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International Tax Watch

The Arm's Length Principle Comes to Brazil—Does Creditability Come with It?

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On December 28, 2022, the Brazilian executive branch promulgated Provisional Measure No. 1,152,[1] containing new rules (the "Proposed Transfer Pricing Rules") that, once enacted, would amend Brazil's corporate income tax law to apply the arm's length principle to related party transactions. The enactment of the Proposed Transfer Pricing Rules would conform Brazil's transfer pricing regime to the standards established by the Organisation for Economic Cooperation and Development ("OECD").[2]

The Proposed Transfer Pricing Rules represent a major policy shift for Brazil's corporate income tax system and push Brazil closer to OECD membership.[3] They also appear to address a fundamental issue that prevented the Brazilian corporate income tax from qualifying as a creditable foreign income tax for U.S. federal income tax purposes. A key question, however, is how the effective dates affect the creditability of this tax. The Proposed Transfer Pricing Rules provide that the new transfer pricing regime is to be considered by the National Congress of Brazil for formal enactment later in 2023 and is not effective until January 1, 2024.[4] In the meantime, however, the Proposed Transfer Pricing Rules permit taxpayers to elect into the regime for the 2023 tax year. This article considers the separate levy and noncompulsory payment analysis that could affect the Brazilian corporate income tax's U.S. creditability analysis during this one-year transition period.[5]

Creditability Crackdown

At the end of 2021, the U.S. Treasury Department ("Treasury") and the Internal Revenue Service (the "Service") released (and published in the Federal Register in early 2022) final foreign tax credit regulations that purported to address foreign governments' disregard of "international taxing norms to claim additional tax revenue, resulting in the adoption of novel extraterritorial taxes that diverge in significant respects from U.S. tax rules and traditional norms of international taxing jurisdiction."[6] The final regulations substantially altered important aspects of the "net gain requirement" for foreign taxes to qualify as "income taxes" eligible for a foreign tax credit under Code Sec. 901. These revised standards for the basic creditability of many foreign taxes caused widespread taxpayer uproar.

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The final regulations were not Treasury's first foray into tinkering with the interpretation of Code Sec. 901. Proposed regulations issued in November 2020 introduced changes to the foreign tax regulations that included tightening the net gain requirement and adding a jurisdictional nexus requirement.[7] At a high level, the 2020 proposed regulations would have revised the net gain requirement and particularly the regulatory tests for realization, gross receipts, and net income (cost recovery) (in Reg. §1.901-2(b)(2), (3), and (4), respectively) for qualification as an income tax in the United States. The proposed jurisdictional nexus rule caused the biggest stir. That rule would have directly affected the creditability of "digital services taxes" and any eventual tax imposed under Pillar One of the OECD/G20 Inclusive Framework.[8] The nexus rule would have looked to "traditional" notions of nexus (*i.e.*, a nonresident's activities occurring physically in the foreign country) to determine whether the amount of income subject to tax bore a sufficient connection to that foreign country.

The Elective Regime presents an opportunity for willing taxpayers to apply a version of the Brazilian corporate income tax that would conform to Treasury's new requirements in the regulations under Code Sec. 901.

The proposed changes, in particular the jurisdictional nexus requirement, resulted in taxpayers submitting numerous comment letters for Treasury's review. More than a year after the proposed regulations were issued, Treasury released a final regulation package, which attempted to respond to comments by "clarifying" the application of the requirements for qualification as an income tax. The basic outline of the requirements remained the same as in the proposed regulations—a tax must satisfy the "net gain requirement," encompassing the realization, gross receipts, and cost recovery requirements. However, the final regulations made some additional, surprising changes to these tests, in particular the cost recovery requirement. In addition, the final regulations replaced the jurisdictional nexus requirement with the "attribution requirement."[9]

