New Brazilian Transfer Pricing Regime Edited by Government

On 29 December 2022, Provisional Measure 1,152 (MP 1,152) introduced new transfer pricing rules in Brazil with force of law but subject to further approval from Congress. The proposal put forward by the government replaced the previous regime, which deviated from international standards, with rules now convergent to the OECD Guidelines.

1. Introduction

On 29 December 2022, Provisional Measure 1,152 (MP 1,152) introduced new transfer pricing rules in Brazil. MP 1,152 is the latest (and possibly final) development of a movement between Brazilian and OECD officials to incorporate the OECD Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD Guidelines) into the tax system of Brazil, one of the major economies still deviating from international practice. Proposed rules abolish the deviating Brazilian approach and explicitly designate the arm’s length standard (ALS) consolidated by the OECD Guidelines the single standard system for controlling transfer pricing in Brazil.

As established by MP 1,152, the new transfer pricing rules will be mandatory as from 2024 and taxpayers are already allowed to opt in for the regime in 2023. As a provisional measure issued by the Executive Branch, MP 1,152 has force of law from its enactment but must be assessed by Congress within 120 days. Upon assessing MP 1,152, Congress may approve the rules as proposed, modify their provisions or reject the measure altogether. The latter will also occur if Congress simply does not assess it.

This article reports on the new transfer pricing regime brought by MP 1,152. One should note, however, that only the text ultimately approved by Congress will be enforceable. Therefore, examining MP 1,152 is an interesting way to follow possible changes in Brazilian transfer pricing practice, but only a statute edited by Congress may definitively introduce new tax rules. This article briefly summarizes the main features of the proposal, especially in view of the Brazilian approach to transfer pricing. It then considers the way ahead for the proposed reform and identifies challenges of implementing MP 1,152 in Brazil.

It finally considers some measures that would be advisable for Congress to consider upon voting on MP 1,152, in order to alleviate the fundamental incompatibility between the proposed rules and the Brazilian legal culture and tax environment without mischaracterizing the adhesion to the international standard.

2. Adherence to the ALS and the Elimination of Predetermined Profit Margins

MP 1,152 expressly addresses the ALS and its basic proposition, stating that “the terms and conditions of a controlled transaction shall be established according to those which would be established between unrelated parties in comparable transactions”. Proposed rules incorporate all the traditional transaction methods (i.e. comparable uncontrolled price (CUP), resale price and cost-plus methods) and transactional profit methods (i.e. transactional net margin and profit split methods) currently prescribed in the OECD Guidelines. MP 1,152 also authorizes the use of “other methods”, as long as they meet the ALS.

Consistent with the OECD Guidelines, MP 1,152 considers the CUP method the most appropriate one to establish the arm’s length price if reliable data on comparable transactions is available and if a most appropriate method is not found for a particular case. Similar to the “best method rule” first conceived by US practice and later adopted by the OECD Guidelines, the most appropriate method is determined by a selection process. It takes into account the availability of reliable information needed to apply the method, the degree of comparability between controlled and uncontrolled transactions, and the nature of the controlled transaction, particularly determined through the analysis of functions, assets and risks involved.

This is a major blow in current Brazilian transfer pricing practice. Among other peculiarities, the previous Brazilian approach has consisted of prescribing certain predetermined profit margins for purposes of the resale price and cost-plus methods, and not authorizing methods other than those traditional transaction methods established by law. The use of transactional profit methods, or the combination of methods, has traditionally been rejected. According to the system valid until 2022, the taxpayer, on the other hand, has expressly been allowed to apply the statutory methods simultaneously and choose the most favourable result, with no “best method rule” outside of transactions with commodities.

