, namely the OECD and WTO.

Confidentiality is a serious issue whenever the adoption of methods that require foreign documents comes into play. Several multinational groups prefer not to disclose confidential data to their Brazilian subsidiaries, even at the cost of an improvement in their tax position. This is why methods such as CPL (for import transactions), and PVA and PVEX (for export transactions) are not used much in practice, since they require the disclosure of foreign information and documents that are very often deemed confidential.

An important confidentiality concern was raised a few years ago with the introduction (and ongoing implementation) of CBCRs. Although in principle CBCRs may not be publicly disclosed, the possibility of leakages of information, due either to information technology complications or wilful misconduct, has resulted in mistrust of CBCRs and this poses the main challenge to their full adoption in practice.

In relation to CBCRs, it is important to highlight that the information they contain is unlikely to be used by tax authorities for transfer pricing scrutiny purposes, as the transfer pricing regime is based on the predetermined margin methods currently in place. It is possible, however, that in future CBCRs may be used to challenge the substance of foreign structures, or even to re-evaluate periodically the appropriateness of the exclusive grounding of the Brazilian transfer pricing regime in traditional methods.

IV INTANGIBLE ASSETS

Intangibles pose a myriad of challenges to transfer pricing control worldwide. In a best-case scenario, tax administrations would accurately require, and have the instruments to ensure, that multinational groups are appropriately attributing the returns derived from the exploitation of a certain intangible to the right entities. Functions, assets and risks (FAR) would then be analysed in combination with the development, enhancement, maintenance, protection and exploitation (DEMPE) of the intangible. However, this is not what occurs in Brazilian practice.

In Brazil, royalties associated with several modalities of intangibles, along with fees for technical, scientific and administrative assistance, are excluded from the transfer pricing regime. There is no need to demonstrate where the substantive activities of developing, supporting or exploiting the intangible asset are carried out to justify the prices applied.

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Although transfer pricing is not applied to the remittance of royalties, there are predetermined limits for the deduction of payments in connection with trademarks, patents and know-how abroad. Royalties may only be deducted from 1 per cent to 5 per cent of the net sales income obtained from the provision of products or services connected with the underlying intangible. The exact applicable percentage depends on the nature of the intangible (e.g., 1 per cent applies to royalties for trademarks).

This approach is clearly not in accordance with the arm's-length principle; however, courts have consistently validated the legality of these parameters.

For import transactions Brazil adopts rigid, restrictive percentages, the use of which is separate from the transfer pricing regime; however, the export of intangibles presents taxpayers with the challenge of having to apply traditional transfer pricing methods to evaluate the adequacy of the price applied.

Methods that require the analysis of uncontrolled prices, costs or resales are not adequate for intangible transactions. An intrinsic characteristic of most intangibles is that they do not have comparables. Few intangibles are marketed with independent parties, and cost is not a good basis for evaluating the contribution each business unit may have made in developing a certain intangible. As Brazilian legislation does not provide for transactional methods, the assessment of intangibles in export transactions is extremely challenging. Notwithstanding this, intangibles export transactions are not very common in a developing-country context.

The maintenance of this simplistic approach to intangibles over the decades may be justified by Brazil's position as a developing country and the lack of a wide range of qualified information, technology and know-how available to tax authorities for the proper identification of an accurate return to be allotted to Brazilian functions, assets and risks.

V SETTLEMENTS

The Brazilian transfer pricing framework is still very poor regarding the interaction between taxpayers and authorities to resolve complex situations. Taxpayers cannot rely on specific settlement provisions to pre-empt tax assessments or provide more certainty about the taxpayer's transfer pricing position.

In this regard, there is no legal provision for APAs in Brazil. It is only possible to consult tax authorities about the interpretation of certain legal provisions by filing requests for rulings. This procedure, however, does not grant taxpayers the option of getting together with the competent authorities to predetermine methods, margins, reach and exceptions for certain commercial and business situations.

Although settlements and APAs do not exist, taxpayers may request a change of margin under the PRL method by arguing, and demonstrating, that the predetermined margin allocated to its sector is not applicable in practice. Such a request has to be addressed to the government's Minister of Treasury and assessed accordingly; however, this mechanism has not been used successfully by taxpayers yet.

VI INVESTIGATIONS

Tax authorities have up to five years to open and close transfer pricing investigations into taxpayers, and issue tax assessments, as the case may be.

The tolling of the five years varies according to the character of the transfer pricing context: (1) in regular situations, the five-year term starts from the taxable event (31

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December of each year under scrutiny); (2) in situations where fraud, wilful misconduct or dissimulation is demonstrated, tax authorities have about one year more, as the five-year term starts on 1 January of the second year following the tax period under scrutiny.

In general, tax investigations start with a first notification to the taxpayer, warning that its transfer pricing adjustments for a certain year (or years) is under scrutiny. In such a notification, tax authorities normally request documents and information concerning the assessment to be carried out. Other notifications may follow depending on the taxpayer's response and the authorities' findings over the course of the investigation.

