# OPTIONS FOR ALIGNMENT WITH THE OECD STANDARD

OECD/RFB
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# Introducing the panellists

- ***Chair: Flavio Araujo (RFB)***
- Tomas Balco (OECD)
- Elizabeth Arnold (UK HM Treasury)
- John Hughes (US IRS)
- Antoinette Musilek (Embassy of Spain in Brazil)

# Overview / key questions

- Is there a need for alignment?
- What would alignment entail?
- What would be the options for alignment?

# IS THERE A NEED FOR ALIGNMENT?

# What are the implications of lack of alignment?

- **Positive implications**
  - Relative simplicity
    - Potential reduction of tax compliance burden
      - Absence of comprehensive comparability analysis and of need for benchmarking study
    - Potential reduction of tax administration efforts
      - Tax administration efforts limited to enforcement of mostly prescriptive rules
    - Potential tax certainty from a domestic perspective
      - Taxpayers may rely on predictable outcomes, when compliant with prescriptive rules

- **Negative implications**
  - Double taxation
  - Loss of tax revenue
  - Absence of tax certainty from a cross-border perspective

# Relative simplicity

- The Brazilian TP system is often characterised by its **practicality** and **predictability**, and provides **tax certainty** (domestically)
- Some of the features of the current rules may be perceived as attractive qualities with respect to providing **simplicity**, e.g.:
  - Absence of comprehensive comparability analysis
  - Absence of functional analysis (assets, functions, risks) and risk analysis
  - Freedom of selection of the method
  - Use of fixed margins
- However, it emerges that these **perceptions of simplicity are relative**:
  - Complexity does arise from other existing features
    - E.g., item-per-item approach, strict standard of comparability, documentation
  - The key features contributing to simplicity undermine the primary objectives of transfer pricing rules → leading to double taxation and BEPS practices

# Double taxation

- **Double taxation** outcomes
  - The assessment performed has revealed that a large number of the gaps or issues identified lead to instances of double taxation
    - Double taxation outcomes confirmed by both MNEs and other jurisdictions
  - Out of the 30 issues identified, **27 create potential risks of double taxation**
- Implications of **double taxation**
  - Impact on trade and investment flows
  - Negative implications on integration of Brazil in global value chains
  - Limited investments into Brazil (market and resource seeking)
- Prevention and elimination of double taxation is one of the **cornerstones** of the OECD policies and also principles to which OECD members commit
  - Closer alignment with the OECD Guidelines would contribute towards a **common understanding** regarding the **application of the arm's length principle** and more efficiently prevent double taxation from arising

# Loss of tax revenue

- **Loss of tax revenue**
  - Results from possible gaps in the current rules
    - Absence of specific TP guidance for areas such as – intangible assets and services
    - Absence of methods (e.g., profit split method or use of valuation methods, where appropriate)
  - Results from features, which give the possibility to taxpayers to “choose” the desired TP outcomes
    - Freedom of choice of the method → may mitigate over-taxation but also facilitate BEPS
    - Absence of comparability analysis and lack of recognition of intangibles and risks as profit driver
      - E.g., limited functional and risk profiles draw the same fixed profit margins as high risk and full fledged activities
- Number of features in the existing system may present BEPS risks
  - Out of the 30 issues identified, **23 lead to potential BEPS risks**
- The tax base of Brazil is therefore prone to base erosion and profit shifting
  - Aligning the rules with the OECD Guidelines would contribute to enhanced ability to **allocate appropriate tax base to Brazil** and also towards the **protection of the tax base**

# Absence of tax certainty from a cross-border perspective

- The relative **tax certainty** resulting from application of prescriptive rules only holds from a **unilateral (domestic) perspective**
  - There is no tax certainty from a cross-border perspective and the risks of double taxation from diverging approaches are significant
- Assessment reveals that **significant tax uncertainty** results from the misalignment of the rules with OECD transfer pricing standard
  - Out of the 30 gaps or issues identified, **tax certainty from an international perspective is only found in 3 instances**
- In the resulting cross-border uncertainty, the taxpayers have “certainty” that their tax planning arrangements based on Brazilian TP rules **will not be challenged** and also that double taxation disputes **will not be effectively resolved**, so they resort to:
  - Tax planning arrangements involving 3rd-party jurisdictions to mitigate the uncertainty
  - Accept double taxation as an inherent costs of doing business in Brazil
  - Rather than relying on bilateral dispute resolution mechanism, they rely primarily on domestic administrative and judicial appeal mechanisms

