The New Transfer Pricing Framework

ENHANCING BRAZIL'S TAX SYSTEM WHILE FOSTERING TRADE AND INVESTMENT

Receita Federal

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Preface

The reform of the Brazilian transfer pricing legislation is a significant step towards modernizing the tax system and achieving fair taxation. Following an intensive process identifying and diagnosing the strengths and weaknesses of the Brazilian transfer pricing system, Brazil is about to implement one of the most significant changes in its international taxation system, reforming its transfer pricing legislation to align with the standard followed internationally by the vast majority of developed and developing countries, in line with UN and OECD recommendations.

Studies to evaluate the Brazilian model formally began in 2017, with the creation of a technical group at the Brazilian Federal Revenue Service (RFB). These studies, together with lessons learned from increased Brazilian participation in international forums, identified that interaction, and integration of the Brazilian approach with the transfer pricing model followed internationally was problematic. In 2018, RFB started a specific project with the OECD to analyse the similarities and divergences of the Brazilian model in relation to the international standard. This project also paid particular attention to the efficiency of the domestic legislation with regard to preventing erosion of the tax base and avoiding double taxation. The report that resulted from this analysis, published in December 2019, contained a rigorous technical and transparent diagnosis, prepared by the RFB technical team in cooperation with OECD specialists, and included input from the private sector. The report highlighted several divergences between the Brazilian approach and the international standards on transfer pricing. The principal conclusion was clear, however: the current Brazilian model, established in 1996, is not adequate for the current reality.

It is recognised that this model has positive features, such as simplicity and certainty, which Brazil should continue to pursue in the future, as part of the international standard. Despite these qualities, however, the current system fails to ensure the proper determination of the tax base giving rise to various situations of double taxation and double non-taxation, and results in an inefficient tool to measure and tax the income in accordance with the ability to pay principle.

On one hand, the double taxation may deter investment or create an additional cost, which companies must bear to conduct their business in Brazil. Barriers are therefore created that hinder trade, the development of new technologies, the attraction of investment, and, consequently, job creation and national development.

On the other hand, and also harmful, are the opportunities for double non-taxation. The gaps in the current Brazilian model allow the erosion of the tax base, reducing the ability to collect the necessary revenues to support public investments and social expenditures. Differences between our existing transfer pricing rules and the principles followed by the vast majority of other countries have unfairly benefited a small number of taxpayers who took advantage of these gaps and differences to shift profits and the tax base outside of Brazil.

For these reasons, the decision to reform the system, announced in 2019, and carefully analysed and openly debated over several years, is necessary. It is essential for the improvement of the tax system, for taxing the MNEs fairly, equally and consistently, but above all for the development of the country. Maintaining the current system is unsustainable. Its shortcomings and the problems generated have been increasingly exacerbated with the economy's evolution, and the development of new business models.

The tax policy change introduced in the legal framework' with the publication of the Provisional Measure is the result of significant and hard work carried out by the Federal Revenue of Brazil team and conducted through an open and transparent dialogue with society throughout several years. This new system delivers a necessary set of tools — perhaps the most modern set of rules on the matter — that will allow Brazil to move in a positive direction, reformulating its tax system, correcting its weaknesses, and contributing to the country's development. It is therefore essential that we move towards its approval, consistently, and without changes, for changes in the rule could affect the pillars of this system, creating new misalignments with the international standard that RFB has worked for years to identify and eliminate.

Robinson Sakiyama Barreirinhas

Special Secretary of *Receita Federal do Brasil*

In 2018, Receita Federal do Brasil invited the OECD to embark on a journey to jointly reflect on transfer pricing policy in Brazil. This journey started with careful analysis of the existing transfer pricing framework, which had been criticised by some observers and multinational enterprises for deviating from the international standard, while others believed in its relative superiority.

The OECD was honoured to support RFB in this effort, which also provided the opportunity for the OECD to gain a deeper understanding of the strengths and weaknesses of the Brazilian transfer pricing framework.

The assessment, reflected in a joint report issued in 2019, uncovered a large volume of issues in the form of gaps and divergences from the international standard, costing Brazil tax revenue and adversely affecting the trade and investment climate. It is true that some features of the existing Brazilin transfer pricing system are perceived as providing domestic tax certainty and simplicity, but not without undermining the integrity of the transfer pricing system as a whole, and creating uncertainty in the international scenario, as well as opportunities for double non-taxation and instances of double taxation, both harmful to Brazil's fiscal and development objectives.

This led Brazil to rethink the status quo. What followed was the exploration of the best option for Brazil to converge with the international standard, a process which effectively gave rise to the ambition to fully align Brazil's transfer pricing framework to the international standard represented by the arm's length principle.

Transfer pricing in Brazil is thus on the verge of a fundamental transformation, as Brazil prepares to embrace this new reality.

The hard work that was spearheaded by RFB and benefited from the involvement of all stakeholders, including business and academia in Brazil, led to the publication of Provisional Measure No. 1,152 on 29 December 2022, unveiling the text of the new transfer pricing rules.

The Provisional Measure incorporates key principles and concepts of the international standard as provided by the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022), which are also reflected in the *United Nations Practical Manual on Transfer Pricing for Developing Countries* (2021).

We continue supporting the reform, including the confirmation of the Provisional Measure into ordinary law, with a view to comprehensively addressing the gaps and divergences found in the rules it replaces and align the Brazilian transfer pricing approach to the international approach followed by all the major trading and investment partners of Brazil.

There are two main benefits of this reform. First, the alignment of the transfer pricing framework to the international standard will enhance the tax system of Brazil and it will also put a stop to the significant revenue losses suffered by Brazil due to the gaps and divergences identified. Based on the analysis carried out jointly with RFB, we are aware that billions of euros in profits are shifted annually out of Brazil by large MNEs. Recent media reports have also pointed out the systemic legal weaknesses of the rigid methods in the system, which allows MNEs to avoid paying tax in Brazil. The proposed transfer pricing reform would address this.

Second, the alignment to the international standard will also improve the trade and investment climate in a meaningful way. Some MNEs currently experience double taxation resulting from the fact that the same profits are allocated and taxed as profits allocated under the current rigid rules to Brazilian member of MNE groups, while these profits are at the same time also allocated under the international standard to another MNE group member taxed in a different jurisdiction. Most MNEs seek to avoid the risk of double taxation by limiting the cross-border trade with and investment in Brazil. The proposed transfer pricing reform would also address this issue and contribute to the integration of Brazil into global value chains.