Under the final regulations, to qualify as a foreign income tax, a foreign levy must satisfy the attribution requirement. The attribution requirement provides that the amount of gross receipts and costs included in the base of the foreign levy must be determined based on one of the two sets of rules.[10] Which rules a foreign levy must satisfy depends on whether the taxpayer is a resident or nonresident of the foreign country imposing the foreign levy. A foreign levy imposed on nonresidents of a foreign country is examined on the basis of whether the gross receipts and costs that make up the tax base are attributable to the taxpayer's activities in the foreign country, arise from sources in the foreign country (as determined under rules that are "reasonably similar to the sourcing rules that apply under the Internal Revenue Code"), or are attributable to a disposition of property located in the foreign country.[11]

A foreign tax law imposing a levy on residents, on the other hand, "must provide that any allocation to or from the resident of income, gain, deduction, or loss with respect to transactions between such resident and organizations, trades, or businesses owned or controlled directly or indirectly by the same interests (that is, any allocation made pursuant to the foreign country's transfer pricing rules) is determined under the arm's length principles, without taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion."[12] While the preamble to the final regulations did not discuss the attribution rule for foreign taxes imposed on residents in any detail, the broader context for Treasury's adoption of the requirement was Treasury's reaction to the proliferation of "novel extraterritorial taxes" that eschewed "consensus-based norms" regarding physical nexus or allocations of income based on the location of functions, assets, and risks—as opposed to customers.[13]

Taxpayers expressed concern that the final regulations' new interpretation of the requirements for an income tax would result in many foreign taxes—which had previously been creditable without controversy—being ineligible for a foreign tax credit. For example, the Alliance for Competitive Taxation commented that the new rules' reach extended beyond the stated target of extraterritorial taxes:

> The original impetus for these regulations was to deny a U.S. foreign tax credit for novel extraterritorial taxes, such as digital services taxes (DSTs), which were considered outside the internationally recognized income tax system and a discriminatory tax similar to a tariff imposed by foreign jurisdictions. However, the Final

Regulations go well beyond this original purpose and will deny foreign tax credits for taxes that have nothing to do with DSTs and that have been creditable for many years.[14]

It is likely that Treasury's concern with foreign transfer pricing rules that used formulary apportionment, as articulated in the preamble to the 2020 proposed regulations, formed the basis for the arm's length requirement in the attribution rule for taxes imposed on residents.[15] Even if the attribution requirement was established to address foreign countries' unilateral measures taxing income on the basis of customer location, however, the broadly drafted rule appeared to sweep in foreign corporate income taxes that had no such extraterritorial basis. Taxpayers specifically cited Brazil's corporate income tax as one such foreign tax that appeared to fail the attribution requirement for taxes on residents, given the requirement that a foreign country's transfer pricing regime comply with the arm's length principle.[16]

Brazil's Transfer Pricing System and the Proposed Transfer Pricing Rules

The modern arm's length principle for transactions between related parties originates from international efforts to address double income taxation while mitigating abusive transfer pricing.[17] Technological innovation, the 2008 financial crisis, and advanced tax planning strategies[18] created the "first structural crisis of the [international tax regime] since the 1920s" and subsequently, in 2013, led to joint cooperation by the G20 nations and OECD on adoption of the arm's length principle worldwide.[19] Until now, Brazil's income tax law did not contain transfer pricing rules that adhered to the arm's length principle found in the OECD's transfer pricing guidelines. Brazil introduced its transfer pricing regime with Law No. 9,430 (the "1997 Law"), effective January 1, 1997. The 1997 Law did not establish any arm's length principle for determining pricing between related parties. Instead, the 1997 Law determined pricing through statutorily fixed margins. For example, the 1997 Law established the "resale price less profit method," which determined pricing benchmarks by reference to a fixed margin rather than any arm's length comparable transaction.[20] Statutorily fixed margins offered a developing country like Brazil several benefits. In particular, they promoted simplicity and certainty by allowing taxpayers to mathematically determine a pricing benchmark without a search for comparable transactions, and thus bypass information scarcity on comparable transactions. A fixed margin approach also removed the need for subjective determinations by tax officials, thereby reducing administrative costs, the temptation for corruption, and the potential for litigation.[21]