# CONSIDERATIONS FOR POTENTIAL ACCESSION TO OECD

# Possibility of future accession of Brazil to OECD

- Potential members of OECD are expected to endorse and adhere to the **key OECD policy principles** (includes tax policy and one of them is adherence to “arm’s length principle”)
  - Eliminating double taxation through ensuring the **primacy of the arm’s length principle**, as set out in the OECD Guidelines, for the determination of transfer pricing between associated enterprises
  - Brazil will undergo in-depth reviews by different OECD technical committees, including the **Committee on Fiscal Affairs**
- The basis for the review is a questionnaire that notably identifies ten key areas in the chapter dedicated to transfer pricing
- Most of the issues identified in Brazil’s transfer pricing framework are highly relevant in this process and commitment to align with the OECD Guidelines will influence the outcome of the accession discussions in this area

# Commitments of OECD Members

- Recommendation of the Council on the Determination of Transfer Pricing between Associated Enterprises [C(95)126/Final], as amended, in *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*

  i) Follow, when reviewing, and if necessary, adjusting transfer pricing between associated enterprises for the purposes of determining taxable income, the Guidelines – considering the whole of the Guidelines and the interaction of the different chapters – for arriving at arm's length pricing for transactions between associated enterprises;

  ii) encourage taxpayers to follow the Guidelines; to that effect Adherents should give the Guidelines publicity and have them translated, where necessary, into their national language(s);

  iii) develop further co-operation, on a bilateral or multilateral basis, in matters pertaining to transfer pricing.

# Adherence to arm’s length principle

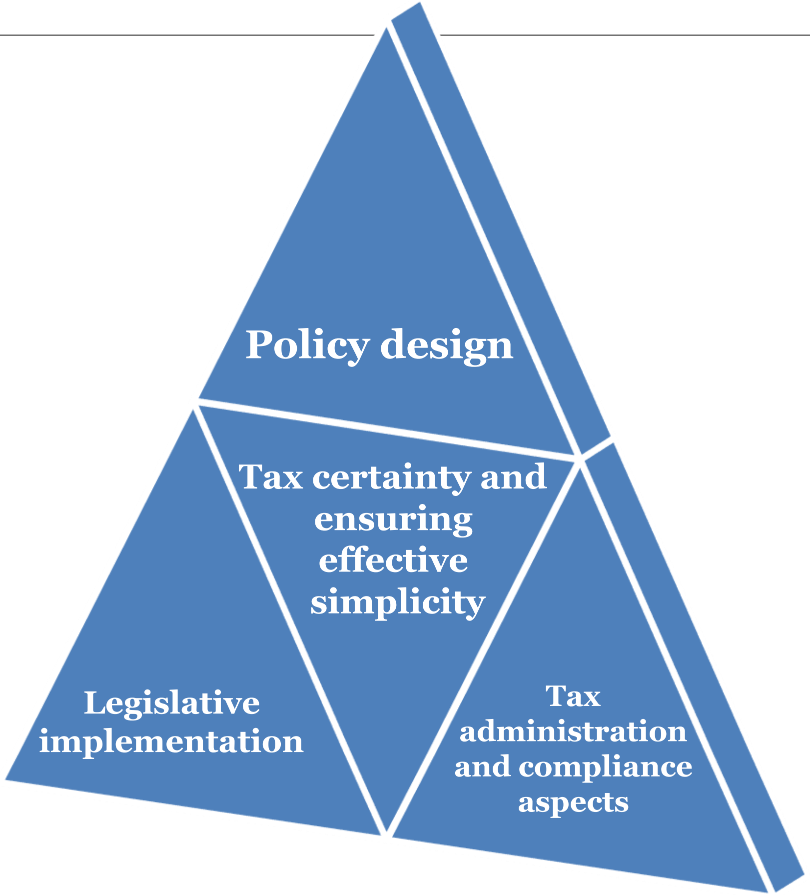
- As explained in the Preface to the OECD Guidelines, OECD member countries have adopted the **arm’s length principle**, under which the effect of special conditions on the levels of profits should be eliminated
  - Serving the dual objective of **securing the appropriate tax base in each jurisdiction** and
  - **Avoiding double taxation**
  - Thereby minimising conflict between tax administrations and promoting international trade and investment