The fiscal benefits and positive impact on the trade and investment climate, including the ramifications for growth, job and transfers of technology and know-how, for Brazil may only be achieved if the current degree of alignment to the international standard and integrity of the legislation as reflected in the text of the Provisional Measure is maintained.

A number of amendments have been proposed to the current text of the Provisional Measure. A large number of the amendments, if accepted, will undo the alignment of the new transfer pricing framework with the international standard, contrary to the assertions made that these amendments would result in greater alignment with the international standard. There are also a significant number of amendments that would weaken Brazil's ability to properly and correctly administer and enforce the transfer pricing rules to prevent transfer pricing abuse and tax avoidance.

Given the significant effort over the last five years to balance the objective of adopting the international standard represented by the arm's length principle with the legislative traditions of Brazil, it will be important to carefully consider the impact of any amendment on the alignment with the international standard.

For this reason, the OECD stands ready to offer continuous technical support to the Government and also to the Congress during the ongoing legislative process, including to provide explanations on specific issues, or consider the implications of specific drafting changes, as well as to provide support in the form of oral explanations in any public hearings organised in this context.

This brochure summarises the journey that was travelled thus far on the Joint Brazil-OECD Transfer Pricing Project. We hope it provides useful background for consideration of the Provisional Measure, which will bring Brazil's transfer pricing framework into the 21st century.

Grace Perez-Navarro

Director, OECD Centre for Tax Policy and Administration

Acknowledgments

This joint project between Brazil and OECD benefited from the input and support provided by numerous stakeholders, including academia, the business community, as well as from the financial support of the United Kingdom.

Furthermore, the input and contributions of the tax administrations of the following jurisdictions are acknowledged: Argentina, Australia, Austria, Belgium, Canada, Colombia, Finland, France, Germany, India, Israel, Italy, Korea, Mexico, the Netherlands, Nigeria, Norway, Peru, Portugal, Singapore, Spain, Sweden, United Kingdom and the United States.

The contribution of the business community is also acknowledged, and particularly the input and support provided by *Business at OECD*, the National Confederation of Industry of Brazil (CNI), the Brazilian Association of Financial Law (ABDF) and the Applied Tax Study Group (GETAP).

The journey travelled

Background

Over the past two decades, Brazil has actively participated in international debates on tax issues in different multilateral fora, including the Organisation for Economic Co-operation and Development (OECD) and the United Nations (UN), and through regional initiatives. As a G20 country, Brazil has been at the forefront of the most recent and decisive projects shaping the rules of international taxation, such as tax transparency, the OECD/G20 BEPS Project and the ongoing work on the *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*.

Brazil is a trusted and important partner of the OECD in different policy areas, including tax. Brazil has contributed to and benefitted from multilateral efforts led by the OECD to eliminate bank secrecy including through the establishment of Automatic Exchange of Financial Account Information, the OECD/G20 BEPS Project,[1] and the Two-Pillar Solution to Addressing the Tax Challenges Arising from the Digitalisation of the Economy.[2]

Brazil is a member of the OECD-hosted Global Forum on Transparency and Exchange of Information for Tax Purposes since 2010, which today has over 165 members. Implementation of the international tax transparency standards through this initiative has had a significant impact in deterring tax evasion. For example, it has resulted in voluntary compliance that contributed to the collection of 46.8 billion of Brazilian reals in 2016 and 1.6 billion Brazilian reals in 2017.

Brazil has also been able to shape the international standards through the OECD/G20 BEPS Project,[3] while also benefiting from the increased tax transparency that informs the work of the tax administration and policy makers in Brazil. For example, thanks to a new type of information reporting known as Country-by-Country Reports (BEPS Action 13), important information on multinational enterprise (MNE) taxpayers became available with respect to where large MNEs locate their economic activities and pay their taxes. Another example is the sharing of

[1] Base Erosion and Profit Shifting (BEPS) refers to tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to locations with no/low tax rates and no/little economic activity, resulting in little or no corporate tax being paid and annual revenue losses for governments of at least 100-240 billion USD, equivalent to 4-10% of global corporate income tax revenue.

[2] Brazil is among the 138 member jurisdictions that joined the *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy* of 8 October 2021, https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-october-2021.htm.

[3] Brazil became a member of the G20/OECD BEPS Project in 2013.

information on rulings given to taxpayers by foreign jurisdictions as part of BEPS Action 5 of the OECD/G20 BEPS Project.

Since the beginning of the OECD/G20 BEPS Project, Brazil has participated on an equal footing in the development of standards on BEPS-related issues, while also participating in the process of reviewing and monitoring the implementation of the OECD/G20 BEPS Project jointly with the more than 140 member jurisdictions of the OECD/G20 Inclusive Framework on BEPS.

Discussions on transfer pricing between *Receita Federal do Brasil* (RFB) and OECD intensified in the midst of the OECD/G20 BEPS Project, with two policy dialogue events held in 2014 and 2015. In May 2017 at the request of Brazil and with the support of the European Commission, the OECD held a third workshop with tax officials from RFB, focused on building a better mutual understanding of the Brazilian and OECD transfer pricing systems. Also in 2017, RFB started an evaluation of the Brazilian transfer pricing rules and their main differences and similarities in relation to the OECD system, which was conducted internally by tax auditors specialising in the matter.

In February 2018, the OECD and Brazil officially launched a joint project to examine the similarities and divergences, including gaps, between the Brazilian and the *OECD Transfer Pricing Guidelines*, which have been widely adopted around the world as the international standard for determining the prices of cross-border transactions between related parties of the same MNE group for tax purposes.

The international standard on transfer pricing

The international standard on transfer pricing relies on the **separate entity approach**, which treats each enterprise within an MNE group as a separate entity. This approach, which was agreed 90 years ago,[4] was determined to be the most reasonable means to achieve equitable results from the perspective of both source and residence country taxation and to minimise the risk of unrelieved double taxation in transfer pricing. In order to apply the separate entity approach to intra-group transactions, individual group members must be taxed on the basis that they act **at arm's length** in their transactions with each other.

However, the relationship among members of an MNE group may permit the group members to establish special conditions in their intra-group relations that differ from those that would have been established had the group members been acting as independent enterprises operating in open markets. To ensure the correct application of the separate entity approach, countries have adopted **the arm's length principle**, under which the effect of special conditions on the levels of profits are eliminated.

