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THE BRAZILIAN REFORM OF TRANSFER PRICING RULES: COMPLYING WITH THE OECD'S STANDARDS

Abstract. The article analyses the international context that led to a broad reform of Brazilian domestic legislation on transfer pricing. The former Brazilian transfer pricing legislation (1996) lacked compliance with the comparability analysis and the arms' length principle. The new legislation, published in 2023, adopted the Organisation's for European Economic Cooperation (OECD) guidelines on the subject. One important issue that may arise from implementing the new rules and the comparability analysis in Brazil is the relative lack of databases on the subject.

Keywords: the Brazilian Tax Law Reform, Transfer Pricing Rules, Arms' length principle, OECD Guidelines

BRAZYLIJSKA REFORMA ZASAD DOTYCZĄCYCH CEN TRANSFEROWYCH – ZGODNOŚĆ ZE STANDARDAMI ORGANIZACJI EUROPEJSKIEJ WSPÓŁPRACY GOSPODARCZEJ

Streszczenie. Artykuł zawiera analizę kontekstu międzynarodowego, który doprowadził do szeroko zakrojonej reformy brazylijskiego ustawodawstwa krajowego w zakresie cen transferowych. Poprzednie brazylijskie przepisy dotyczące cen transferowych (1996) nie były zgodne z analizą porównywalności i zasadą ceny rynkowej. Opublikowane w 2023 roku. nowe przepisy przyjęły wytyczne Organizacji Europejskiej Współpracy Gospodarczej (OECD) w tym zakresie. Ważną kwestią, która może wiązać się z wdrożeniem nowych przepisów i analizy porównywalności w Brazylii, jest względny brak baz danych na ten temat.

Słowa kluczowe: brazylijska reforma prawa podatkowego, zasady dotyczące cen transferowych, zasada ceny rynkowej, wytyczne OECD

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1. INTRODUCTION

Issues related to digitalisation are one of most discussed topics within international taxation. The Organisation for European Economic Cooperation (OECD) has addressed such matters through the BEPS Action Plan, and profit allocation and nexus rules have been discussed in order to tackle how taxation can align with digitalised economy and how countries can address challenges that have emerged from digitalisation. Transfer pricing and the arm's length principle (ALP) play a key role in such discussions, since they tackle profit allocation when transactions are held between related parties.

In 1996, Brazil adopted their own framework for transfer pricing rules, which were not aligned with the OECD's Transfer Pricing (TP) Guidelines. In 2018, Brazil and the OECD launched a joint project to analyse and modify the Brazilian framework for transfer pricing rules, which resulted in a new legislation effective from 2024 (Federal Law no. 14.596/23).

This article aims to review Brazil's previous and current TP rules and to describe how the process of adapting Brazilian legislation to the standards recommended by the OECD was carried out.

2. THE PREVIOUS BRAZILIAN TP LEGISLATION AND THE OECD GUIDELINES

2.1. OECD and Brazil's Joint Project (2018–2019)

Internal studies by the Brazilian Tax Administration aimed at reforming transfer pricing legislation began in 2017, with the formation of a specific technical group to analyse the topic. In 2018, the joint OECD-Brazilian Tax Administration project began, with the declared objective being the analysis of the similarities and differences between Brazilian legislation and the OECD's standards on transfer pricing (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2023).

The joint project was concluded in 2019, with the publication of its final report. The main conclusions of that report were that Brazil's former TP rules, which remained practically unchanged since 1996, were not aligned with the OECD's guidelines, did not achieve ease regarding tax compliance, and raised concerns in terms of protecting the Brazilian tax base (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019).

It was not until 1995 that the Brazilian legislation introduced measures to tax worldwide income (Federal Law no. 9.249/95), as opposed to taxing only income raised within its jurisdiction. Soon after, transfer pricing rules were introduced by Federal Law no. 9430/1996. This legislation – which did not follow the OECD's Transfer Pricing Guidelines (Organisation for Economic Cooperation and Development 2022) and was maintained until 2023 – aimed to impose objective and simplified rules which, according to the joint work performed by the OECD and the RFB, seemed to have taken in regard the lack of information available on comparable uncontrolled transactions and profitability levels, limited administrative resources, and the costs and time involved in litigating transfer pricing cases (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019).

The joint project was divided into two work streams. The first one analysed differences and gaps between the Brazilian framework and the OECD's TP framework. The second one considered the effectiveness of Brazil's TP rules regarding the criteria of: (i) the prevention of BEPS risks; (ii) the prevention of double taxation; (iii) the ease of tax administration; (iv) the ease of tax compliance; and (v) tax certainty.