# WHAT WOULD ALIGNMENT ENTAIL?

# Key areas requiring alignment

- Restatement of the arm's length principle
- Transfer pricing methods and selection of the most appropriate method
- Comprehensive comparability analysis and related considerations (including functional and risk analysis)
- Prevention and effective avoidance of double taxation, reflected also in the compliance and examination practices
  - Ensure effective dispute resolution for transfer pricing cases (corresponding adjustments and MAP)
- Aligning the rules to address special considerations for specific types of transactions, including:
  - Intangibles, intra-group services, cost contribution agreements
  - Attribution of profits to PEs and financial transactions

# Key considerations related to alignment



# Policy design – challenges to be addressed

Addressing the key areas requiring alignment

Retaining and ensuring simplicity, limiting tax compliance costs and ensuring effective tax administration

# Legislative implementation

## Revision of Primary Law Framework

- Ensuring compliance with existing legal and constitutional principles

## Development of Secondary Law Framework

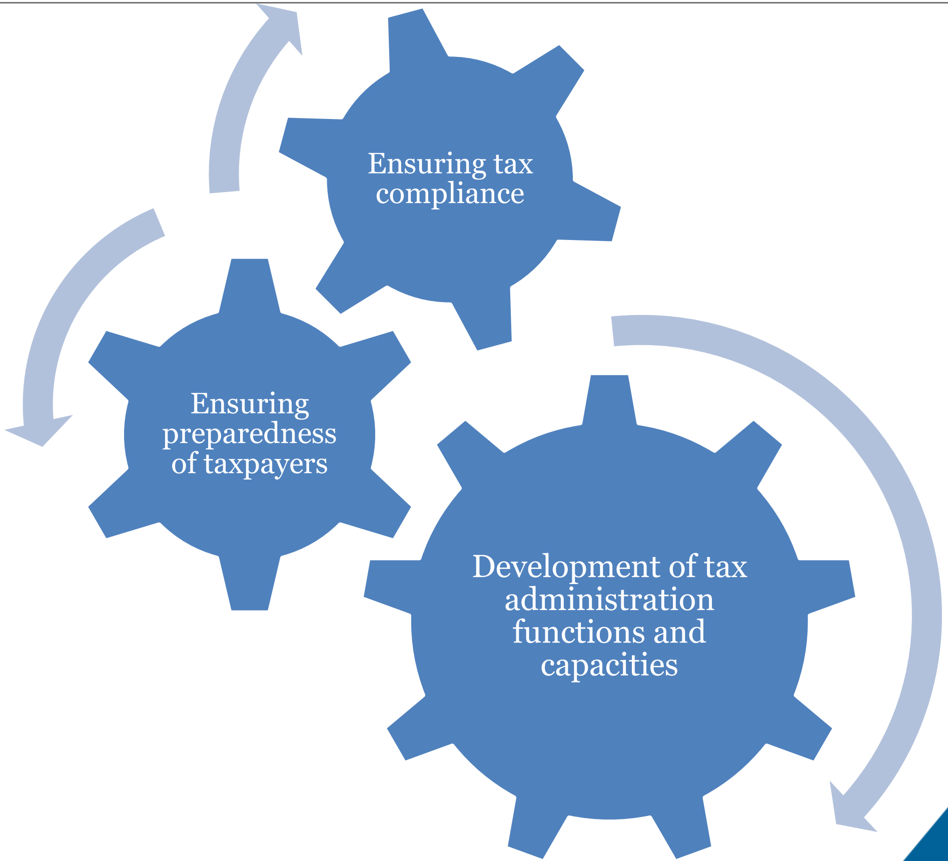
- Elaborating on the primary law concepts and principles