The arm's length principle is incorporated in both the *OECD Model Tax Convention on Income and on Capital* (OECD Model Tax Convention) and in the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (UN Model Tax Convention). The arm's length principle is also reflected in the domestic legal framework of the vast majority of jurisdictions around the world and followed by developing and developed nations alike, as well as all of the major trading partners of Brazil.

Since 1973, the OECD has been developing guidance in the form of the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (**OECD Transfer Pricing**

[4] See 1933 Draft Convention in League of Nations Fiscal Committee adopting the arm's length principle, further to the "Carroll Report", Carroll, M. B., 1933. "*Taxation of Foreign and National Enterprises – Volume IV. Methods of Allocating Taxable Income*." Geneva: League of Nations, 1933; and 1933 Draft Convention in League of Nations Fiscal Committee (1933, Annex, pp. 3-6).

Guidelines), which contains detailed guidance on the application of the arm's length principle in different situations. This detailed guidance, serves the **dual objectives of securing the appropriate tax base in each jurisdiction and avoiding double taxation, thereby minimising conflict between tax administrations and promoting international trade and investment.** The OECD guidance was revised significantly in 1995 and has been updated and clarified on a regular basis, with significant updates in 2010, 2017, and 2022.

In 2013, the United Nations has also issued practical transfer pricing guidance in the form of the *United Nations Practical Manual on Transfer Pricing for Developing Countries* (**UN Practical Manual**), which reflects the same underlying principles, and demonstrates their application on practical examples.

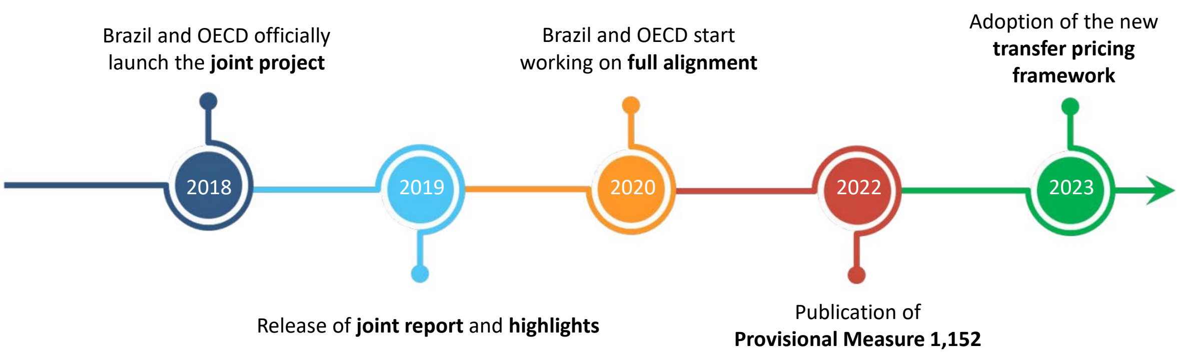
The *OECD Transfer Pricing Guidelines* focus on the application of the arm's length principle to evaluate the transfer pricing of associated enterprises. The Guidelines are intended to help tax administrations (of both OECD member countries and non-member countries) and MNEs by providing guidance on the methods for evaluating whether the conditions of commercial and financial relations within an MNE satisfy the arm's length principle and discuss the practical application of those methods. Where both the MNEs and tax administrations consistently follow these Guidelines, the risks of double taxation and double non-taxation will be significantly reduced. These Guidelines continue to be supplemented with additional guidance to address emerging issues.

See the latest edition of the Guidelines: OECD (2022), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022*, OECD Publishing, Paris, https://doi.org/10.1787/0e655865-en.

The Brazilian transfer pricing framework was inspired by the early work of the OECD on transfer pricing (*Transfer Pricing and Multinational Enterprises* also known as the "1979 Report") but has remained relatively unchanged since it was enacted in 1996.

Aligning the Brazilian transfer pricing rules to the internationally accepted standard is key to achieve the dual objectives of securing the appropriate tax base in Brazil and avoiding double taxation of MNEs doing business in Brazil, thereby minimising conflict between RFB and foreign tax administrations and promoting international trade and investment into Brazil.

Overview of the stages of the Transfer Pricing in Brazil project



Technical analysis (initial phase)

The Brazil/OECD Joint Transfer Pricing Project provided an opportunity for Brazil and the OECD to conduct a detailed and thorough analysis of the similarities and differences between the two systems as well as the strengths and weaknesses of the Brazilian transfer pricing system. The gaps or issues identified in the Brazilian system were then assessed according to five objective criteria: the first two criteria derived from the two main policy objectives of transfer pricing legislation, namely securing the appropriate tax base in each jurisdiction and avoiding double taxation, and three other criteria derived from other general tax policy objectives, namely ease of tax administration, ease of tax compliance, and tax certainty (from both a domestic and international perspective).

The initial phase of the joint project carried out over 15 months included a mutual in-depth technical analysis of the Brazilian transfer pricing legal and administrative rules as well as their administration by RFB. In light of the findings of this assessment, the project also explored the potential for Brazil to move closer to the international standard.

Source: High-level event held on 11 July 2019 (Edifício Roberto Simonsen, Brasília). Pictured in the photo (from left to right): Antoinette Musilek (Spanish Embassy in Brazil), John C. C. Hughes (US IRS), Andrea Chaves (RFB), Claudia Pimentel (RFB), Tomas Balco (OECD), Camille Tirand (OECD), Elizabeth Arnold (UK HM Treasury)

The preliminary results of the initial phase were announced during a high-level event in July 2019,[5] which was followed by several months of further work and analysis of two areas which were not part of the initial scope of the analysis (namely, financial transactions and attribution of profits to permanent establishments). Additional efforts were made to produce a comprehensive report, consolidating the various findings.

[5] Press release: OECD and Brazil share outcomes of project to align Brazil's transfer pricing rules to OECD standard, https://www.oecd.org/tax/transfer-pricing/brazil-identifies-a-clear-pathway-for-aligning-its-transfer-pricing-framework-with-the-oecd-standard.htm.

Engagement with key stakeholders

The mutual analysis carried out during the initial phase was informed by valuable input collected from MNE groups with operations in Brazil and Brazil's major trade and investment partners through various forms of engagement.