No settlements are possible, even if during a formal inspection the tax authorities identify mistakes or controversial application of the rules in force. Any disagreement on methodology or calculations shall lead to a formal tax assessment, charging the deemed underpaid Brazilian CIT, plus interest (calculated using the official index, Selic) and penalties (75 per cent, or 150 per cent in cases of fraud, wilful misconduct or dissimulation). Tax assessments must either be paid within 30 days (with a 50 per cent discount on the penalty imposed) or challenged by the taxpayer at administrative or judicial level.

VII LITIGATION

i Procedure

Transfer pricing litigation may be conducted at the administrative or judicial level. Taxpayers are free to choose the level at which they want to make their case against the tax authorities' assessment.

Generally, litigation starts at the administrative level and, if necessary, proceeds to the judicial level. This is because taxpayers lose the right to have the same matter heard at the administrative level if they start the challenge in the judicial courts and the courts present an objection. An unappealable administrative decision favourable to taxpayers is definitive, therefore the Treasury is not entitled to challenge it in the judicial courts afterwards. Conversely, if taxpayers lose the challenge at the administrative level, they are still able to make their case before the judicial courts.

The administrative challenge does not require the taxpayer to offer any guarantees or security, and concerns two different levels of analysis by Ministry of Treasury governmental bodies. Although the judges are not as independent as career judges, they are generally more technically prepared to handle complex tax matters such as transfer pricing.

At the first administrative level, a tax authority council (DRJ) analyses the assessment in light of the arguments and documents presented by the taxpayer. It is rare for a DRJ to cancel tax assessments, unless the assessment identifies a flagrant error. The DRJ's decision may trigger the following consequences: taxpayers may either appeal an unfavourable decision or terminate the process by paying the outstanding debt (or even starting judicial litigation at this early stage); and decisions unfavourable to the Treasury concerning amounts above 2.5 million reais are subject to mandatory review by the Tax Appeals Board (CARF).

The second administrative level deals with the adjudication of taxpayers' appeals or mandatory reviews of CARF decisions unfavourable to the Treasury. This administrative court is composed of members jointly representing both the Treasury (through career tax authority judges) and the taxpayers (through judges nominated by industry bodies representing myriad sectors). Although CARF's composition is jointly representative of both Treasury and taxpayers, in tie situations the vote of the president (always a career tax authority judge) prevails. Adjudication may be carried out in the lower and the higher chamber.

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At the judicial level, the transfer pricing lawsuit is first assessed and decided by a single judge, then the case is scrutinised by the court, as in a taxpayer's appeal or a mandatory review of a decision against the Treasury. The High Court of Justice and the Supreme Court may review all the decisions whenever there is a legal or constitutional matter raised by the parties (no factual analysis is allowed at this stage).

In judicial litigation, taxpayers are required to offer guaranties (court deposit, bank letter and real estate assets are the most usual) to avoid having patrimonial constraints.

During the administrative or judicial litigation, taxpayers may strengthen their case by using different means of proof produced by third parties. Because Brazilian transfer pricing rules have objective parameters, taxpayers generally use expert legal opinions (normally prepared by scholars) either to reinforce their position or to discredit any restrictive application of the rule by the treasury. Tax authorities normally rely only on their own assessments.

ii Recent cases

There have been several cases of transfer pricing-related litigation over the years following Brazil's enactment of transfer pricing rules in 1996. These cases were mainly considered at the administrative level.

It is difficult to refer to specific taxpayers' cases in Brazilian case law, as there are a number of similar cases representing administrative or judicial challenges to certain positions imposed by tax authorities. Therefore, reference is made here to court positions addressing relevant matters that have been considered over the years.

A broad international taxation issue is the discussion of the compatibility of Brazilian rules with Article 9 (associated enterprises) of double-tax treaties because predetermined margins represent a deviation from the arm's-length price demanded by Article 9. CARF maintains the firm position that there is no conflict between domestic rules and Article 9 of double-tax treaties.

CARF has also decided that tax authorities are not obliged to adopt a method that is more favourable to the taxpayer in the course of inspections if the taxpayer has not indicated any method in its return ECF, or if the method indicated in the ECF is not suitable for a particular transaction. Furthermore, CARF has consistently stated that during an administrative tax proceeding the taxpayer is not able to change or indicate another transfer pricing method in relation to the challenged transactions.

In relation to the utilisation of the methods themselves, the discussions have been primarily focused on the legality of restrictive interpretations enacted by tax authorities in regulations concerning the PRL method. The two main discussions undertaken at the administrative level related to calculation particularities concerning the method (proportional calculation and inclusion of freight and insurance in the assessment), and in both cases CARF decided against the taxpayer.

The judicial courts are still at an incipient stage of analysis of these issues.

VIII SECONDARY ADJUSTMENT AND PENALTIES

There are no secondary adjustment mechanisms in the Brazilian transfer pricing framework.

In cases where adjustments are imposed to reflect, from a tax perspective, a more appropriate price, the legislation does not entitle tax authorities to require secondary adjustments to correct the price differences arising.