## Development of Administrative Guidance and Manuals

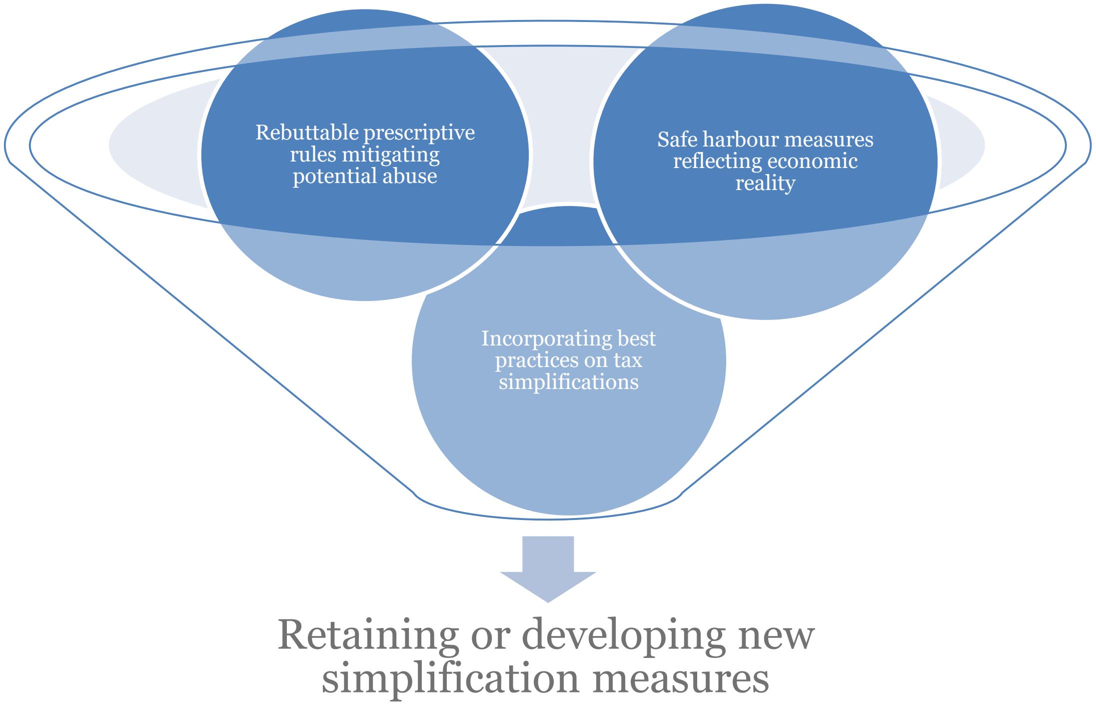
- Detailed administrative and implementation guidance

# Tax administration and tax compliance aspects

- Ensuring preparedness:
  - Tax administration
    - Development of relevant functions and capacities
      1. Risk assessment
      2. TP economic analysis
      3. Tax audit
      4. Dispute prevention and resolution
  - Taxpayers
    - Tax compliance guidance and relevant procedures/forms



# Tax certainty and ensuring effective simplicity



# ADDRESSING SPECIAL MEASURES

# Relevance of special measures

- **Special measures**
  - Their objective is to address specific issues, risks or challenges
    - BEPS challenges
      - E.g., BEPS Action 2 – Hybrid mismatch rules, BEPS Action 4 – Interest deductibility limits
    - Addressing specific tax avoidance practices
      - Diverted Profit Tax, BEAT, royalty barriers, etc.
  - Compliance and alignment of special measures with existing commitments
    - Elimination of double taxation, non-discrimination, etc.
- **Special deductibility limits in Brazil**
  - Royalty payments
  - Technical services
  - Interests

# OPTIONS FOR ALIGNMENT

# Alignment with international OECD standard

International OECD standard

# Options considered during the project

- **Immediate alignment**
  - Relatively immediate change of the transfer pricing regime – affecting all the taxpayers as of given date
- **Gradual alignment**
  - Alignment graduated over a given period of time – e.g., based on the type of transactions or categories of taxpayers (large MNEs vs. micro and SMEs)
- Partial alignment
  - **Considered but rejected** because alignment only in certain areas or for certain types of transactions would create more complexity
    - Transactions are often interrelated/interconnected
      - E.g. Value of intangibles embedded in the value of goods and services
    - **Significant gaps could remain in the system with negative effects on tax certainty, compliance burden as well as risks of persisting double taxation**
    - **Partial alignment in form of opt out of current regime to follow ALP would mean revenue losses and continued BEPS practices, where taxpayers would cherry-pick the regime they wish to apply with the motivation to pay less tax**