An invitation for MNEs to provide input was formally issued and also disseminated by *Business at OECD*[6] and the National Confederation of Industry (CNI) as well as the Applied Tax Study Group (GETAP) in Brazil, which included a questionnaire requesting information on their experience regarding the application of the Brazilian transfer pricing rules.

Input was also requested and provided by Brazil's key trading and investment partners. The tax administrations of these jurisdictions were formally invited to respond to a questionnaire on their experience with the interaction of existing transfer pricing rules and practices in Brazil with the practices followed by these jurisdictions.

The results of the comprehensive analysis carried out jointly by the OECD and RFB are well documented in a consolidated report, "*Transfer Pricing in Brazil: Towards Convergence with the OECD Standard*",[7] along with shorter brochures, containing the highlights of the report (also available in Portuguese),[8] all published on the occasion of a dedicated high-level event, which took place on 18 December 2019 in Brasília, Brazil.[9]

Source: Meeting between Brazilian and OECD officials held on 6 March 2023 (Palácio Itamaraty, Brasília). Pictured in the photo (from left to right): Claudia Pimentel, Undersecretary of Taxation and Litigation (RFB), Adriana Gome Rêgo, Deputy Commissioner (RFB), Grace Perez-Navarro, Director of the OECD Centre for Tax Policy and Administration, Ambassador Sarquis José Buainain Sarquis, Secretary for Foreign Trade and Economic Affairs at the Ministry of External Relations, Tatiana Rosito, Secretary for International Affairs at the Ministry of Finance.

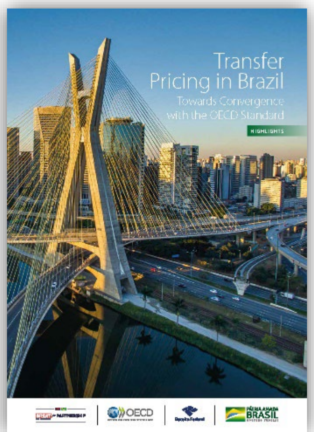
6 An international business body working with MNEs and small and medium enterprises (SMEs) from all industries and sectors through close co-ordination with 55 national business organisations from all OECD countries and beyond.

7 OECD/Receita Federal do Brasil (2019), *Transfer Pricing in Brazil: Towards Convergence with the OECD Standard*, OECD, Paris, www.oecd.org/tax/transfer-pricing/transfer-pricing-in-brazil-towards-convergence-with-the-oecd-standard.htm.

8 Highlights of the report (English version): https://www.oecd.org/tax/transfer-pricing/transfer-pricing-in-brazil-towards-convergence-with-oecd-standard-brochure.pdf; Versão em português: https://www.oecd.org/tax/transfer-pricing/precos-de-transferencia-no-brasil-convergencia-para-o-padrao-ocde-folheto.pdf.

9 On 18 December 2019, Brazil announced a clear pathway for aligning its transfer pricing framework with the OECD standard: https://www.oecd.org/tax/transfer-pricing/brazil-identifies-a-clear-pathway-for-aligning-its-transfer-pricing-framework-with-the-oecd-standard.htm.

Spotlight on the joint report



The technical analysis described above led to the identification of a large number of issues arising from gaps and divergences in the Brazilian transfer pricing framework as compared to the OECD framework. The assessment of these issues against the policy objectives of transfer pricing rules revealed weaknesses in Brazil's framework, which facilitate erosion of the Brazilian tax base and profit-shifting to low-tax jurisdictions and result in double taxation which discourages future investments.

The key findings of the technical work were that, on the one hand, the current system contains some attractive features that may present potential for simplicity and certainty, although such outcomes do not always materialise in every case. On the other hand, the system was found to contain significant gaps and divergences and lacking principle-based guidance, which prevents achieving reasonable outcomes in addressing the variety of situations that occur in commercial reality of MNEs. As a consequence, the current system fails to reflect the changing economic realities brought for example by the growing importance of intra-group services and intangibles. Combined with other unique features of the system, such as the rigid fixed margins approach and the freedom of selection of the transfer pricing method, the current system leads to negative outcomes in the form of:

- **Base Erosion and Profit Shifting (BEPS)** and frequently combined with **double non-taxation** – the profits that would be under the international standard allocated to Brazil are shifted out of Brazil to entities established in low- or no-tax jurisdictions. This prevents Brazil from collecting tax revenues in relation to profits from economic activities performed in Brazil.

Examples of base erosion and profit shifting (BEPS) under the current framework

All these examples below have a common feature, which is that the profits generated from activities originating in Brazil are shifted abroad. These profits are shifted to both low- or no-tax jurisdictions but also to high-tax jurisdictions which grant so-called downward adjustments and exempt these profits from taxation – resulting in double non-taxation. Alternatively, arrangements involving use or transfer of accounting and tax losses were identified to achieve similar outcomes.

Producers and exporters of various products originating from Brazil can, under the current law, sell their products at cost plus a very modest gross profit margin of +15% to their foreign related party. Where the actual market margin exceeds the 15%, which is frequently the case, these remaining profits tare shifted to foreign jurisdictions. Even the specific methodologies introduced by Brazil in 2012 to deal with commodity transactions contain gaps and weaknesses that allow profits that should be taxed in Brazil to be shifted to low tax jurisdictions.

Transfer of intangibles developed in Brazil – intangible assets are recognised as one the key profit drivers in almost all sectors of the economy. Under the current law, the internally developed intangibles can also be transferred at cost +15%, while the real economic value is significantly higher. Subsequently, these intangibles are exploited in foreign jurisdictions and sometimes they even include payments of royalties from Brazil, where the current deductibility limitation still allows for generous deductions and base erosion.

Financial transactions – the potential for base erosion involving financial transactions is based on the round-tripping of capital, which originates in Brazil and is re-invested back in Brazil as an intercompany loan, rather than equity – generating interest deductions and thus eroding the tax base despite the existing interest deductibility limitation rules and exploiting the differences of tax treatment for inbound and outbound financial transactions. Additional base erosion practices include the use of inter-company financial guarantees and financial derivative transactions.