Nearly 26 years after the 1997 Law, Brazil issued by presidential decree the Proposed Transfer Pricing Rules as part of a multi-year effort to accede to the OECD and gain the benefits of membership.[22] In 2017, Brazil initiated accession discussions with the OECD.[23] After almost five years of negotiations and planning, on January 25, 2022, the OECD Council formally invited Brazil to open accession discussions.[24] As part of this accession, the OECD will review Brazil's elimination of double taxation through the primacy of the "arm's length" principle as set forth in the OECD's transfer pricing guidelines.[25] In April 2022, Brazil announced that it was close to finalizing legislation that would harmonize Brazil's transfer pricing regime with the OECD guidelines—an example of Brazil's increasing conformity with OECD guidelines, especially compared to other OECD prospects.[26]

It is reasonable to conclude that Brazil's compliance with Treasury's demands has made the modified Brazilian corporate income tax a creditable income tax for those taxpayers that elect to apply it for the 2023 transition year.

The Proposed Transfer Pricing Rules represent a dramatic step toward Brazil's accession to the OECD, setting forth the primacy of the arm's length principle through calculating the taxation of "controlled" transactions by reference to comparable transactions between unrelated parties.[27] The Proposed Transfer Pricing Rules do not incorporate the OECD transfer pricing guidelines by reference, but they set forth a framework that appears to be generally consistent with those guidelines.[28] Furthermore, the Proposed Transfer Pricing Rules would discard the fixed statutory margins of the 1997 Law. It is possible

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that the specific formulation of the rules as enacted and interpreted could change over the course of the legislative and regulatory process—as it is often said, the devil is in the details. Assuming the Proposed Transfer Pricing Rules are enacted into law, they will apply to all taxpayers effective January 1, 2024. Starting January 1, 2023, however, taxpayers may elect to follow the Proposed Transfer Pricing Rules.

In a letter to the President of Brazil explaining the motivations behind the Proposed Transfer Pricing Rules,[29] the Executive Secretary of the Ministry of Finance, Marcelo Pacheco dos Guaranys, made it clear that the reasons behind promulgating the Proposed Transfer Pricing Rules were: (i) the loss of foreign direct investment resulting from the U.S.' policy change to make the Brazilian corporate income tax non-creditable; (ii) strengthening the Brazilian corporate tax system; (iii) facilitating OECD accession; (iv) bolstering the collection of taxes, particularly those lost due to base erosion and profit shifting; and (v) preventing double taxation resulting from the allocation of income to Brazilian taxing jurisdiction and allocation of the same income, under another country's application of the arm's length standard, to that other country.

Where Do Electing Taxpayers Stand in 2023?

As recently as December 2022, business groups have petitioned Treasury to reverse course on the final regulations' arm's length requirement for taxes imposed on residents, citing "the growing … risk they pose to the commercial viability of U.S. foreign direct investment in Brazil, a major U.S. trading partner."[30] A new set of proposed regulations that came out in November 2022 addressed a number of complaints with respect to the attribution rule for taxes imposed on non-residents, the cost recovery requirement, and certain other matters in the final regulations.[31] But Treasury has shown no sign of relenting on the arm's length requirement for foreign taxes imposed on residents.

This leaves U.S. multinationals with Brazilian subsidiaries in something of a quandary for 2023, the period before Brazil plans to make the new arm's length standard mandatory for all corporate taxpayers, but during which taxpayers may elect to apply the forthcoming regime (the "Elective Regime"). Taxpayers may wonder—is the Brazilian corporate income tax as applicable under the Elective Regime creditable?

