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VIEWPOINT

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# U.S. Foreign Tax Credit Regulations: The Last Straw for Brazil's Transfer Pricing Regime?

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In this article, the authors examine potential double taxation of U.S. multinationals operating in Brazil resulting from the U.S. final foreign tax credit regulations and Brazil's transfer pricing regime, which is not aligned with the arm's-length standard, and they consider whether this outcome might accelerate Brazil's accession to the OECD and adoption of the arm's-length standard.



In January the U.S. Treasury Department and the IRS published final foreign tax credit regulations (T.D. 9959) that dramatically narrowed the circumstances in which a U.S. tax credit will be available for income taxes paid to a foreign jurisdiction.

Section 901 allows a credit for income taxes paid to a foreign country during a tax year; section 903 provides that, for this purpose, such taxes include a tax paid in lieu of an income tax. This could be withholding taxes on dividends, interest, and royalties.

Under the final regulations, each levy imposed by a foreign country must be analyzed separately and independently to determine whether it constitutes a creditable foreign income tax. A foreign levy either is or is not a creditable foreign income tax, in its entirety, for all taxpayers subject to the levy. Put simply, a foreign levy's status as a creditable foreign income tax does not depend on and is not affected by a particular taxpayer's specific facts and circumstances.

## Previous Requirements

U.S. FTC regulations historically required that a foreign levy satisfy a three-part test to be considered a creditable foreign income tax:

- the levy is imposed upon or is subsequent to an event that results in the realization of income (the realization requirement);
- the levy is imposed on gross receipts or computed using a method that is likely to produce an amount that is not greater than fair market value (the gross receipts requirement); and
- the base of the levy is computed by reducing gross receipts to permit recovery of significant costs and expenses incurred to generate the gross receipts (the net income requirement).

A foreign levy that does not satisfy one or more of the requirements is not considered a foreign income tax and, therefore, does not give rise to a U.S. FTC under either section 901 or section 903. A deduction for such a levy, however, is permitted.

The final regulations largely retain the three historical requirements, with some modifications. For example, the net income requirement has been renamed the cost recovery requirement, and a new, fourth requirement has been added — the so-called attribution rule.

## New Attribution Rule

The attribution rule prescribes one set of rules for foreign levies imposed on residents (typically corporate income taxes) and a separate set of rules governing the treatment of levies imposed on nonresidents (typically withholding taxes). As a result of the final regulations, numerous foreign withholding taxes that were previously creditable are no longer eligible for a U.S. FTC.

While the rules applicable to residents may not draw the same degree of attention as those applicable to nonresidents, they have the potential to produce an equally harsh outcome. Under the final regulations, a foreign levy may include all worldwide gross receipts of a resident. However, the foreign levy must provide that any allocation to or from the resident of income, gain, deduction, or loss for the resident and organizations, trades, or businesses owned or controlled directly or indirectly by the same interests be determined under arm's-length principles. This cannot take into account, as a significant factor, the location of customers, users, or any other destination-based criteria.

## The Arm's-Length Standard and Brazil

Given this requirement in the final regs, if a country's income tax regime does not use arm's-length transfer pricing principles, the foreign levy fails the new attribution requirement and is not creditable. In addition, any withholding or payment in lieu of taxes stemming from such a corporate income tax would also be non-creditable.[1]

U.S. tax practitioners will now need to understand the intricacies of tax laws around the world because these new rules affect the creditability of taxes in several countries. But no country will be more severely affected than Brazil.

Brazil does not use the arm's-length standard. Instead, it has a series of safe harbors and rigid formulary requirements companies must follow to compute transfer prices. Sometimes these calculations result in an arm's-length outcome. Other times the outcome is above or below the arm's-length range.

The arm's-length principle is the international standard used to "prevent evasion of taxes or clearly to reflect the income" of multinationals.[2] A transfer price on an inbound payment that is below the arm's-length range would mean the U.S. tax base is eroded. Similarly, an outbound payment that is above the arm's-length range would result in insufficient taxes paid in the United States. Section 482 is full of methods meant to ensure that the U.S. tax net receives at least an arm's-length result.

Although Brazilian transfer prices are computed in unconventional ways, they sometimes produce an outcome that meets or exceeds the arm's-length result, so the U.S. tax net is fairly (or even more than fairly) compensated. But even in these cases, the final regulations deny an FTC because the underlying transfer pricing calculations are not aligned with the accepted method. Thus, the relevant question becomes, "How was it calculated?" rather than, "What is the result?"

The irony here is that the final regulations use the arm's-length standard as a reason to disallow an FTC, even when the transfer pricing result is consistent with the arm's-length standard. The final regulations create double taxation by pointing to the arm's-length standard, which has long been the mechanism for avoiding double tax.