- **Double taxation** – there are documented instances of the same profits being allocated to a Brazilian entity, due to the rigidity of prescribed profit margins on both inbound and outbound transactions, and at the same time allocated to the foreign related party in a jurisdiction where the arm's length principle is used. This results in so-called economic double taxation, where the two legal entities are taxed in relation to the same amount of profit. This puts a higher cost to trade and investing in Brazil than in other countries, thereby discouraging expansion of existing foreign investment in Brazil as well as discouraging new investment, and undermines Brazil's integration into global value chains.
- **Unlevel playing field** – as it tends to favour some MNEs by under-taxing them, as they benefit from base erosion and profit shifting opportunities, while others may be over-taxed due to the double taxation outcomes caused by the gaps and divergencies between the Brazilian transfer pricing system and the international standard

The assessment also recognises the strengths of the Brazilian approach in terms of ease of compliance for taxpayers and ease of administration by the tax authority, which are also important policy objectives. However, these objectives should not undermine the achievement of the dual objective of transfer pricing rules, namely to secure the appropriate tax base in each jurisdiction and to avoid double taxation. Simplicity and administrability must not compromise the protection of the tax base against BEPS or create uncertainty for cross-border business resulting from double taxation. Ease of administration and compliance are nevertheless important goals for Brazil, and for any transfer pricing system in general, but they can be achieved through measures that can be consistent with the arm's length principle and internationally accepted practice.

Recognising that the current Brazilian system undermines the fiscal and development interests of the country, it was concluded that alignment with the international standard was the best option for Brazil. Full alignment was considered necessary because, otherwise, significant gaps would remain in the system with negative effects on tax certainty, the compliance burden, as well as risks of persisting double taxation and loss of tax revenue. Full alignment is defined as the adoption and commitment to the international transfer pricing standard, including the arm's length principle and the guidance for its application contained in the OECD Guidelines.

Full alignment does not have to come at the expense of losing or failing to achieve the objectives of simplicity, ease of tax administration and tax compliance, and tax certainty. Such objectives can be achieved by introducing safe harbours designed in line with the arm's length principle, including carefully considered entry criteria, to ensure that transfer pricing outcomes will be broadly consistent with the outcomes produced by complete comparability analysis according to the *OECD Transfer Pricing Guidelines*.

Implementation of the new transfer pricing framework

In early 2020, the project moved into the design and implementation phase of a transfer pricing framework aligned with the international standard.

Source: Meeting between Brazilian and OECD officials held on 6 March 2023 (Palácio Itamaraty, Brasília).

The project's implementation activities started with the policy design, legislative drafting, as well as initial capacity building and preliminary work on design of simplification measures and measures enhancing tax certainty.

The policy design work included analysis of practices adopted by major trading partners of Brazil and identifying the relevant best practices. This work informed the policy design approaches considered, which also benefitted from discussions with business stakeholders during 2022. This has informed the drafting of the draft provisional measure that forms the basis of the legislation now pending in the Congress.

The initial capacity-building activities were tailor-made for the needs of the officials from the taxation, audit, and risk assessment areas of RFB, in addition to representatives (judges) of the Administrative Court of Tax Appeals (CARF) and representatives (attorneys) from the General Office of the National Treasury Attorney (PGFN). Additional virtual capacity-building activities were carried out during this period and focused on knowledge-sharing between the tax officials from the UK HMRC and officials from the US IRS and other OECD member countries, such as Spain and Italy.

The work on designing simplification measures and safe-harbour measures was launched with the publication of a survey inviting taxpayer input,[10] with a view to identifying taxpayers' specific needs in terms of simplicity and certainty. The findings of such engagement were discussed at two virtual conferences.[11]

Following the previous announcements that Brazil would align its transfer pricing framework to the international standard in July 2019,[12] and reiterated in December 2019 on the occasion of the

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[10] OECD and Brazil's federal revenue authority invite taxpayer input on transfer pricing issues relating to the design of safe-harbour provisions and other comparability considerations, https://www.oecd.org/tax/transfer-pricing/oecd-and-brazil-federal-revenue-authority-invite-taxpayer-input-on-transfer-pricing-issues-relating-to-the-design-of-safe-harbour-provisions-and-other-comparability-considerations.htm.

[11] The first event, held on 15 September 2020, was an opportunity to promote the survey and to clarify some of the questions raised following its publication (https://www.youtube.com/watch?v=4TR3q0J3NDI).

The second event, held on 15 December 2020, was organised to present an overview of the input received, including the categories of safe harbours requested, and to present the next steps of this initiative (https://www.youtube.com/watch?v=y-V2011LlfM).

[12] Joint Statement on the OECD-Brazil Transfer Pricing Project, https://www.oecd.org/tax/transfer-pricing/joint-statement-oecd-brazil-transfer-pricing-project-july-2019.pdf.

release of the joint report,[13] in April 2022, the key features of the new system were publicly disclosed to taxpayers.[14] This was followed by further clarifications and discussions by RFB during various engagements with the business community and other stakeholders (including academia and representatives of foreign tax administrations) to confirm that full alignment with the international standard was imminent.[15]

The legislative process was ultimately accelerated by global developments, in particular the imminent additional risks of double taxation of significant foreign investors in Brazil, which is why the format of a provisional measure was chosen for the adoption of the new transfer pricing system. Provisional Measure 1,152/2022 (*Medida Provisória Nº 1.152/2022*)[16] allows for an accelerated adoption process to mitigate potential negative consequences such as divestment by major investors, which would further deteriorate the economic and employment situation in Brazil in the challenging context of the global energy crisis.

Key motivations for adopting the new transfer pricing framework

Adoption of the new transfer pricing framework will address the negative outcomes resulting from the gaps and divergences from the international standard present in the current framework. It will improve tax revenue collection in the area of transfer pricing and also reduce the risk of double taxation, which poses a trade and investment barrier.

Positive fiscal effect and impact on meeting Brazil's development goals

The new transfer pricing framework will provide protection against the ongoing erosion of the tax base in Brazil and prevent the shifting of profits to foreign jurisdictions. The new rules remove the significant gaps and divergences that led to negative outcomes in the form of erosion of tax base of Brazil and profit shifting out of Brazil that also result in double non-taxation.

As indicated in the Explanatory Statement of the Provisional Measure,[17] it is estimated that various deficiencies in the transfer pricing rules as well as other elements of the Brazilian legislation cause an annual erosion of the tax base in the range of billions of dollars from Brazil to other jurisdictions and thus significantly reduce tax revenues. The information available in the public domain as well as the internal studies carried out by RFB based on the Country-by-Country reports provided by Brazilian MNEs,[18] and also notifications received by RFB from other jurisdictions, provide very useful evidence of these practices. Brazil has received more than 600 such notifications (tax rulings) since 2015, many of which involve the so-called "downward transfer pricing adjustments" granted by foreign tax administrations, and resulting in double

[13] Press release: OECD and Brazil share outcomes of project to align Brazil's transfer pricing rules to OECD standard, https://www.oecd.org/tax/transfer-pricing/brazil-identifies-a-clear-pathway-for-aligning-its-transfer-pricing-framework-with-the-oecd-standard.htm.