References:

2. Tres. Reg. § 1.482-1(c).
3. OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations para. 2.2 (OECD 2022), Primary Sources IBFD [hereinafter OECD Guidelines].
Characteristic of the previous Brazilian approach, the legal prescription of profit margins has left out the comparability analysis that embodies the ALS assessment in the OECD Guidelines. This has never been endorsed by the OECD, though the practice has been mentioned in the UN Practical Manual along with “comments for countries considering the adoption of fixed margins”. In spite of deviating from the OECD Guidelines, the previous Brazilian approach did not entail a full departure from the ALS. Profit margins were prescribed by law on the basis of minimum market research and, in principle, were rebuttable by the taxpayer, who was entitled to demonstrate that an arm’s length margin for the relevant transaction would fall short of the statutory profit margin. All in all, the previous Brazilian approach could claim to meet the practical needs of its stakeholders (taxpayers and authorities) and avoid the painstaking comparability analysis by putting together the option for the separate entity doctrine, which seemed preferable over formulary alternatives, and legal certainty. Perhaps in view of its benefits, the Brazilian compromise has managed to survive the conclusion of the BEPS Project: containing a disclaimer with diplomatic language, a footnote was included in the BEPS Actions 8-10 Final Report to clarify that Brazil “considers this in line with the arm’s length principle” and “will continue to apply this approach”.

The previous Brazilian approach, however, might not survive MP 1,152. The proposed rules do not prescribe profit margins to be adopted (or rebutted) by the taxpayer, and otherwise ground the methods on the thorough assessment of functions, assets and risks of the controlled transaction, as the comparability analysis under the OECD Guidelines requires. This is the ultimate outcome of a movement by the OECD and Brazilian officials that, irrespective of the advantages of the approach above, seeks a full alignment to the OECD Guidelines instead of adapting or improving the current practice. Behind the call for abolishing the Brazilian approach, one can find political and vague statements such as the difficulty “for Brazil to both integrate to global value chains and to accede to the OECD” without fundamentally modifying the current practice of transfer pricing.

3. Comparability Analysis and the Options Realistically Available

Comparability analysis under MP 1,152 brings together the inherent complexity of the procedure. All the comparability factors (i.e. contractual terms, functions performed, characteristics of property or services being transferred, economic circumstances of the parties and of their market, business strategies) devised by the OECD Guidelines in order to delineate the transaction and perform the analysis are incorporated. Also consistent with the OECD Guidelines, adjustments must be made to eliminate the material effects of any existing differences between the controlled and uncontrolled transactions. These are only deemed comparable if there are no differences between them that could materially affect the price, profit margin or any other element being examined by the most appropriate method.

Under MP 1,152, the comparability analysis is as rigorous (and burdensome) as the international standard wants it to be. Upon the delineation of the controlled transaction, the proposed rules prescribe to incorporate the assessment of options realistically available (ORA) to the parties. Investigating the ORA is not to be confused with the search for comparable transactions, which is aimed at uncontrolled transactions, nor with a substance-over-form doctrine, which is intended to reconcile the adopted form for the transaction with its economic and commercial circumstances. What might create more problems than the two approaches above is that the proposed assessment completely sets aside the controlled transaction as it was actually performed by the taxpayer, in substance and in form. The actual transaction is replaced with a hypothetical alternative that would have been available and more beneficial to independent parties, based on the notion – advocated by the OECD Guidelines – that independent parties evaluate a potential transaction by comparing it to other alternatives available to them and only enter into the transaction if a clearly more attractive alternative is not found.

However compelling from a conceptual standpoint, the ORA may well be criticized due to its complexity and unsatisfactory results. It is reasonably stated that the “substitution of transactions should not be undertaken lightly as this would create significant uncertainty for taxpayers and tax administrations”, possibly leading to “double taxation due to the divergent views taken by countries on how any substitute transactions are structured”.

The ORA is also in potential violation of article 9 in tax treaties, which arguably does not go as far as allowing transactions to be re-characterized. It brings an additional domestic problem in Brazil: the Tax Code rejects taxation that results from analogy, and it is far from clear whether the ORA assessment would not impose to the interpreter a genuine analogy, or at least operate the effect of an analogy, similar to the one of a general anti-avoidance rule (GAAR). Even if it is argued not to be analogy, but a legal fiction, the problem would remain, since the vague terms employed by MP 1,152 offer no clear or objective indication as to the facts to be considered for the purpose of calculating the transfer pricing. Hundreds