This question invokes other aspects of the Code Sec. 901 regulations that go to a criterion even more basic than whether a levy is an income tax. That is, we must ask when a levy is considered a single levy in the first place. Specifically, it matters whether one tax constitutes a "separate levy" that may be assessed on its own, and separate from, another levy. This is important in Brazil's case because, under current Brazilian law, presumably the corporate income tax does not constitute a creditable income tax. Thus, if the Elective Regime for 2023 is considered the same levy as the corporate income tax, it is questionable whether its creditability may be assessed separately from the creditability of the corporate income tax under current law. If the Elective Regime is not considered a separate levy, it is possible that a payment under the Elective Regime would not be viewed as a creditable income tax, notwithstanding the Proposed Transfer Pricing Rules' express intention to alter the Brazilian corporate income tax to comply with U.S. creditability requirements. Below we discuss several considerations in connection with the treatment of the Provisional Measure's Elective Regime as a separate levy that is a creditable income tax.

A foreign levy is a separate levy if "it is described in paragraph (d)(1)(i), (ii), (iii), or (iv) of [Reg. §1.901-2]." Three of the four would not apply to the Elective Regime. These include a levy imposed by one taxing authority as opposed to another taxing authority,[32] a levy imposed on nonresidents as opposed to one imposed on residents,[33] and a levy that is limited or modified by an income tax treaty to which the foreign country imposing the levy is a party *versus* the levy imposed under the domestic law (without regard to the treaty) of the foreign country.[34] A foreign levy is also a separate levy, however, when it has a different taxable base from that of another levy.[35] The application of this rule in the Elective Regime context is less clear.

The regulations also provide a special rule for contractual modifications. Specifically, under Reg. §1.901-2(d)(2), if a foreign country enters a contract with a taxpayer where that contract alters the foreign levy the country imposes, then Treasury deems every altered levy afterwards imposed to constitute a separate levy for all persons to whom the contractual modification applies.[36] It is therefore worth considering whether Brazilian taxpayers opting into the Elective Regime have made a "contractual modification," as agreed with the Brazilian government, to the applicable corporate income tax law.

To summarize, the Elective Regime could be evaluated as a levy separate from the current law corporate income tax either because the base of the tax under the Elective Regime is computed differently for different classes of persons subject to the Elective Regime, or because making the election constitutes a contractual modification. The

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discussion below assesses, at a high level, potential merits and drawbacks of these two approaches.

Different Tax Bases

The single paragraph of Reg. §1.901-2(d)(1)(ii) provides something of a laundry list of situations in which a levy constitutes or does not constitute a separate levy because of the taxable base, some of which are worth considering in the context of the Elective Regime. In the first situation, where the base of a foreign levy is computed differently for different classes of persons subject to the levy, the levy is considered to impose separate levies with respect to each class of persons. The regulations provide that, for example, foreign levies identical to the taxes imposed by Code Secs. 1 (individual income tax), 11 (corporate income tax), 541 (personal holding companies), 871(a) (non-effectively connected income ("non-ECI") of non-residents), 871(b) (nonresidents' ECI), 881 (non-ECI of foreign corporations), 882 (foreign corporations' ECI), 3101 (Federal Insurance Contributions Act ("FICA") taxes), and 3111 (employer FICA taxes) are each separate levies, because the levies are imposed on different classes of taxpayers, and the base of each of those levies contains different items as compared with the base of each of the others. Income included in the taxable base of a separate levy may also be included in the taxable base of another levy (which may or may not also include other items of income). Levies are not separate merely because different rates apply to different classes of taxpayers that are subject to the same provisions in computing the base of the tax. And, in general, levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy.