[14] Press release: OECD and Brazil work together to align Brazil's transfer pricing rules to international standard, https://www.oecd.org/tax/tax-global/oecd-and-brazil-work-together-to-align-brazil-s-transfer-pricing-rules-to-international-standard.htm.

[15] A replay of the Transfer Pricing Seminar organised jointly by RFB and the Inter-American Development Bank (IDB) on 29 June 2022 is available at the following link: https://www.youtube.com/watch?v=4J6BD5k7eAE.

[16] Provisional Measure No. 1,152, of 28 December 2022, https://www.in.gov.br/en/web/dou/-/medida-provisoria-n-1.152-de-28-de-dezembro-de-2022-454516132.

[17] Explanatory Statement of the Provisional Measure (EM nº 00448/2022 ME) (paragraph 104).

[18] Country-by-Country report statistics anonymised and aggregated statistical analyses in OECD database: https://stats.oecd.org/Index.aspx?DataSetCode=CBCR_TABLEI.

non-taxation outcome and revenue losses for Brazil. The volume of these notifications demonstrates the magnitude of such harmful outcomes made possible by the current transfer pricing framework of Brazil.[19]

The revenues lost due to the base erosion and profit shifting and resulting in double non-taxation outcomes are detrimental to Brazil's economic development as they could otherwise have been used to address the social, economic and infrastructure challenges that Brazil faces. At the same time, the revenue shortage also creates pressure to raise additional tax revenues through other tax measures, resulting in over-taxation of certain sectors and making them less competitive internationally.

Positive impact on trade and investment

Brazilian companies are still currently not well integrated in global value chains and transfer pricing is one of the main issues in the way of further trade and investment opportunities.[20] Brazil has not been fulfilling its potential as the destination of foreign investments due to the inherent double taxation risks, which significantly increase the cost of doing business in Brazil in addition to the other barriers currently preventing the country from integrating the global value chains of MNE groups.

Brazil is currently missing out on the import of additional capital, creation of more and possibly better jobs, and on transfers of technology and know-how.

The risk of double taxation will be significantly reduced, removing obstacles for international trade and investment related to distortions and tax uncertainty for businesses operating cross-border.[21]

The new legislation will allow Brazil to more effectively fulfil its commitments internationally, especially with regard to double taxation agreements (DTAs) concluded with other jurisdictions, and make it possible to sign new agreements with other jurisdictions with a view to preventing the risk of double taxation of the concerned MNEs. Alignment will also contribute to the prevention of potential conflict and disputes with other tax administrations on transfer pricing related double taxation.

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[19] This issue was discussed at the live webinar *RFB e OCDE: Remodelando as regras de preços de transferência* held on 15 September 2020: https://youtu.be/4TR3q0J3NDI?t=5681 (timestamped).

[20] "*Brazilian companies have also shown only scant participation in global value chains, where Brazil's only discernible link is with neighbouring Argentina (Criscuolo and Timmis, 2018). In Latin America, Mexico, Chile and Costa Rica exemplify how trade and the integration in global value chains can contribute to economic growth (OECD, 2017)*". See OECD (2020), *OECD Economic Surveys: Brazil 2020*, OECD Publishing, Paris, https://doi.org/10.1787/250240ad-en, at page 71.

[21] Tax uncertainty adversely affects the investment and trade climate and a main source of tax uncertainty relates to misalignment of domestic transfer pricing rules with the internationally accepted standard.

More recently, an additional economic risk has arisen as a result of some of Brazil's major trading partners having strengthened their adherence to the international tax standards and refusing foreign tax credits in relation to countries that do not adhere to and follow the international tax standards, including the transfer pricing standards.

Alignment of the transfer pricing framework to the international standard presents an important step towards integration of Brazil into the global value chains.[22] Further tax policy reforms in other areas of taxation, such as indirect taxation and direct taxation will contribute towards fully mobilising the development potential of Brazil.

[22] The National Confederation of Industry (CNI) highlighted in a study published in 2018 that the inconsistency of transfer pricing rules place Brazil far from global value chains: "*The consistency of transfer pricing rules and the absence of barriers to trade in services encourage the full insertion of different countries in such chains. The Brazilian system operates in a situation diametrically opposed to that recommended. For this reason, Brazil remains far from the best stages of global value chains due to inconsistent transfer pricing rules (mainly when it comes to intangibles), for imposing barriers to the import of services, for maintaining a limited network of ADTs, and for, consequently, not using the best international administrative practices (such as bilateral or multilateral APAs and MAPs)*". Available at https://static.portaldaindustria.com.br/media/filer_public/41/f8/41f81e87-6556-4d39-884f-b732db0e4146/tributacao_renda_pj_web.pdf, at page 26.

The new transfer pricing framework

Key features and components of the primary legislation

Provisional Measure 1,152/2022 has four main parts:

1. The general part containing the fundamental principles and concepts for the application of the new transfer pricing framework, based on the Chapters I-III of the *OECD Transfer Pricing Guidelines* (Chapter II of the PM – articles 2 to 19);
2. A special part addressing specific topics, namely intangibles, intra-group services, cost-contribution agreements, business restructurings, and financial transactions, based on the Chapters VI-X of the *OECD Transfer Pricing Guidelines* (Chapter III of the PM – articles 20 to 34);
3. A part dedicated to documentation requirements as well as special measures, including for simplification purposes, and instruments for tax certainty, based on the Chapters IV and V of the *OECD Transfer Pricing Guidelines* (Chapters IV and V of the PM – articles 35-40); and
4. A final part covering topics related to transfer pricing (e.g. rules on deductibility of interest and royalties), which require modifications to ensure appropriate interaction with the new transfer pricing rules.

The new legal framework expressly incorporates the arm's length principle, which is the foundation of the international standard and followed by most countries around the world to set the prices of cross-border transactions between associated enterprises part of the same MNE group.