4. UN, Practical Manual on Transfer Pricing for Developing Countries, Part D, sec. 1.9 (UN 2021).
5. For further discussion on the Brazilian practice, see L.E. Schoueri, Arm’s Length: Beyond the Guidelines of the OECD, 69 Bull. Intnl. Taxn. 12 (2015), Journal Articles & Opinion Pieces IBFD.
7. OECD Guidelines, supra n. 3, at para. 1.38.
8. For an assessment of the ORA, see D. Amici, In-Depth Analysis of the Concept of Options Realistically Available in Transfer Pricing, 27 Intl. Transfer Pricing 1, 2 (2020), Journal Articles & Opinion Pieces IBFD.
9. UN, supra n. 4, at Part B, section 3.3.2.
of options are often available for an enterprise and many of them could equally be claimed “realistically available”. It is not clear that the constitutional Principle of Legality admits that tax authorities may choose the facts they wish to consider in order to calculate the tax base. Legal certainty demands facts to be well established by law, which does not seem to be the case of the ORA. In any case, and as it happens in other jurisdictions, one can expect significant difficulties in practice, as tax authorities and taxpayers are invited to discuss, without any objective criteria, if a certain alternative transaction would have been realistically considered by independent parties.

4. Commodities

The previous Brazilian approach of prescribing predetermined profit margins has proven insufficient to capture the arm’s length consideration in commodities transactions. Either because of a highly volatile market or the interposition of trading companies in more favourable jurisdictions, predetermined margins (roughly at 15% over the costs) afforded taxpayers the leverage to meet the minimum revenue upon the export of commodities and to easily shift profits abroad. In order to reconcile the transfer pricing with the actual market pricing, Law 9,430 was amended in 2012 to provide for specific methods (PCI and PECEX) applicable to commodities quoted at exchanges. Although a best method rule makes PCI and PECEX methods mandatory for commodities transactions, their scope and application do not resemble the “sixth method” found in other Latin American countries, as they are neither exceptional nor specifically aimed at abusive arrangements. Their application is similar, though not identical, to the ordinary practice of the CUP method, and the quoted price can be adjusted by the market premium.

MP 1,152 confirms this trend of placing the transfer pricing control of commodities under the ordinary CUP method, where the quoted price is used as a starting reference and adjusted further. Conforming to the OECD Guidelines, MP 1,152 assumes that the pricing of commodities is most appropriately done by the CUP method and adjustments to quoted prices will be made to account not only for physical and functional differences, but also for the “economically relevant characteristics” of the transaction altogether. Despite the increased burden, a comparability analysis as such might be beneficial to taxpayers in a context where tax authorities are adopting a restrictive position on the items that could be adjusted (most notably, trade tariffs) under the “market premium”. The limitation as such is no longer applicable under MP 1,152, which finally reduces its scope to an anti-abuse provision aimed at: intra-group services, generally following chapter VII of the OECD Guidelines; cost-sharing arrangements, generally following chapter VIII of the OECD Guidelines; business restructurings, generally following chapter IX of the OECD Guidelines; and financial transactions, including intra-group loans, cash pooling and guarantees, all of which generally follow chapter X of the OECD Guidelines. Apart from intra-group loans (which must be priced after the interest rate for Brazil government bonds or the LIBOR), none of these matters are specifically provided for by current Law 9,430, and their introduction by MP 1,152 largely impacts Brazilian transfer pricing practice – arguably, some of these specific transactions do not even trigger pricing control in the country. However complex and innovative, the provisions put forward by MP 1,152 are mostly general and conceptual. Revenue Service is expected to regulate their application, with all likelihood of further reproducing the OECD Guidelines.

6. Royalties and Intangible Property

MP 1,152 requires transactions involving intangible property to be assessed under the ALS. An otherwise obvious provision under the OECD Guidelines, it is a fundamental shift from the previous Brazilian approach, where royalties from the exploitation of intangible property were simply excluded from transfer pricing control.

Previous legislation severely restricted the deductibility of outbound royalties to related parties, which were subject to deduction caps (up to 5%) calculated on the revenue earned by the Brazilian entity from exploiting the intangible property. The limitation, based on a territorial source-oriented policy from the 1950s, violated any possible meaning of an ALS and had been causing double taxation in the host country of the intangible property, which would most likely demand an arm’s length consideration for the licensing to the Brazilian counterpart. The limitation as such is no longer applicable under MP 1,152, which finally reduces its scope to an anti-abuse provision (royalties are only rendered non-deductible if paid to tax havens) or a switching clause (if deduction leads to double non-taxation).