The goal of the joint project was to design a new Brazilian TP framework in order to (i) ensure the appropriate allocation of tax base which would include BEPS risks (including under-taxation and double non-taxation) as well as (ii) prevent double taxation.

The OECD and the Brazilian Tax Administration collected inputs from Brazilian taxpayers in their joint project, which was conducted through the application of tailored questionnaires. The inputs came from Brazilian-headquartered MNE groups and foreign-headquartered MNE groups with operations in Brazil, and from sixteen countries which trade with Brazil, fifteen of them being OECD members (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 62–69).

2.2. The Arm's Length Principle (ALP) and the comparability analysis

In order to comply with the ALP, as foreseen by the OECD's TP Guidelines and Art. 9(1) of the OECD MTC 2017 (Organisation for Economic Cooperation and Development 2017), it is fundamental to evaluate whether the conditions made or imposed in a commercial or financial relation between two related enterprises differ from the conditions which would have been made between independent enterprises. Such evaluation requires two main aspects: the first one is to delineate the commercial and financial relations between associated parties and the second one is to compare the conditions set out between related enterprises to the conditions which would have been established between independent enterprises in comparable circumstances (Andrus, Collier 2017, 101).

In order to verify if the transaction aligns with arm's length prices, the conditions set out by the controlled transaction are tested by one of the OECD's Guidelines methods, and the application of such methods is accompanied by a functional analysis of the factors involved in the particular situation, such as risks or asset allocation (Oats 2023, 314). The OECD sets out nine steps to perform the comparability analysis, five of them involving the delineation of the commercial and financial relations and the remaining four of them addressing the selection and application of the TP methods (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 245).

Considering such process, it is important to highlight that the ALP is at core intertwined with the comparability analysis, since comparability is used both to select the most appropriate transfer pricing method (considering the circumstances of the case) and to apply the method in order to achieve the arm's length price.

Brazil's former TP legislation lacked compliance with the comparability analysis and the ALP. The legislation did not make any referrals to the ALP and the rules did not compare the conditions that relevant characteristics of the operation held between related parties to uncontrolled transactions.

2.3. The extent of TP rules

The extent of TP rules can be divided into personal (the extent of associated enterprises), material (transactions reached), and territorial (cross-border or also domestic operations) scopes.

The main differences between the OECD's framework and the Brazilian framework could be found in the material extent of the rules. According to the OECD's Guidelines, the rules should apply to any related-party transaction, such as a transfer of goods, assets, rights, or services. There are also specific provisions which deal with commodities, intangibles, intra-group services, financial, and others.

However, Brazil's former legislation had had a narrower scope and did not reach royalties and payments with regard to technical, scientific, administrative, or similar assistance. Also, it was a common practice for taxpayers in Brazil to make use of a broad interpretation of what could be held as a cost contribution/cost-sharing agreement (CCA) in order to argue that the operation does not involve profits/costs subject to TP rules. Although tax authorities had issued guidance on the matter, the OECD pointed to the need for a clearer legal framework to limit the CCA scope (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 561).

2.4. Methods

The OECD recommends that entities aim to find the most appropriate method for their particular case considering the nature of the transaction and foresee the possibility of applying other methods if the circumstances require so.

In contrast, Federal Law no. 9.430/1996 allowed taxpayers to freely choose a method regardless of whether it was the most appropriate one for a particular case (with the exception of commodities) and it was not possible to apply a different method than the one provided by the legislation.[1]

[1] See Article 18 and Article 19, paragraph 3 of Brazilian Federal Law no. 9.430/1996.

The OECD provides two broad categories of methods – the transaction-based method and the transactional profit method, which, as their respective nomenclatures imply, consider either comparable transactions or comparable profits, respectively. The transaction-based methods include the comparable uncontrolled price (CUP), resale price (RPM), and cost plus, and the profit-based methods include the transactional net margin (TNMM) and profit split.

In contrast, Brazil's former rules divided transfer pricing rules into imports and exports. All the methods provided by Brazil were transaction-based and there were no equivalent methods for TNMM and profit split. Reassembling the CUP, the following methods were included in the Brazilian legislation: Compared Independent Prices (used for imports), Exports Sales Price (used for exports), and Export Quotation Prices (used for commodities exports). Similar to RPM, the following methods were included in the Brazilian legislation: Resale Price Less Profit (used for imports), Wholesale Price Less Profit, and Retail Price at Destination Less Profit (both used for exports). Finally, reassembling the cost plus, the following methods were included in the Brazilian legislation: Production Cost More Profit (used for imports) and Production or Acquisition Cost More Profit (used for exports).