The Provisional Measure provides for the five OECD-recognised transfer pricing methods, adopted by most countries around the world (OECD members and non-members alike) to establish compliance of transfer prices with the arm's length principle, namely the CUP method (PIC), which is preferable when there is information on reliable prices or values identified in comparable transactions carried out between unrelated parties, the resale price method (PRL), the cost plus method (MCL), the transactional net margin method (MLT), and the transactional profit split method (MDL). It also provides for the possibility to use "other methods" like valuation techniques in appropriate circumstances. The choice of the method is based on the most appropriate method rule.

Entry into force

The new transfer pricing rules will enter into force on 1 January 2024, except for taxpayers who make the irreversible choice of opting in already as of 1 January 2023. The modalities of entry into force have been regulated by Normative Instruction 2,132/2023.

Alignment with international standards

The OECD Secretariat has reviewed the final version of Provisional Measure 1,152/2022 and considers that the Provisional Measure incorporates key principles and concepts encompassed by the OECD instruments in the area of transfer pricing and provided by the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (2022),and reflected in the *United Nations Practical Manual on Transfer Pricing for Developing Countries* (2021).

There are some provisions, which, while aligning with the international standard, are more prescriptive in nature due to the traditions of the Brazilian tax system. These provisions aim to reduce the compliance burden and to provide tax certainty for taxpayers while also enhancing efficiency of tax administration. Nevertheless, these provisions do provide the possibility for taxpayers to determine the outcomes based on a facts-and-circumstances analysis consistent with the international standard.

The rules currently in place do not effectively deal with transactions involving intangibles, which has resulted in situations where the intangibles developed in Brazil have been moved out of Brazil mostly with little or no compensation and are often commercially exploited from low- or no-tax jurisdictions. The new transfer pricing rules reflected in the Provisional Measure aim to prevent this and include key principles based on Chapter VI of the *OECD Transfer Pricing Guidelines*.

The Provisional Measure also contains specific rules that limit the deductibility of royalties to prevent abuses, as is also occasionally observed in other countries, including the OECD member countries.

The first part of these special royalty limitation rules focuses on royalty payments made to jurisdictions with nominal tax rates lower than 17%. The rule has objectives similar to the global minimum tax agreed by 138 countries and jurisdictions as part of the Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy. As these rules rely on a nominal, rather than effective tax rate, they may however not be very effective.

The second part of these rules focuses on royalty payments, which result in double non-taxation due to the outcomes referred to as hybrid mismatches in the OECD/G20 BEPS Action 2 (double deduction, deduction with non-inclusion, and imported hybrid mismatch). This part of the rule is in line with BEPS Action 2 recommendations, and it may benefit from detailed regulations, which will further define the specific outcomes described.

Is there a need for a special anti-avoidance measure linked to transition?

Already it appears that some MNEs are restructuring their operations to shift their intangibles out of Brazil, in anticipation of the enactment of the new transfer pricing framework. In order to avoid the risk that such behaviours undermine the benefits of the transfer pricing reform, a special anti-avoidance provision could be introduced.

Status of the transfer pricing reform

The timing of the transfer pricing reform is welcomed by the business community and other stakeholders – this is due to the perceived urgency of its entry into force, which results from several factors:

- The revenue losses that Brazil experiences year after year due to the weaknesses in the Brazilian legislation, which allows BEPS practices.
- Double taxation resulting from the rigidity of the current rules, although assumed by some taxpayers as a necessary cost of doing business, which deter further investment into Brazil.

- The recent change in the tax policy of important investment and trade partners, such as the United States, which no longer allow foreign tax credits (i.e. credit for tax paid in Brazil) when there are deviations such as not following the arm's length principle, running the risk of disinvestment and leading to a less attractive environment for investors. This in turn has repercussions on the levels of employment, the economy, transfers of knowledge and technology.

The process of Brazil's accession to the OECD is also worth mentioning, as alignment on transfer pricing will be one of the key areas that will be considered in the tax area.

Key pressure points arising from proposed amendments

As explained above, the Provisional Measure was carefully drafted and developed to strike the balance between the traditions of the tax system of Brazil and the underlying objectives of the Transfer Pricing reform while aligning to the international standard.

A total of 107 proposed amendments were submitted on Provisional Measure 1,152/2022. Most of these would potentially undermine the transfer pricing reform objectives and alignment with the international standard, despite claims that some of the amendments would further align the reform with international standard.

A significant number of the amendments would weaken the ability of Brazil to properly and correctly administer and enforce the transfer pricing rules to prevent transfer pricing abuse and tax avoidance. Such amendments, if adopted, could diminish the fiscal benefits of the tax reform. For example, the proposals to retain the existing system as an option for taxpayers would facilitate and prolong the ongoing base erosion and profit shifting out of Brazil and as consequence, would undermine the fiscal benefits expected from the reform.

A large number of the amendments, if accepted, would create misalignment with the international standard. Such amendments for example propose to change the definition of related party, or to introduce specific tax exemptions. These amendments will need to be handled carefully to prevent misalignment with the standard, which would re-introduce the problems arising from the current system – i.e. continued revenue losses and risks of double taxation.

The OECD Secretariat stands ready to offer technical support to the Government and also to the Congress in helping to assess the proposed amendments and to review any draft text developed during the legislative process, including to provide explanations on whether provisions or proposed amendments are in fact aligned with the international standard, or to consider the implications of any specific drafting changes that may emerge.

The OECD Secretariat is also prepared to provide support in the form of oral explanations in any public hearings organised in the context of the legislative process.

Steps towards practical application of the new system

Normative instructions

The primary legislation (Provisional Measure) provides for the fundamental principles and concepts of the transfer pricing framework, but does not provide all of the guidance and details necessary for the application of the new rules. In this regard, it strikes a balance between providing strong principles and being concise, in line with Brazilian legislative practice.

Additional guidance on how to apply these principles and concepts will need to be provided through the secondary law, by way of RFB issuing normative instructions.

Simplification measures

Developing simplification measures and safe harbours was an objective that RFB stated early on in the project.[23] The Provisional Measure foresees the possibility to issue such simplification measures through one or more regulations.

RFB launched a survey in 2020 to seek public input into the development of safe harbours as well as other simplification measures and measures that can contribute to enhanced tax certainty in 2020.[24]

Some of these measures, such as a simplified approach for low value-adding services or marketing and distribution activities (i.e. results on the Amount B work, as part of Pillar One of the Two-Pillar Solution, which seeks to develop a simplified and streamlined solution to price in-country baseline marketing and distribution activities in a manner consistent with the arm's

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[23] The Joint Statement of 11 July 2019 identifying a clear pathway for aligning its transfer pricing framework with the OECD standard states: "*The options also consider how to maintain a number of elements of simplification, which provide ease of tax administration, ease of tax compliance and tax certainty*."