Replacing the previous limitation, proposed rules for intangible property generally follow the development, enhancement, maintenance, protection and exploitation (DEMP) approach, as it is outlined by the OECD Guidelines. MP 1,152 thus leaves aside the traditional transactional assessment by taking the legal ownership of the
intangible property as a mere starting point, with all the complex outcomes of the method arguably in breach of tax treaties concluded after the OECD Model.\textsuperscript{12}

7. Safe Harbours

MP 1.152 delegates to the Revenue Service the power to issue regulations intended to simplify the comparability analysis and related documentation, as well as to deal with situations of limited available data on comparable transactions.

Typical of the previous Brazilian approach, safe harbours and similar simplification measures were known to local practice long before the OECD recognized them in 2013 for small companies or transactions of low complexity. Previous legislation exempted taxpayers from pricing control in view of, or inter alia, the volume of controlled transactions (net profit from exports should not exceed 5\% of the total net profit in the period) and their profitability (average profitability of minimum 10\% of the revenues from controlled exports in a two-year period), regardless of the sector, transaction or functions involved.

Considering the open clauses of MP 1.152, it is impossible to anticipate whether the Revenue Service will stick to the OECD Guidelines and thus enact limited measures aimed at simplifying the compliance of low-risk and value-added activities, or will rather maintain the Brazilian approach of more broad measures (including profit margins) aimed at exempting certain transactions or even at simplifying the transfer pricing control of economic sectors as a whole. As mentioned in section 14. below, the policy goal of simplification and legal certainty that has been historically pursued by the Brazilian approach could be largely preserved if the Revenue Service manages to regulate sectorial safe harbours. This approach could even be expanded if safe harbours are built on effective market research, as it is ordinarily carried out by Brazilian federative states together with entities representing the economic sectors for the purpose of presumptive consumption taxation.

8. Advance Pricing Agreements

MP 1.152 authorizes the Revenue Service to establish a procedure whereby the taxpayer may consult the competent authorities on the methodology to be adopted for ensuring compliance of future controlled transactions with transfer pricing rules. Upon payment of a fee set at BRL 80,000, the consultation includes the selection of the most appropriate method, the determination of comparables and comparability adjustments, and the critical assumptions grounding the future transactions. Unless these critical assumptions are later modified, the final decision from competent authorities will be valid for a four-year period, which may be extended for a two-year period upon payment of an additional fee of BRL 20,000.

Well known in international practice, but absent from the previous Brazilian approach in view of the legally predetermined profit margins, APAs as proposed by MP 1.152 may become an important tool for taxpayers who are not eventually considered by safe harbours and the like simplification measures. In this context, APAs may be particularly relevant for transactions involving unique intangible property. As important as introducing the legal procedure, though, is improving the willingness of tax authorities to enter into the agreements: the track record under current legislation is not exemplary. Since enacted in 1996, Law 9,430 authorizes the taxpayer to challenge the predetermined profit margin before the Ministry of Finance and to require a specific pricing to their transaction. In spite of the legal authorization, changing the applicable margins has proven to be nearly impossible, particularly because of the extensive sensitive documentation demanded by regulations from the Revenue Service. One hopes the APAs under MP 1.152 will follow a different course.

9. MAP and Pricing Agreements

MP 1.152 contains a specific provision on tax treaty-based agreements under the mutual agreement procedure (MAP). It establishes that, upon the conclusion of a MAP, the tax authority will review any assessment issued to the taxpayer in order to implement the solution agreed to by the competent authorities in view of the provisions, the object and purpose of the relevant treaty.