## Brazil's Transfer Pricing Rules

Brazil is known for having unique transfer pricing regulations that are not aligned with international standards or the OECD transfer pricing guidelines. Given the specific requirements and their misalignment with international transfer pricing rules, Brazilian entities must often identify transfer pricing adjustments to be added back to corporate tax basis and taxed at a combined rate (income tax and social contribution) of 34 percent.

[1]Notwithstanding the general rules and requirements above, a foreign levy that would not otherwise constitute a foreign income tax may qualify as such if the levy is treated as an income tax under the relief from double taxation article of an income tax treaty entered into by the United States and the foreign country imposing the levy (and the payer of the levy is a U.S. citizen or resident that elects the benefits of the treaty).

Similarly, a foreign levy paid by a controlled foreign corporation that would not otherwise constitute a foreign income tax may qualify as such if the levy is modified by an applicable income tax treaty between the CFC's country of residence and the foreign country imposing the levy (reg. section 1.901-2(b) or 1.903-1(b)).

[2]Section 482.

The Brazilian regulations specify separate methods for import and export transactions. Except for the comparable uncontrolled price method and two specified methods aimed at testing intercompany transactions involving the commodities market, Brazil's transfer pricing methods do not consider comparability factors or reflect the objective of reaching an arm's-length result. Although the names of the methods sometimes coincide with the methods specified in the OECD transfer pricing guidelines, such as the resale price method or cost-plus method, their application is unique to Brazil and driven by predetermined margins or markups that range from 15 percent to 40 percent.

## Brazil Joining the OECD?

The possibility of Brazil's joining the OECD has been widely publicized in recent years. To get there, its transfer pricing rules would need a major overhaul to align with international norms and adopt the arm's-length standard.

In 2018 the OECD and Brazil launched a joint project evaluating the similarities and divergences between the Brazilian and OECD transfer pricing approaches to valuing cross-border transactions between associated enterprises for tax purposes. Accordingly, the Brazilian tax authority, the Receita Federal do Brasil, has formed a specific team focused on the OECD's tax work that is receiving technical transfer pricing training from the OECD. This is an ongoing project that is expected to be completed within the next few years.

In January the OECD council formally opened accession discussions with Brazil. As part of the accession process, Brazil must comply with approximately 250 requirements, including several distinct topics related to tax and transfer pricing. The OECD's tax work team has stated in no uncertain terms that Brazil must implement the arm's-length principle to be formally accepted as an OECD member country. On April 12 the Receita Federal do Brasil, together with the OECD, publicly presented a detailed set of policy guidelines[3] to be implemented by Brazil, which include the arm's-length standard as the central point.[4] The stated implementation goal in this presentation was to have this new transfer pricing regime operational by 2024.

Some of the important deviations in practical application of Brazilian transfer pricing rules are shown in the table.

**Comparison of Transfer Pricing Regimes**

| Characteristics | OECD Transfer Pricing Guidelines | Current Brazilian Rules |
|---|---|---|
| Subjectivity in the analysis | x | |
| Functional and economic analysis | x | |
| Analysis of net profit by business segment | x | |
| Analysis performed on product-by-product basis | | x |
| Adjustments offset not possible | | x |
| Pre-defined margins/ markups | | x |
| Benchmark analysis | x | |
| Advanced pricing agreements | x | |
| Best-method rule | x | |

## Extra Motivation

By eliminating FTCs for taxes paid in Brazil, the final U.S. regulations increase the cost of doing business in Brazil for U.S. multinationals. As a result, foreign investment in Brazil may suffer unless changes are made to its transfer pricing regime to incorporate the arm's-length standard.

The release of the final U.S. regulations would seemingly provide extra motivation for Brazil to

[3]KPMG, "Brazil: Update on Revisions to Transfer Pricing Rules, Steps Toward OECD Transfer Pricing Guidelines" (Apr. 12, 2022).

[4]Roberto Salles and Kimberly Tan Majure, "Brazilian Transfer Pricing: Here Today, Gone Tomorrow?" 51(6) *Tax Mgmt. Int'l J.* 1 (2022).

accelerate the adoption of the arm's-length standard and possibly even entry into the OECD. But much remains uncertain. Although Brazil's current government has good momentum toward joining the OECD, future elections could hinder that momentum or even put a halt to it altogether. In the meantime, U.S. multinationals should consider the implications of losing FTCs for taxes paid in Brazil and keep a close eye on whether the arm's-length standard in Brazil can become a reality.[5] ■

[5] The foregoing information is not intended to be "written advice concerning one or more Federal tax matters" subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the author(s) only, and does not necessarily represent the views or professional advice of KPMG LLP.

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