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Tax challenges in Brazil's accession to OECD

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Introduction

After decades of discussions about Brazil becoming a member of the Organisation for Economic Co-operation and Development (OECD), Brazil was finally invited on 25 January 2022 to start its accession process to the organisation. The process will be long and will require a lot of dialogue on the adhesion to the OECD's legal instruments and other measures. There is no doubt that tax issues and changes for the alignment with OECD guidelines will be part of such discussions, which will be a challenge to be overcome in the complex Brazilian tax system.

Tax barriers

The convergence of the Brazilian transfer pricing rules with the OECD standard is one of the important issues to be faced.

The similarities and differences between Brazilian and OECD transfer pricing approaches have already been analysed in a joint project, which was carried out by the Brazilian Federal Revenue Service and the OECD during 2018 and 2019. In this project, many gaps and divergences were identified, which create distortions and tax uncertainty in the assessment of benchmarks in cross-border transactions, as well as risk of double taxation.

Although Brazilian tax authorities claim that local transfer pricing rules follow the arm's length principle, Brazilian legal provisions and practices do not confirm such statement. There are several factors in the Brazilian transfer pricing framework that oppose this principle, such as:

- the absence of a complete comparability analysis;
- the particularities of the transfer pricing methods implemented in Brazil, including the adoption of fixed profit margins; and
- the lack of transactional profit methods.

As a practical matter, foreign related parties that carry out transactions with Brazilian companies should be aware that further analysis from the perspective of Brazil is generally required to combine, to the furthest possible extent, the unique Brazilian approach with the OECD guidelines that are generally adopted in other countries.

In this context, the alignment of the Brazilian transfer pricing rules and practices with OECD standards tends to create a better scenario for cross-border transactions. However, the large number of gaps and the lack of experience of Brazilian tax authorities and of certain companies with the OECD approach certainly raise many difficulties and demand a longer transition period.

Another tax barrier for Brazil's accession process is complying with the key conditions that underlie the OECD Model Tax Convention (the Convention). Despite taking some direction from the Convention, which is mainly focused on a residence-based taxation, Brazil also follows certain aspects of the United Nations Model Double Taxation Convention, which advocates for a source-based taxation.

As a result, most double tax treaties that are signed by Brazil ensure taxing powers to the source state regarding interest and royalties, among other provisions that are not fully aligned with the Convention.

Additionally, the appropriate interpretation of double tax treaties needs to be addressed as well. Even when the wording of double tax treaties that are signed by Brazil coincides with the Convention, Brazilian tax authorities and administrative and judicial courts have, in certain cases, taken a different approach than the one adopted in the commentaries to the Convention and by other countries.

The interpretation on the effects of article 7 of double tax treaties (referring to business profits) on the taxation of service remittances abroad is an example of the unique understanding of Brazilian tax authorities. In summary, such authorities historically claim that withholding income tax is levied on technical service remittances abroad because they would fall under article 21 (other income) or article 12 (royalties) of the treaties signed by Brazil, disregarding article 7. Only after much controversy has the application of article 7 been accepted in certain limited cases. The matter is still under discussion in judicial courts.

Comment

The alignment with OECD guidelines of Brazilian transfer pricing rules and double tax treaties that have been signed by Brazil will represent important challenges, but many other tax issues should be debated in connection with Brazil's accession process to become a member of the OECD. The roadmap for the detailed assessment process of Brazil prepared by the OECD will provide a clearer view of the tax barriers to be overcome.

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