2.4.1. *CUP*

As for the methods *per se*, the closest methods to the OECD's standards were the ones which reassembled the CUP method. The CUP method compares the price charged for an item in a controlled transaction with the price charged for the same or comparable item in an uncontrolled transaction, as long as they are held in comparable circumstances (Oats 2023, 326).

In the Brazilian legislation, Compared Independent Prices (used for imports) and Exports Sales Price (used for exports) would perform a similar function, since they would determine the price on the basis of the weighted arithmetic average of identical or similar items in transactions carried out either on the domestic market or on foreign markets by the interested party itself or by third parties under similar payment conditions. For commodities, there were similar and mandatory methods which would establish a comparison with the daily average values of the quotation of goods or rights subject to public prices on internationally recognised commodity and futures exchanges. The main differences between CUP and Brazil's similar methods relied on the fact that the Brazilian methods would consider the average price/costs of the same items, focusing on the feature of the item itself (good, services, or rights),[2] but it did not take into account other trading factors which may influence the transaction, e.g. quality, commercial reputation, and others (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 191–214).

Furthermore, other Brazilian methods would foresee pre-fixed profit margins, which are detached from the comparability analysis.

[2] Commodity future contracts are considered by the legislation as "rights."

2.4.2. *RPM*

The OECD's RPM method tends to be used when the operation involves one company (Company A) selling to another (Company B), and the later making the final sale to the consumer with minimum processing or added value. Such method considers the price charged by Company B to the final consumer and deducts an appropriate gross margin, which should cover selling expenses and net profit. The difference between the final sale price and the gross margin should be the price charged by Company A to Company B. An industry average gross profit percentage might be applied or the gross margin can be obtained by comparison between independent suppliers (Oats 2023, 327).

The former Brazilian TP legislation provided Resale Price Less Profit as a similar method for imports. The taxpayer would initially verify the average net price of the sale and how much the imported items would represent in terms of the final sold product, which would then be reduced by a pre-fixed profit margin in order to verify if the costs exceeded reasonable amounts. The pre-fixed profit margins would be of 40, 30, or 20%, depending on the industrial sector of the enterprise.

The same rationale would be applied for export methods – Wholesale Price Less Profit and Retail Price at Destination Less Profit. By Wholesale Price Less Profit, an arithmetic average of the wholesale price of identical or similar goods in the country of destination under similar payment terms would be initially obtained, less taxes included in the price that are levied in the country of destination, but it would consider less a profit margin of 15%. Retail Price at Destination Less Profit would apply the same methodology, but would consider the average of the retail price rather than a profit margin of 30% (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 203).

2.4.3. *Cost Plus*

The cost plus method considers initially the costs incurred by the supplier of property or services in a controlled transaction. A mark-up, determined by reference to comparable uncontrolled transactions, is then added to these costs to consider an appropriate profit margin in the light of the performed functions and the market conditions. It is frequently used when semi-finished goods are sold between associated parties (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 184).

The former Brazilian TP legislation methods which reassembled cost plus were Production Cost More Profit (used for imports) and Production or Acquisition Cost More Profit (used for exports). Production Cost More Profit would consider the average production cost of identical or similar products, services, or rights in the country or jurisdiction where they were originally produced, increased by taxes paid in that jurisdiction and by a mandatory fixed profit margin of 20%. Production or Acquisition Cost More Profit would consider the acquisition or production cost of exported goods, services, or rights, plus domestic taxes and contributions, plus a profit margin of 15% on the sum of costs, taxes, and contributions. Those methods would consider not only comparable transactions, but also pre-fixed profit margins, which represented the main issue of divergence between Brazil's and the OECD's transfer pricing rules. Such margins were supposedly based on industry practices, but, as pointed out in the joint report, there was no specification as to how these figures were reached and if they, in fact, reflected what would be expected from entities (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 198–212).

Whilst pre fixed margins can be practical and reduce compliance costs, they could also entail fairness and equity problems – as non-compliant with the principle of ability to pay – since they did not consider the specific circumstances of each contributor.