# Immediate versus gradual alignment

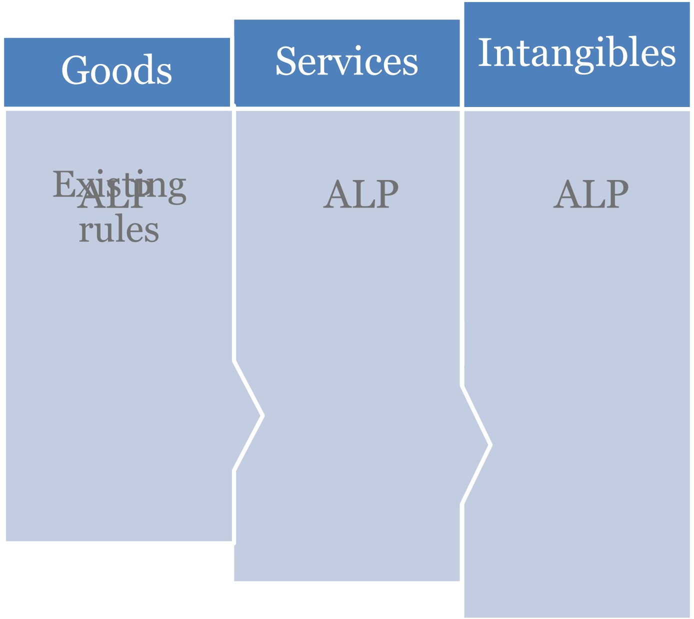
- Both options contemplate
  - Adherence to arm's length principle → **full alignment**
  - Inclusion of simplification measures to ensure
    - Ease of compliance
    - Effectiveness of tax administration
    - Tax certainty from a cross-border perspective
- Key differences
  - Effects of implementation
    - Immediate vs. gradual
  - Impact on tax administration and taxpayers preparedness
    - Immediate vs. gradual transition

# Possible approaches to gradual alignment

- Possible variations could entail:
  - Gradual alignment based on **types of transactions**
    - Gradually different types of transactions will be governed by rules based on ALP until full alignment is achieved
      - Challenge with interactions between the categories of transactions (interrelated, embedded transactions)
      - All taxpayers would have to follow the new rules for the specific types of transactions
      - Until the full alignment – **similar problems as partial alignment**
  - Gradual alignment based on **categories of taxpayers**
    - Gradually different categories of taxpayers would be obliged to follow to rules based on ALP, with the option for others to opt in
      - This would allow to distinguish between the need to reflect the specific challenges of specific categories of taxpayers
      - **Preferred option** as this would also allow certain categories of small taxpayers to continue applying the existing regime until specific safe-harbours and simplifications are established

# Possible approaches to gradual alignment – based on types of transactions

- Gradual alignment based on **types of transactions**
  - E.g., transactions involving goods would remain governed by existing rules for the time being, while the transactions involving services or intangibles would gradually be governed based on rules compliant with the arm's length principle, eventually also the transactions involving goods would be governed by rules based on ALP
  - Challenge: what about **interrelated transactions**? – e.g. combined transactions, packaged deals, embedded royalties
    - Due to the challenges and potential implementation issues, **this option has not been considered feasible**



# Possible approaches to gradual alignment – based on categories of taxpayers

### Largest MNE groups

- Turnover threshold tbd
- Applying ALP rules consistently with their global TP policies

### Large MNE groups

- Lower threshold
- Option to follow ALP earlier

### Remaining MNE groups

- Remaining MNEs meeting certain criteria
- Option to follow ALP earlier

# Conclusion and way forward

- Options identified are results of **technical analysis**
  - **Time is ripe** for political decisions whether to align and if yes, what option should be chosen
- Addressing remaining areas relevant for accession
  - Financial transactions
  - Attribution of profits to permanent establishments
- **Blueprint** and **roadmap for implementation** would be useful to inform the decision-making process