The provision is welcome, as the case for pricing agreements has been a difficult one in Brazil. Tax treaties in force do not adopt the corresponding adjustment of article 9(2) of the OECD Model, and authorities used to state in the Commentary to Article 9 of the OECD Model that “the view that in the absence of paragraph 2 in Article 9, economic double taxation arising from transfer pricing adjustments does not fall within the scope of mutual agreement procedure”. It was not before 2016 that, in the context of the BEPS Inclusive Framework, the Revenue Service demonstrated certain willingness to enter into a MAP on transfer pricing issues; administrative guidance to MAPs edited that year covered “advance pricing arrangements, ruling and similar procedures”. In 2017, the restrictive position stated above was removed from the Commentary on the OECD Model. In 2018, the protocol to the treaty with Switzerland clarified that the absence of article 9(2) “cannot be construed so as to hinder a Contracting State to make such an appropriate adjustment if it has been agreed to in the course of a mutual agreement procedure”. In 2022, the treaty concluded with the United Kingdom was the first to include article 9(2) and establish that “any such adjustment shall be made only in accordance with the mutual agreement procedure”. The provision of MP 1,152, which plays the role of a domestic authorization to that effect, seems the ultimate development towards the conclusion of pricing agreements between the competent authorities and their further implementation in Brazil.

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10. Primary and Secondary Adjustments

Consistent with the practice found in other jurisdictions, MP 1,152 classifies the transfer pricing adjustments into spontaneous/primary (performed by the taxpayer/competent authority in order to adjust the taxpayer’s pricing to the ALS) and secondary (where the excess profits determined by the primary adjustment are treated as a constructive loan transaction within the MNE). The proposed rules also provide for a compensating adjustment through which the taxpayer is allowed to avoid a secondary adjustment by, before the year-end, adjusting the pricing of the controlled transaction to the pricing that will result from the spontaneous/primary adjustment.

Previous Law 9,430 was only based on the primary adjustment, so transfer pricing did not further impact the calculation of taxes and the commercial practice of the taxpayer. Any year-end adjustments intended by the taxpayer, however, did not find a straightforward procedure: customs documentation should be rectified accordingly and, lacking a clear legal basis for the price adjustment, tax authorities often deemed the amounts received taxable revenue, with decisions unfavourable to the taxpayer at the administrative review procedure. In this context, the compensating adjustment of MP 1,152 may offer a way out for complying with transfer pricing rules on an ex-post basis (the “outcome-testing approach” mentioned by the OECD Guidelines).

The secondary adjustment, though, adds a burden to the system. The constructive loan (with a deemed accrued interest that is owed as from the following period until the excess profits shifted to the related party abroad are completely repaid to the Brazilian entity) may impact the calculation of income tax over time and is thus able to significantly interfere with the commercial practice of the taxpayer, who may change its pricing instead of recognizing taxable notional revenue in a constructive transaction. The constructive transaction of MP 1,152 is also flawed. It appears that the secondary adjustment can only result in a creditor position for the Brazilian entity (who will never deduct deemed interest in a debitor position). The interest rate at a fixed 12% could hardly meet an arm’s length assessment; if the proposed rules were intended to align with the ALS as defined by the OECD Guidelines, then MP 1,152 should have sought out the interest that independent parties would have contracted in a loan under comparable circumstances, instead of a flat and fixed 12% rate.

11. Penalties

If the taxpayer fails to prepare or present the transfer pricing documentation established by MP 1,152, the applicable penalties range from 0.2% per month of the gross revenue earned in the relevant period of the documentation (in the case of late presentation) to 3% of the gross revenue earned in the same period (in the case of inconsistent documentation). A penalty amounting to 5% of the value of the transaction, or to 0.2% of the consolidated revenue of the MNE in the previous period, is provided for documentation on the operation of the MNE, and on the global allocation of the revenues, assets and income tax paid by the MNE (allegedly, the “Master File” and the “country-by-country report”, as defined by the OECD Guidelines). In any case, MP 1,152 establishes a minimum of BRL 20,000 and a maximum of BRL 5 million for the penalties above.

The proposed rules also mitigate the application of the standard penalty (at 75% of the unpaid tax) that would otherwise apply if the tax authorities ultimately disagreed with the self-assessment performed by the taxpayer – the procedure through which they are obligated to state the relevant facts, interpret the relevant legislation and apply the law, paying the taxes so calculated before any exam by authorities. According to MP 1,152, no penalties will be charged if the taxpayer manages to rectify their tax returns as demanded by the authorities, has not acted contrary to any mandatory guidance from the tax administration, has been cooperative during the tax audit, has undertaken efforts to observe the rules and has adopted coherent and reasonable criteria for their transfer pricing. The rectification of the relevant tax return, however, “may” be authorized by the competent authority, and therefore the resulting elimination of the penalties is at the discretion of the Revenue Service.