2.5. Safe harbours

Although the initial OECD's Guidelines from 1995 expressed a view against safe harbours, recent TP frameworks have recognised that such measures might contribute to enhance tax certainty and can be favourable both to tax administration and taxpayers. The OECD's Guidelines recommend that those safe harbours be directed at taxpayers and transactions which involve low transfer pricing risk, recognising that such rules could, for example, allow taxpayers to apply methods in a specific way, exempt some taxpayers or transactions from the TP rules, or relieve from burdensome compliance obligations (Organisation for Economic Cooperation and Development 2022).

In Brazil, the safe harbours provided by previous TP legislation could be and were used by taxpayers as a tax loophole, providing an opportunity for inappropriate tax planning and double non-taxation. The legislation used to foresee three main safe harbours, all of them applicable to exports: (i) taxpayers with export revenues of 5% or less of total revenue (in relation to both related and unrelated parties) were exempt from applying TP rules; (ii) if the export price represented at least 90% of the domestic market price, the adopted export price would be deemed acceptable; (iii) if exports to related parties generated a minimum 10% net profit margin, the transactional conditions would be deemed acceptable, except for taxpayers entering into outbound inter-company transactions whose net revenue from related parties represents more than 20% of the total outbound transaction net revenue (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 395).

Many issues were raised with regard to those questions. The first safe harbour did not distinguish different size of taxpayers, which meant that even huge companies would have been able to escape from TP rules if their exports had not been significant to their revenues. Also, a company could misprice their exports in order to fall under such safe harbours. The second safe harbour raised concerns in terms of appropriateness, because it compared prices based on the domestic market with prices in foreign markets. The last safe harbour was applied both to significant MNE's and smaller companies, and could also lead to under-taxation, since the taxpayer only needed to justify the minimum of the 10% net profit margin.

As noticeable, those safe harbours were not in line with the OECD's standards, which direct safe harbours only to taxpayers and transactions involving low transfer pricing risk.

2.6. Corresponding adjustments and DTCs

In terms of avoiding and resolving transfer pricing disputes, a number of concerns were raised regarding former Brazilian TP rules. The first concern was due to the fact that Brazil had reserved their right not to insert Art. 9(2) in their DTC, which addresses the need for states to account for the adjustments made by other parties as a consequence of TP rules in order to avoid double taxation.[3]

When Art. 9(2) is not included in DTC, mutual agreement procedures provided by Art. 25 can be used. However, even though Brazil has included MAP provisions in most of their tax treaties and such procedure is domestically regulated, the OECD raised a time issue for applying the MAP procedure in Brazil. This is due to the fact that Brazil has stated the position that reliefs and refunds from mutual agreement procedures should be linked to time limits prescribed by domestic law – i.e. five years (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 376–382).

According to BEPS Plan Minimum standards and to Action 14, a DTC should either foresee that domestic time limits do not prevent the implementation of MAP and do not frustrate the objective of resolving cases, or should accept an alternative treaty provision that limits the time during which a Contracting State may make an adjustment pursuant to Art. 9(1) in order to avoid late adjustments and the impossibility of applying MAP to relieve double taxation. The Peer Review Report for Action 14 states that Brazil does not fully meet such BEPS Plan Minimum Standard and that the domestic time limits had caused MAP disputes not to be resolved in the past (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2019, 388).

[3] "Art. 9(2) OECD Model Convention: Where a Contracting State includes in the profits of an enterprise of that State – and taxes accordingly – profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other."

3. THE OVERVIEW OF BRAZILIAN NEW TRANSFER PRICING RULES

The final report of the already mentioned joint project between the OECD and the Brazilian Tax Administration was finalised and published at the end of 2019. In early 2022, the Brazilian Tax Administration formally announced that it would send a bill to the parliament to amend transfer pricing legislation with the aim of aligning it with the OECD's standards. However, this bill was not sent to the parliament for deliberation during the year 2022. At the end of the year 2022, on 28 December, the executive branch published Provisional Presidential Decree no. 1.152, provisionally establishing new rules on the subject.

After five months of parliamentary debate, and without any significant changes in relation to the rules of this Provisional Presidential Decree, a new law regarding transfer pricing rules was approved by parliament (Federal Law no. 14.596/2023).

Federal Law no. 14.596/2023 restates the arm's length principle (Art. 2) and delimitates the identification of commercial and financial relations which are relevant to TP rules, expressing that the comparability analysis must be used (Art. 5–9).

