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Brazilian Transfer Pricing: Here Today, Gone Tomorrow?

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In Brazil there is a fruit that is small, round, and black. An untrained eye could mistake it for a grape. Unlike grapes, however, it grows on trees, really close to the stem and branches. The view of a tree covered by these tiny little black balls is. . .amazing. This fruit is unique in a lot of ways: its very sweet flavor; the 13 or more years that it takes the trees to bear fruit for the first time; and the fact that it occurs naturally only in Brazil. The fruit is called ''jaboticaba.''

Because it is so uniquely Brazilian, the name ''jaboticaba'' has been given to everything that only happens in Brazil. There are economic jaboticabas, political jaboticabas and, of course, tax jaboticabas.

Several tax jaboticabas are related to international tax matters, with the Brazilian transfer pricing system likely being the most infamous one. Only Brazil has a transfer pricing regulation with fixed margins for some of the methods (cost plus margin and price less margin), almost completely departing from the Arm's-Length Principle (ALP). Brazil's transfer pricing regime also features abundant safe harbors and almost no rules to prescribe or prohibit the use of specific methods; taxpayers have tremendous flexibility to choose the methods they would like to apply. These issues, and their departure from OECD transfer pricing principles, are well known and have been pointed out in a 2019 report, Transfer Pricing in Brazil: Towards Convergence with the OECD Standard — OECD, jointly published by the OECD and the Brazilian Federal Tax Authorities (RFB, based on the Portuguese language acronym). Since then, Brazilian taxpayers have been waiting for new regulations that would more closely align this particular tax jaboticaba with the rest of the world.

The wait ended in late April 2022, when RFB and the OECD came together once more to present their vision for what could be a new transfer pricing system for Brazil.

This new TP system would be, well, *new* in every sense of the word. Since 2018, Brazilian taxpayers have been expecting this new system to be an overhaul of the old one, a hybrid between the historical jaboticaba and the OECD system. Instead, the new system would represent a complete departure from the old. The RFB and OECD presentation started with a blunt affirmation that the new system would be entirely aligned with the international practice and fully compliant with the ALP.

The new system would incorporate several very important features of the OECD transfer pricing framework, including: OECD transfer pricing methodology and valuation techniques; the possibility of testing a related foreign party; the OECD concept for Cost

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Contribution Arrangements; rules addressing internal restructurings; OECD standards for financial transactions control; authority for RFB to enter into advance pricing agreements and conclude mutual agreement procedures; and expanded BEPS Action 13 documentation requirements including Master File and Local File.

Significantly, RFB and the OECD also heralded the adoption of a new (for Brazil) definition of intangibles, broader than the accounting notion and aligned with international standards. Transfer pricing rules for intangibles would include the DEMPE (development, enhancement, maintenance, protection, and exploitation) concept, and guidance addressing valuation as well as uncertain situations and cases in which comparables are absent.

In addition, the overhaul of the transfer pricing rules for intangibles would also trigger a revision of the current royalty deductibility rules, which impose severe limitations for the deductibility of royalties. Currently, Brazil disallows deductions for royalties paid to shareholders, otherwise limits deductions to 1% to 5% of the net revenues for royalties linked to technology transfers, and excludes royalties altogether from the scope of transfer pricing regulations. In a world where intangibles are arguably becoming (maybe they already are) more important than tangible assets, this kind of limitation arises as another Brazilian tax jaboticaba. As announced, new rules would disallow royalty deductions only in anti-abuse scenarios.

Many U.S.-based multinationals with Brazilian operations are breathing sighs of relief in the wake of these announcements, due to the recent expansion of the U.S. foreign tax credit regulations that has called the creditability of Brazilian income taxes into question. The new regulations added a new ''attribution'' requirement to the historical creditability requirements (known as the realization test, the gross receipts test, and the net income test). Although a detailed discussion of the new attribution requirement falls outside the scope of this article, very generally, a foreign income tax will be creditable only if treated as attributable to the foreign taxing jurisdiction. Whether attribution of the income is proper depends significantly on the consistency of that jurisdiction's taxing rules with those of the United States — particularly use of the ALP as well as nexus, sourcing, and deductibility rules similar to the U.S. rules. In regard to royalties, the new foreign tax credit rules appear much more exacting about deductibility of specific items; the fact that Brazilian law establishes so many limitations for deductibility represents a serious obstacle to be considered. Absent changes to Brazil's transfer pricing system and the royalty deductibility rules, the new requirement puts at significant risk the creditability of Brazilian income tax (at least with respect to related-party, cross-border income).

Still, there is some question whether U.S. multinationals will get the wholesale creditability fix they need out of new transfer pricing rules. While it is true that the changes discussed above could better align the Brazilian general tax system with that of the United States, they would only address the creditability of the *Income* Tax itself (the IRPJ/CSLL, in the Brazilian acronym). However, when it comes to Brazilian *Withholding* Income Tax — which is considered a tax paid ''in lieu of'' the general Income Tax — there are additional reasons for concern. For the Withholding Income Tax, creditability depends on the criteria used by Brazil for taxing the relevant income, e.g., determining the source of the income. If the rule establishes taxable nexus or source in a manner that is consistent with the U.S. rules, creditability is possible. If, however, the Brazilian rule imposes the tax on income that would not have been taxed under U.S. principles, creditability is at risk.

The problem is that, historically, Brazil has sourced practically all income — and consequently imposed withholding tax — based on place of payment, including payments for technical services and royalties. (This is practically a third tax jaboticaba if we consider the extent to which Brazil has upheld this position.) In comparison, the United States sources services income based on place of performance; royalties are sourced based on place of exploitation or use. These issues would not be solved by the changes announced to the transfer pricing system. They would need to be dealt with separately, but so far there has been no word from the Brazilian tax authorities. Hopefully the new foreign tax credit regulations will also act as a catalyst for alignment of the withholding tax sourcing rules.

In conclusion, it is safe to say that while the new transfer pricing regulations, as announced, would take giant strides in the right direction for U.S.-based multinationals, there is still a lot of uncertainty and a long way to go before true consistency between the Brazilian and U.S. income tax systems can be claimed. The idea of solving two problems at once normally calls to mind ''killing two birds with a stone.'' But, maybe in this case we should say that a new Brazilian transfer pricing system would be picking two — and hopefully three — jaboticabas with one stroke of the knife.

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