Despite the discretion granted, the provisions are noteworthy in a system that heavily relies on penalties as a means to ensure the taxpayer’s compliance, and are fully justified in the context of rules conceived following the international standard. When discussing the alignment with the Guidelines, the OECD and Brazilian officials themselves admitted that “the 75% penalty that is automatically applicable to a tax underpayment, irrespective of the reason, may be considered unduly harsh in some situations (e.g. good faith)”.

The practice of the OECD Guidelines is, after all, a matter of reasonableness. Tax authorities must be convinced that the adopted pricing is reasonable to the detriment of several possible alternatives, and taxpayers must justify and document the adopted price to the extent possible. Since the operation of proposed rules is not straightforward, it would be soundly disproportionate to charge a flat penalty of 75% of the unpaid tax regardless of any circumstance of the case.

12. The Way Ahead

MP 1,152 was edited by a government fully supporting the accession to the OECD, but which left office three days thereafter. The assessment of the proposed rules by Congress may largely depend on their support from the proponent (the Executive Branch), and there is no clear indication of the preference of the new government between the previous policy and full alignment with the OECD. In principle, a government leaving office should not financially or politically bind a new government – Congress has constitutional authority to reject MP 1,152 altogether.

13. OECD Guidelines, supra n. 3, at para. 3.70.

and the Executive Branch itself could edit a new provision, measure abrogating the previously proposed rules. At this stage of years-long efforts between the OECD and Brazilian officials, however, rejection might not be on the political agenda.

As well as rejecting them, Congress has the power to modify the provisions of MP 1,152 at will. It could well temper the alignment with the OECD Guidelines with a sunset clause or provisions typical of the approach Brazil has developed over the years. To this effect, an alternative dual regime serving as training wheels for approximating Brazil to the OECD practice is proposed elsewhere.  

If the only political alternative at the end of the day is approving a system aligned with the OECD Guidelines, then challenges for the further implementation of MP 1,152 in the country should be considered.

13. Challenges for Implementing MP 1,152

MP 1,152 is mostly representative of the OECD Guidelines, and can be said to incorporate their fundamentals into the Brazilian system with general and conceptual legal provisions. Full incorporation of the OECD Guidelines may be carried out by regulations and administrative guidance from the Revenue Service, which is likely to further reproduce the details and examples of the document. Considering that significant changes are brought to the OECD Guidelines from time to time, one may expect the tax authorities to subtly modify and update their guidance regardless of any changes in law. This dynamic application of legislation, besides being questionable from a constitutional standpoint, may raise an additional issue of legitimacy if Brazil does not eventually accede to the OECD.

Open clauses such as those demanded by the OECD Guidelines, and now proposed by MP 1,152 in Brazil, are a source of uncertainty and litigation. In other jurisdictions, the outcome of adopting the OECD Guidelines is contingent on the preparation and reasonableness of the stakeholders. Although some Brazilian taxpayers may be acquainted with the proposed rules as the MNE headquarters deal with similar regimes elsewhere, the same expertise cannot be promptly expected from the tax authorities. Brazil has continental proportions and, as much as well-prepared staff may be ready to conclude APAs on hard cases at the Revenue Service coordination in Brasilia, tax authorities that hold no similar specialization will always have to audit transfer pricing countrywide. Without any institutional development or refinement, MP 1,152 incorporates decades of evolutionary transfer pricing practice in the OECD area at once. Its methodologies and operations have never been put to test in Brazil.

The mistrust between both stakeholders in the country does not seem to allow a cooperative tax environment that could construe the reasonable interpretation of MP 1,152 and its general provisions. Rules demanding the selection of the most appropriate method, the comparability analysis of all the economic circumstances of the transaction, or the assessment of the ORA naturally require a level of interaction and trust between taxpayers and the authorities that is still distant from the local tax environment. An arm’s length price can only be determined by a decision, which should be taken through the cooperation of taxpayers and tax authorities. The Brazilian tax practice, like the Brazilian legal culture altogether, calls for a more thorough and specific treatment at a legislative level.