The new rules also align with personal, material, and territorial scope provided by the OECD's framework. The personal scope provided by the OECD should follow the conditions set out in Art. 9(1) of the OECD MTC, which includes enterprises participating directly or indirectly in the management, control, or capital of another enterprise of the other Contracting State, and Brazil's new rules consider all enterprises which participate in at least in 20% of another's capital (Art. 3 and 4).

The material scope now reaches intangibles (Art. 19–22 of Federal Law no. 14.596/2023), intra-group services (Art. 23), cost-sharing agreements (Art. 25), business restructures (Art. 26), financial operations, specifically addressing issues related to hybrid instruments (Art. 27–31), as well as other situations. Furthermore, the deduction of royalty payments was banned if they result in double non-taxation, such as when the same amount is held as deductible by the other related party or when the amount is not taxed in foreign jurisdiction (Art. 44).

The territorial scope of the new rules was limited to cross-border operations (Art. 1 of Federal Law no. 14.596/2023), although former domestic provisions were affected, such as ones which used to limit royal payments between the parties.

All of the OECD's methods were included in the new legislation and the taxpayer should choose one of them according to the most appropriate fit to their circumstances (Art. 5 of Federal Law no. 14.596/2023).

The previous safe harbours were eliminated, and the legislation now foresees that specific regulations can be further provided by tax authorities in order to simplify the application of the comparability analysis or the required documentation. Such regulations should also provide further guidance regarding transactions with intangibles, cost-sharing, business restructuring, financial and others special situations, and should provide means to assist taxpayers when the available information upon the controlled or comparable transactions is limited (Art. 37 of Federal Law no. 14.596/2023).

These new rules also provide for the Advance Pricing Agreement procedure (Art. 38 of Federal Law no. 14.596/2023), allowing taxpayers to consult the best method and applicable comparable/prices with their operations. The consultancy response would be valid for a period of four years, subject to a postponement of extra two years. This procedure is similar to the regular tax consultation process implemented in Brazil, by which taxpayers can question tax authorities, and their response will be binding, unless tax authorities change their interpretations and notify the taxpayer of such change.

The new rules also reinforce the Mutual Agreement Procedure in Art. 39 of Federal Law no. 14.596/2023, but the mentioned time limit issue (five years) was not resolved.

Considering such changes and its alignment with the OECD's TP Guidelines, a question arises as to whether or not Brazil will start introducing Art. 9(2) into their DTC's in order to prevent double taxation arising from TP adjustments, and if the new rules will impact international commerce in a positive way, i.e. if foreign companies will be motivated to do business with Brazilian taxpayers, since the new rules are now in accordance with the OECD's standard.

One important issue that may arise from implementing the new rules and the comparability analysis in Brazil is the lack of databases. The OECD's Guidelines recognise that databases are usually developed by independent companies and rely on public available information presented in an electronic format suitable for searches and statistical analysis. However, in Brazil, no such database system has been made available yet and developers might find endurance considering that many companies are not obligated to publish their financial statements. In fact, only companies incorporated as "anonymous societies" (S.A.) need to publish their accounting statements according to Law 6.404/1976, but most companies in Brazil are incorporated as "limited companies" (LTDA) and do not need to disclose their accounting information.

An interesting tool could be developed by the Brazilian Tax Administration itself, since the federal authorities collect all financial data from companies' electronic accounting and fiscal systems (Digital Accounting Records and Digital Fiscal Records), and such databases could reduce both tax compliance burden from a taxpayer perspective and inspections costs from the perspective of tax authorities.

4. FINAL REMARKS

The movement of the Brazilian Executive Branch and Tax Administration, initiated in 2018, towards aligning itself with the OECD's standards on transfer pricing was interpreted as a clear sign of Brazil's interest in becoming a full member of the OECD, joining Mexico (1994), Chile (2010), Colombia (2020), and Costa Rica (2021) in the restricted set of Latin American countries that are part of the organisation.

In January 2022, the Brazilian government announced that it had been invited by the 38 members of the OECD to "start the formal process of joining the organisation". At the time, the Brazilian government revealed that becoming a full member of the OECD was a "priority of its foreign policy".

The Provisional Presidential Decree that provisionally adopted new transfer pricing rules aligned with OECD's standards was adopted in the last days of President Bolsonaro's government, which ended on 31 December 2022. President Lula's government, which began in 2023, fully supported the approval by Congress of the new transfer pricing rules (Organisation for Economic Cooperation and Development, *Receita Federal do Brasil* 2023), but does not treat the country's accession to the OECD as a priority of its international policy.

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