Bloomberg Tax

Tax Management
International Journal™

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Brazilian Transfer Pricing: Timing Is Everything

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New Year, new life — at least for Brazilian transfer pricing.

A few months ago, we published an article addressing announcements of the (then) potential- changes to the Brazilian transfer pricing system, and the shift from Brazil's historical, formula-based transfer pricing rules to an arm's length standard consistent with the OECD Guidelines.[1] In addition, the new system would incorporate several very important features of the OECD transfer pricing framework including:

- Transfer pricing methodology and valuation techniques;
- The possibility of testing related foreign parties to a Brazilian transaction;
- The OECD concept for Cost Contribution Arrangements;
- Rules addressing internal restructurings;
- OECD standards for financial transactions control;
- Authority for the Brazilian tax authorities (the Portuguese acronym for which is ''RFP'') to enter into advance pricing agreements and conclude mutual agreement procedures; and
- Expanded BEPS Action 13 documentation requirements, including Master File and Local File.

After a few months of waiting, RFB has delivered on the promise. Just before the new year, on December 28, 2022, the government issued Provisional Measure No. 1,152 (the ''Provisional Measure''), which, but for a few minor issues such as limitations to the possibility of compensating adjustments that reduce the taxable basis, incorporates all heralded changes.[2]

Besides adopting a transfer pricing system compliant with the OECD Guidelines, the Provisional Measure would implement important changes to royalty deduction rules. Since the mid-20th century, Brazil has imposed severe restrictions for the deductibility of royalties, such as the deduction disallowance for royalties paid to a foreign shareholder or a limit (i.e., 1% to 5% of the net revenues) on royalties and technical assistance payments made to foreign parties. Those restrictions would be eliminated by the new transfer pricing system, which would introduce more reason-

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This article may be cited as Jessie Coleman, Kimberly Tan Majure, Doug Poms, and Roberto Salles, *Brazilian Transfer Pricing: Timing Is Everything*, 52 Tax Mgmt. Int'l J. 2 (Feb. 3, 2023).

[1] Roberto Salles and Kimberly Tan Majure, *Brazilian Transfer Pricing: Here Today, Gone Tomorrow?*, 51 Tax Mgmt. Int'l J. No. 6 (June 3, 2023).

[2] http://www.planalto.gov.br/ccivil_03/_Ato2019-2022/2022/Mpv/mpv1152.htm.

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ISSN 0090-4600

able, anti-abuse types of restrictions. If final legislation implements the provisions of the Provisional Measure, Brazilian companies would not be able to deduct royalties paid to persons resident in a tax haven jurisdiction or to related parties in double non-taxation scenarios.

Taxpayers must apply the new transfer pricing rules to their Brazilian intercompany transactions for taxable periods beginning on or after January 1, 2024. Significantly, the Provisional Measure allows taxpayers to elect application of the new rules for the 2023 taxable period. Once made, an election to adopt the new rules for 2023 would be irrevocable.

Notably, despite its name, the Provisional Measure should not be viewed as a mere proposal. Provisional measures are legal instruments that represent a "joint effort" between the Presidency and the Brazilian National Congress. After issuance, a Provisional Measure must be sent to the National Congress, which has 120 days from the issuance date to approve the measure (here, June 2, 2023, which takes into account the Congressional recess period). If Congress approves the Provisional Measure, a "Conversion Law" is enacted; in the case of a wholesale adoption of the Provisional Measure, the rules are deemed valid from the issuance date (December 29, 2022).

Things get complicated if Congress changes the Provisional Measure or negates it entirely (hence its "provisional" nature). If approved with changes, the modified rules are treated as valid in their original form, for the period between the issuance date and the enactment of the Conversion Law, and the modified rules take effect on the publication date of the Conversion Law. In this case, the unchanged pieces of Provisional Measure would be in effect for the entire period, while the changed pieces would be valid as originally drafted until enactment of new rules per the Conversion Law. Changes are subject to the rules on Presidential veto (including partial veto) powers, which can complicate things even further.

If Congress negates the Provisional Measure entirely, either by expressly voting "no" or by not voting at all during the 120-day period, two additional scenarios come into play. First, the applicable Constitutional rule states that the Provisional Measure would lose all effect as of the date of its issuance, i.e., retroactively. That same rule also provides that, within 60 days, Congress may enact a Legislative Decree to regulate the effect on items arising or transactions occurring while the Provisional Measure was valid. In this scenario, there are no limits on Congressional action, other than ordinary adherence to the Constitution itself. Notably, this path is very rarely taken.

If, instead, Congress negates the Provisional Measure but does not enact a Legislative Decree – which is by far the more common scenario when a Provisional Measure is not approved – the Provisional Measure is deemed valid during the period between the issuance date and the negation date.

In most cases, the complexity of these scenarios would be avoided, as the potential application of a Provisional Measure is typically beyond the 120-day period; taxpayers would know whether the Provisional Measure was approved or denied well before they would have to apply its rules. That is likely to be the case for the taxpayers choosing not to apply the new transfer pricing system for the 2023 taxable period, but those wishing to become "early adopters" must at least consider these legislative scenarios. While the existence of the 2023 election is known, the exact mechanics of the election – manner, timing, etc. – will be detailed in forthcoming regulations. Hopefully, the tax authorities specify an election deadline that is beyond the 120-day period, allowing taxpayers to understand the legislative outcome before choosing their approach to 2023.