[24] Press release: OECD and Brazil's federal revenue authority invite taxpayer input on transfer pricing issues relating to the design of safe-harbour provisions and other comparability considerations, https://www.oecd.org/tax/transfer-pricing/oecd-and-brazil-federal-revenue-authority-invite-taxpayer-input-on-transfer-pricing-issues-relating-to-the-design-of-safe-harbour-provisions-and-other-comparability-considerations.htm.

length principle, may inspire some of the design of future safe harbours in Brazil),[25] will be announced in 2023.

Other safe harbours may be considered once the needs for them are clearly established, based on adequate information about the circumstances to be covered. While designing these simplification measures, RFB will need to ensure that they reflect the economic reality and are in line with the arm's length principle.

Considerations related to preparedness

The transition period is a key aspect of the transfer pricing reform. The key stakeholders, including RFB and taxpayers, are taking steps to prepare for the entry into force of the new transfer pricing framework.

Tax administration side

The adoption of a new transfer pricing framework presents new challenges for the tax administration. While the previous framework provided for relatively straightforward and formulaic tax administration processes, necessitating only limited compliance testing of the formulas and the entry values affecting these formulas, the new transfer pricing rules require new skills and revision of the tax administration compliance processes.

Preparation of the tax administration is about upgrading both the knowledge and the skills of the RFB officials dealing with transfer pricing matters. The different functional areas of RFB may need to review their current approaches to transfer pricing compliance, risk assessment, as well as audit and dispute resolution.

In this preparatory stage and beyond, RFB can draw on the rich experience and the international best practices of other jurisdictions that already apply and enforce transfer pricing rules based on the international standard.

The RFB tax officials in charge of auditing and risk assessment may also benefit from acquiring a better understanding of the different models of operations of MNEs and deepening their knowledge of different industry sectors.

Additional efforts will need to be dedicated to identify and access relevant data on comparable uncontrolled transactions. The auditors carrying out the benchmarking studies will need to continue developing the skills of performing both the quantitative statistical analysis as well as qualitative analysis of the data on comparable transactions.

RFB officials will also need to develop in-depth knowledge of the application of the various transfer pricing methods, which are currently absent in the legal framework – such as the Transactional Net Margin Method (TNMM) and the Transactional Profit Split method (TPSM) – as well as "other methods", like valuation techniques.

Taxpayer side

Similar preparatory efforts need to be made on the side of taxpayers. However, the MNEs operating in Brazil are mostly very familiar with the application of the transfer pricing rules based on the international standard. This is because they operate globally and therefore apply the transfer pricing rules applicable in other jurisdictions where they operate and those rules

[25] Brazil is actively contributing to the work on transfer pricing at the OECD, for example in the tax certainty work or Amount B under Pillar One of the Two-Pillar Solution to Address the Tax Challenges to the Digitalisation of the Economy. For additional considerations on the design of Amount B, see the recent consultation document: https://www.oecd.org/tax/beps/public-consultation-document-pillar-one-amount-b-2022.pdf.

tend to be based on the international standard. Moreover, they are likely to be applying the international standard to the other side of transactions involving taxpayers in Brazil.

This makes it much easier for the Brazilian taxpayers who are members of these MNE groups to prepare for the transition to the new rules and align the approach used in Brazil to that used in the counter-party jurisdiction.

It is however important to point out that the local tax managers in Brazil and their team will need to become more familiar with the new transfer pricing framework based on the international standard.

Given the experience many taxpayers already have with applying the international standard, there are taxpayers who are prepared for this transition and will choose the option to start applying the new transfer pricing framework as of January 2023. Other taxpayers will have most of the year 2023 to finalise their preparations to start applying the new transfer pricing framework from January 2024.

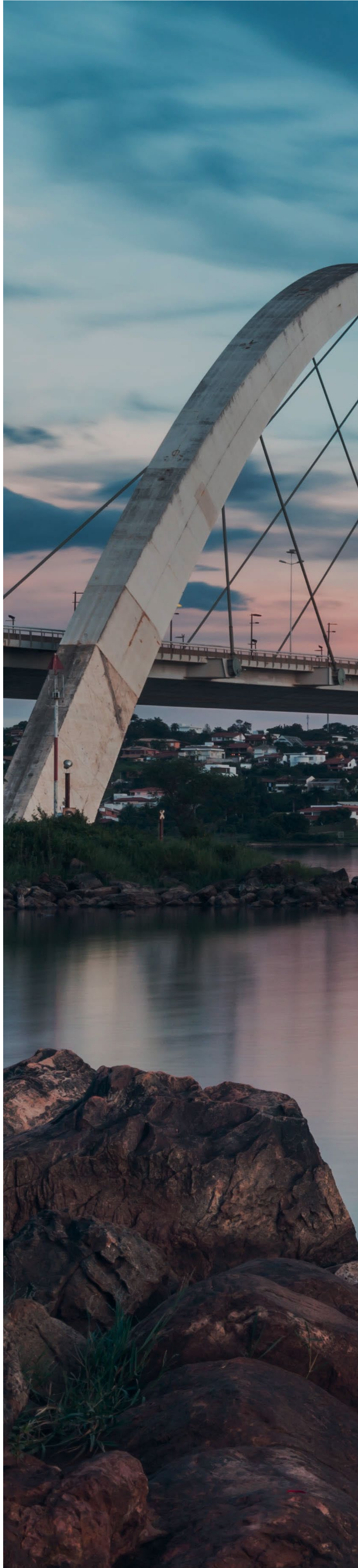
On 17 February 2023, RFB published Normative Instruction 2.132 providing guidance on the option for early adoption of the transfer pricing rules set forth in article 46 of the Provisional Measure.[26]

The option, which must be exercised on an irreversible basis by September 2023 (between 1 September 2023 and 30 September 2023), requires the application of the transfer pricing rules to controlled transactions carried out during calendar year 2023.

[26] RFB Normative Instruction No. 2132 of 17 February 2023, http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?idAto=129187.

The New Transfer Pricing Framework

ENHANCING BRAZIL'S TAX SYSTEM WHILE FOSTERING TRADE AND INVESTMENT



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