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This means that transfer pricing adjustments result in a mismatch between tax and accounting books. Consequently, the amounts overpaid or under recognised in controlled transactions may not be treated as deemed dividends or loans to related or deemed-related persons abroad.

IX BROADER TAXATION ISSUES

i Diverted profits tax and other supplementary measures

Brazil has still not introduced a specific diverted profits tax or other measure as part of its response to the BEPS project.

No mechanisms have been created to counteract arrangements aimed at diverting profits under the specific circumstances that such a tax would address. Currently, the sole consequence of base erosion arising from artificial arrangements is the readjustment of the taxable basis subject to Brazilian CIT.[2]

ii Double taxation

Brazilian legislation is very rigid when it comes to transfer pricing control. Traditional methods based on predetermined margins leave almost no flexibility to conduct the FAR analysis in the most tax-efficient way.

In several situations, the Brazilian approach leads to overpayment or underpayment of taxes. While administration of the relevant rules is relatively easy, this regime very often fails to produce the fully arm's-length pricing that more flexible, transactional methods would achieve. This is particularly the case as Brazil does not include Article 9(2) of the OECD Model Convention in its double-tax treaties. This Article provides a mechanism for making correlative or corresponding adjustments in one country following adjustments imposed by authorities of the other contracting country.

Until a few years ago, there were neither mechanisms provided by treaties nor unilateral measures to counteract economic double taxation. In general, Brazilian rules do not authorise the tax administration to rely on adjustments imposed by authorities of other countries, which follow a different set of rules.

Notwithstanding this, Brazil has implemented in domestic law the mutual agreement procedure (MAP) contained in double-tax treaties. The domestic legislation refers to the possibility of applying the MAP to transfer pricing matters involving different countries. It remains to be seen whether the Brazilian authorities are actually willing to adopt the MAP in practice or whether this is only a political approach forced by the BEPS scenario. To date, there have been no known cases in which the MAP has been successfully applied in Brazil.

While binding arbitration could be an interesting solution to double taxation issues in some situations, the use of arbitration in tax matters is far from becoming a reality in Brazil. The current understanding is that arbitration would demand a waiver of rights connected with taxation and the Brazilian Constitution would not allow such a situation in tax matters. Arbitration, therefore, may not be invoked.

iii Consequential impact for other taxes

Rules only concern CIT and do not interact with legislation related to import duties, such as customs valuation, and value added tax (VAT).

2 Namely IRPJ and CSLL.

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Although the purpose of transfer pricing for import transactions and customs valuation is materially the same (the reach of the appropriate arm's-length price on imports), there are two incommunicable sets of rules dealing with these matters separately.

Likewise, any import or export transaction adjustments to CIT taxable bases do not have any impact whatsoever in relation to Brazilian federal, state and local VAT.

This Brazilian approach results in several inconsistencies from a tax standpoint; even the nature of Brazilian federalism and the existence of taxes at three different administrative levels (federal, state and local governments) do not justify this approach, as most customs duties and VAT are administered at the same federal level, which implements transfer pricing rules for CIT purposes.

X OUTLOOK AND CONCLUSIONS

Brazilian transfer pricing rules are already two decades old, but they still struggle to adhere to the OECD Guidelines and align with the transfer pricing practice of developed countries.

The major consequence of this is the detachment from the arm's-length principle in Brazilian practice in several circumstances: (1) through the use of traditional methods only, and disallowing transactional methods; (2) through the adoption of predetermined margins, without thorough regard to functions, assets and risks; and (3) through the imposition of a rigid, inconsistent set of rules, other than transfer pricing, to assess the deduction of royalties.

Despite this, Brazilian transfer pricing rules are easier to manage both from the taxpayer's and the tax administration's perspectives. No comprehensive economic analyses and reports are needed, as the safe harbours and fixed margins make implementation of the legislation simple compared with what would be required under the OECD settings.

Brazilian legislation provides more certainty and effectiveness for the parties involved, although litigation proceedings frequently arise from the restrictive interpretations enacted periodically by tax authorities. The lack of APAs and settlement mechanisms contributes negatively to most of the discussions currently held in administrative and judicial courts.

The still recent introduction of CBCRs in Brazil poses a question about whether the transfer pricing framework may change in the near future. The information contained in a CBCR is not of much use in a system based on traditional methods and predetermined margins. Perhaps, however, this is a first step towards either improving the system and providing for a wider range of fixed margins, or rebooting it by introducing transactional methods.

In December 2019, the Brazilian tax authorities intensified Brazil's movement towards TP Guidelines standards by launching, together with the OECD, the joint report *Transfer Pricing in Brazil: Towards Convergence with the OECD Standard*. The report concerns the joint assessment of the similarities and differences between the Brazilian and OECD frameworks, and creates milestones and ideas for an imminent change in Brazilian legislation to mitigate existing gaps and divergences. Competent authorities have committed to a full alignment with the OECD, either immediate or gradual over a period of years. Guidance on the next steps is expected soon.

The Brazilian approach to the Inclusive Framework Pillar One and GloBE proposals is also still awaited from the tax authorities.

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Appendix 1

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