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Brazil mulls arm's-length principle as part of tax reforms

Brazil will likely need to move away from formulary apportionment and adopt the arm's-length principle as it considers reforming its cross-border tax rules to become an OECD member.

March 12, 2018

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An OECD membership could be within reach for Brazil, which at the end of February announced that it is cooperating on a project with the OECD on cross-border tax rules.

The 15-month long project will consider the similarities and gaps between the Brazilian and OECD approaches to valuing cross-border transactions between associated firms for tax purposes and will assess how Brazil can move closer to the OECD's transfer pricing regime. Brazil requested OECD membership in a formal letter to the OECD in May 2017, and is now picking up the pace in fulfilling outstanding criteria.

Arm's-length principle

A lot of policy and methodology guidelines will have to follow to reform transfer pricing, VAT and tax treaties, among other things. For example, Brazil does not apply the widely applied arm's-length principle in transfer pricing calculations, but uses formulary apportionment.

Thiago Medaglia, partner at Cascione, Pulino, Boulos & Santos in São Paulo, said this will constitute the biggest change in the Brazilian tax system since the current constitution was enacted in 1988.

"These radical changes may impact on tax inspections, quantification of profits, etc., and our clients would be required to review business structures and even how they price their products," he said.

"Our transfer pricing rules only apply to imports and exports of goods and services. To be accepted as an OECD member, I believe Brazil should adopt the arm's-length standard to calculate transfer pricing and sophisticate its system," Medaglia told TP Week.

EY wrote in an **article**: "In principle, the OECD would require Brazil to start accepting the arm's-length standard, or, at least, accept the arm's-length standard when compelled to do so under a treaty MAP provision. This would likely require Brazil to adopt the arm's-length standard in its domestic legislation."

Ricardo Silveira and Stephanie Makin, partners at Machado Associados in São Paulo, told *TP Week* Brazilian transfer pricing rules provide for fixed profit margins, do not consider any functional analysis and do not provide for a "most appropriate method".

Silveira and Makin anticipated that Brazil's transfer pricing rules for services would have to be expanded, as the current legislation is focused on the sale of goods. New transfer pricing rules on intangible transactions would also be necessary since the current rules establish a very low deductibility limit for the payment of royalties abroad, Silveira and Makin said.

"[The rules would also need to] establish guidelines to enable the comparison of benchmark prices with third-party transactions, allowing for adjustments related to specific activity sectors. Although the current rules provide for the use of a method that is very similar to the comparable uncontrolled price method, in practice, Brazilian companies are only allowed to use this method when comparing the tested transaction with transactions performed by the company with third parties," they said.

Aggressive audits

Brazil is widely known for having an extremely complex transfer pricing regime vastly different from OECD standards. A process to change this could become lengthy but increasing certainty is largely welcomed by the tax community.

"One of the most relevant problems for MNEs is the lack of certainty when interpreting tax rules, and many MNEs have been assessed by the tax authority based on very aggressive interpretations to increase tax payments in Brazil," said Diego Marchant, partner at Marchant Transfer Pricing in São Paulo, who believed moving closer to OECD standards would help increase the trust in the tax authority.

"Tax authorities should change their mind to understand that complying with the OECD standards would result in fair taxation and would increase investment by Brazilian companies," he added.

Brazil has not yet signed up to the multilateral instrument, but introduced the common reporting standard and country-by-country reporting (CbCR) in 2017.

André Oliveira, partner at Castro Barros Sobral Gomes Advogados in Rio de Janeiro, said although Brazil has implemented BEPS actions related to transparency and international exchange of information, such as CbCR, the country has evolved little on other BEPS actions.

Amendments made in 2014 modified Brazil's controlled foreign company rules, but more modifications in accordance with BEPS Action 3 will be needed, Oliveira said.

Tax treaties

Brazil also does not fully accept the OECD guidelines on double tax treaties. This caused Germany to terminate its double tax treaty with Brazil in 2005.

"Brazilian authorities believe they are not bound by those guidelines. Because of this, several tax agents and courts construe the treaties differently from what is normally accepted overseas," Medaglia said.

Brazil is slowly picking itself up from the economic depression and corruption scandals of recent years and is looking for ways to invite investment and reignite the economy. Aligning transfer pricing rules with international standards will aid this effort as legal certainty is a priority for many MNEs.

OECD Secretary-General Angel Gurría said on February 28, as he announced the cooperation project with Brazilian Finance Minister Henrique Meirelles, Federal Revenue Secretary Jorge Antonio Rachid and National Confederation of Industry President Robson Braga de Andrade, that transfer pricing rules "are critical for avoiding double taxation and ensuring that taxable profits are not artificially shifted away".

"The project we are launching today will enable us to better understand the options for improving the application of transfer pricing rules in Brazil, and achieving greater convergence. This will help enhance the investment climate in Brazil by reducing the risk of double taxation," he said.

Lena Angvik

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