IMPLICATIONS FOR U.S. FOREIGN TAX CREDITABILITY

Brazil's President has authority to enact provisional measures in certain urgent cases. As discussed in our prior article, the likely motivation to move to (or to accelerate a move to) an OECD-style transfer pricing regime, and to make changes to the royalty deductibility rules, was the tightening of the U.S. foreign tax credit (FTC) regulations in early 2022, and the resulting risk to the creditability of Brazilian income and withholding taxes in the US. The formal justification conveyed to Congress for the Provisional Measure describes the new U.S. regulations as directly affecting Brazilian investment by U.S. companies and states, "One of the main reasons this [Provisional Measure] is urgent is the recent change to the U.S. tax policy, disallowing tax credit in regard to income tax paid in Brazil due to the deviation of the Brazilian TP system from the [arm's length standard]."

On November 18, 2022, the U.S. Treasury and IRS released proposed regulations that introduced a number of provisions that, at a high level, would loosen the requirements of the current FTC rules.[3] This would include, among other things, cost recovery safe harbors that permit some level of deduction disallowance or justification for a disallowance based on tax or non-tax policy considerations that reflect the same policy choices made in analogous U.S. rules. With respect to royalty withholding taxes, the proposed regulations also include a single country license exception

[3] REG-112096-22, *IRS Proposed Rules on Guidance Related to the Foreign Tax Credit* (Nov. 22, 2022).

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that would allow taxpayers to substantiate (subject to very specific documentation requirements) that an intangible property license is used solely in the taxing jurisdiction. This seems to be a workable solution for addressing the differences between the U.S. place of use source rule and Brazil's payor's residence source rule and, if all other substantive requirements are satisfied, would provide a much-needed avenue for creditability.

In terms of those other substantive requirements, it is important to note that, while Provisional Measure would go a long way toward making the Brazilian corporate income and withholding taxes creditable for U.S. purposes, several significant issues remain unresolved. For example, Brazilian deductions and deduction limitations must be confirmed to satisfy the U.S. realization, gross receipts, and cost recovery requirements. In addition, optionality related to 2023 adoption of the OECD Guidelines raises separate levy, as well as voluntary tax, issues. Thus, while the new Brazilian legislation—if enacted— is a significant step in the right direction, there are several additional technical issues that must be addressed before taxpayers can get comfortable with Brazilian tax creditability.

PRACTICAL CONSIDERATIONS

MNEs are working quickly to understand the practical transfer pricing and international tax consequences of moving from Brazil's historical formulaic transfer pricing system to an arm's-length approach based on the 2022 OECD Guidelines.

The first, perhaps most obvious, set of issues include transition period considerations. As noted above, MNEs have the legal right to change their intercompany pricing as of January 1, 2023, to align to the OECD arm's-length principle. To get a sense of whether electing use of the OECD Guidelines for 2023 is favorable, companies are currently modeling application of the Brazilian formulaic approach versus the OECD Guidelines to their intercompany transactions. Key pieces of the modeling exercise are the effects of possible restructuring (e.g., migration of intangibles from Brazil elsewhere); potential U.S. foreign tax creditability of resulting income and withholding taxes; and the ability to use transfer pricing approaches from other markets to estimate treatment of intercompany transactions related to the Brazilian market.

Note, while the Provisional Measure has many taxpayers scrambling right now, they may not be able to settle on their transfer pricing approach for 2023 until they understand the extent to which the final law reflects, or varies from, the Provisional Measure. It is also unclear how the Brazilian government will interpret the OECD Guidelines. For example, will Brazil focus on the ''control of risk'' and development, enhancement, maintenance, protection and exploitation (DEMPE) provisions of the OECD Guidelines and assert, for robust Brazil operations with management functions, that Brazil would be entitled to a larger return? With these factors in mind, MNEs are trying to understand their practical deadline for settling on their 2023 transfer pricing approach. Although the Provisional Measure does not include exact mechanics for electing 2023 treatment, one possibility is that the current rule of year-end transfer pricing adjustments could apply. Or, taxpayers could be required to opt into 2023 adoption of the OECD Guidelines on the 2023 tax return due in July, 2024. Conceivably, taxpayers might even be able to follow their historical approach for 2023 and then, if it later appears that an arm's length approach is more favorable, elect that treatment on an amended 2023 tax return.

Regardless of when MNEs want to implement the OECD Guidelines (beginning in the 2023 or 2024 taxable period), MNEs are currently identifying *how* they will gather the data to be able to implement the OECD Guidelines. For example, some companies are realizing that they will need to source data on a business segment, as opposed to a business line basis to perform their transfer pricing analysis. MNEs are also considering technology solutions to ensure the accuracy and consistency of their transfer pricing calculations under the OECD Guidelines.

In addition, as discussed above, assuming creditability of Brazilian withholding tax on royalties, the underlying licenses must meet very specific documentation requirements. While it may not be a time-consuming exercise to modify intercompany license agreements to fit the bill, the same may not be true of third-party licenses. Taxpayers may need to devote significant resources towards a re-papering exercise and, if they have any hope of crediting royalties (Brazilian or otherwise) paid as early as November 18, 2022, they need to re-paper by May 17, 2023 (the deadline established in the proposed regulations).

Finally, MNEs should consider indirect tax issues that could be affected by a change in their transfer pricing approach in Brazil. For tangible goods transactions, for example, compliance with Brazilian prescribed methods for customs purposes may prove challenging as the customs methodologies are not aligned with those required under the OECD Guidelines.

The next several months will be busy ones. Fingers crossed the Provisional Measure marks the beginning of the end – as opposed to the end of the beginning – of transfer pricing transformation in Brazil.

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ISSN 0090-4600