Transfer pricing rules under previous Law 9,430 have a track record to that effect. In a context where the comparability analysis was mostly dismissed by the predetermined profit margins and transfer pricing practice was thus reduced to the application of precisely defined statutory provisions, dissenting opinions on the law caused enormous litigation, part of which could not be settled by administrative review. Long-lasting controversies reached the judiciary up to the Superior Court of Justice, to whom jurisdiction was granted to finally decide on the interpretation of federal law, and where parties are not even allowed to discuss matters of fact. If matters of law were able to cause significant dispute in both administrative and judicial courts, then one could expect the matters of fact introduced by MP 1,152 (e.g. comparability analysis) to substantially increase controversy.

14. Measures for a Less Troublesome Alignment with the OECD Guidelines

Aligning the Brazilian legislation with the OECD Guidelines does not mean that specific measures could not be adopted by Congress to alleviate the incompatibility of the international practice with the local legal culture and tax environment. These measures would be mostly related to the unusual power and discretion granted by MP 1,152 to tax authorities upon assessing transfer prices. For instance, certain criteria should be further specified for determining the most appropriate method and the burden of proof should rest with the competent authority to demonstrate that the taxpayer did not choose the most appropriate method, or otherwise failed to consider a clearly more attractive option that was realistically available for their transaction. Ideally, the ORA analysis should be removed altogether so that delineating the controlled transaction would not imply the enormous burden and uncertainty of substituting the transaction actually entered into by the taxpayer. The alternative to rectifying tax returns without penalties upon certain conditions should not be a “may” for the competent authority, but a “shall”, thus granting the bona fide taxpayer with the right not to be penalized. Among others, these measures would not mischaracterize the ALS as enshrined by the OECD Guidelines, and would significantly favour the practice of proposed rules in Brazil.

There is also no reason why certain rules, like the secondary adjustment, should always operate in disfavour of the Brazilian taxpayer. If profits are to be consistently allocated between the related parties, then any excess

profits calculated for the Brazilian entity on a primary adjustment should cause it to owe deductible interest to the related party abroad. If notional payments are otherwise not to be deducted in Brazil, then the constructive transaction need not be a loan – it could well amount to a capital contribution or a dividend distribution to the related party abroad, both of which are not deductible. A constructive contribution or dividend would not cause the same immediate tax consequence of recognizing the notional interest revenue (no withholding currently applies), though certain outcomes could be found over time (a capital contribution could lead to an investment to be accounted for and dividends could reduce profits to be further distributed). In any case, the adoption of a secondary adjustment should be carefully considered. The transaction construed in one country might not correspond to the transaction construed in the other country, as the adjustments are based on domestic law with possible diverging practice.  

The OECD Guidelines themselves admit that the other “tax administration should make a corresponding adjustment only insofar as it considers the primary adjustment to be justified both in principle and in amount” so that the other country “is not forced to accept the consequences of an arbitrary or capricious adjustment by another State”. The loan constructed after the fixed and flat 12% interest rate, as proposed by MP 1,152, is not likely to find correspondence in the other country, and the notional interest revenue imposed on the Brazilian entity may not match any interest deduction elsewhere.

Alignment with the OECD Guidelines also does not preclude the country from pursuing certain policy goals. A notable example lies in the DEMPE assessment for intangible property, to which other functions like the acquisition (“DAEMPE” in the UN Practical Manual18) or promotion (“DEMPEP” in China19) of the intangible are being added by jurisdictions according to their marginal importance to the relevant economy. In Brazil, where most companies are not publicly traded and data on profitability is scarce, a sound policy goal is simplification. Congress should make it clear that the power granted to the Revenue Service to edit simplification measures includes the necessary regulation of sectorial safe harbours, possibly built on information shared by the players to entities representing each sector.

In a country where the status of the OECD Guidelines was nothing more than a brief mention at the memorandum that followed the bill of the previous law, the more feasible the new system is, the more likely that the proposed rules will have a smooth implementation.

17. OECD Guidelines, supra n. 3, at para. 4.35.
18. UN, supra n. 4, at Part B, sec. 6.3.3.