While these guidelines are somewhat helpful, they can be hard to apply without concrete examples. In addition, nowhere do the regulations define what is meant by "different classes of persons," although the list of Code sections that provide analogies to foreign separate levies indicates how taxpayers may be divided into classes. Some of the examples in Reg. §1.901-2(d)(3) provide additional insight into the parameters for separate levy status when taxes are imposed on different bases, as well as what is meant by separate classes of taxpayers. In Example 6, Country X imposes a net income tax as well as an alternative minimum tax. The taxable base for the minimum tax is the same as that of the regular tax, increased for certain disallowed deductions. The example concludes that the regular tax and minimum tax are separate levies, as each levy's taxable base is computed separately and not combined as a single taxable base. The Example also expressly provides that the separate levy "result would be the same if under Country X tax law the Minimum Tax equaled the alternative minimum taxable income times the Minimum Tax rate, and residents of Country X were required to pay the greater of the Income Tax or the Minimum Tax (rather than the Income Tax plus the excess, if any, of the Minimum Tax over the Income Tax)."

Contrast Example 9, in which Country X imposes a net income tax on resident corporations. The taxable income computation for the income tax places a cap on allowed interest deductions for companies engaged in the extraction, production, or refinement of oil or natural gas. The corporations engaged in these particular business activities are likely viewed as a "class" of taxpayers (as they are in Example 10, discussed below). The example concludes, however, that the income tax as applied to corporations engaged in these activities is not a separate levy from the income tax as applied to other corporations subject to the levy. While the example does not state it explicitly, the reasoning that can be inferred from Example 10, below, is that all taxpayer classes must compute their income according to the single computation prescribed under the income tax, and the separate class of taxpayer merely alters *the same* computation by limiting its interest deduction. Thus, the income tax is a single levy in spite of the interest expense deduction cap applying only to some, but not all, corporations subject to the income tax.

In Example 10, Country X imposes a net income tax and an oil tax. The oil tax applies only to resident corporations engaged in the extraction, production, or refinement of oil. Resident corporations subject to the oil tax are not subject to the income tax. The taxable base under the oil tax is the same as that for the income tax, increased by disallowed interest expense. Unlike Example 9, Example 10 concludes that the oil tax is a separate levy from the income tax. The rationale for this conclusion is that the taxable income under the oil tax is not combined with the taxable income under the income tax as a single taxable base. Rather, the levies are imposed separately with respect to different classes of taxpayers, each of which must compute its tax liability under either the income tax or the oil tax, and the base of each of those levies contains different items. This is the case even though the taxable income base for both levies is substantially the same, with the only difference being the disallowance of interest expense deductions under the oil tax.

The reasoning in Rev. Rul. 2011-19[37] may elucidate further the basis for finding a separate levy where the taxable base differs for different classes of taxpayers. It should be noted that the revenue ruling based its analysis

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on the regulations that predated the final regulations issued in 2022, and that the standard articulated in those regulations required that the taxable base of one levy be "different in kind, and not merely in degree" from the other levy.[38] The revenue ruling evaluated whether the United Kingdom's long-term non-domiciliary levy (the "Non-Domiciliary Levy") constituted a separate levy as compared to the generally applicable individual income tax. The Non-Domiciliary Levy generally allowed individuals who were U.K. residents but who were not permanent residents (non-domiciliaries) to elect each year to be taxed on an alternative basis. By default, U.K. individuals were subject to income and capital gains taxes on their worldwide income and capital gains. Under the Non-Domiciliary Levy, non-domiciliaries with non-U.K.-source income or gains could elect to be taxed on their non-U.K.-source income and gains only when "remitted" to the United Kingdom. Importantly, this meant that the income and gains would be subject to tax only in the year of remittance, even if those items arose in previous taxable years. Electing non-domiciliaries would also be subject to tax on their U.K.-source income and gains under the separate statutory income tax provisions applicable to all U.K. resident individuals, in the taxable year in which such items arose. Special rules also applied to certain categories of taxpayers electing into the Non-Domiciliary Levy. U.K.-source, remitted non-U.K.-source, and other specially identified income or gains, although separately computed, were combined into a single base and taxed at the graduated rates of U.K. income or capital gains tax that are generally applicable in the relevant tax year.

The Service ruled that the Non-Domiciliary Levy constituted a separate levy under U.S. tax principles. This is understandable, considering the analogous U.S. separate levies applicable to nonresidents' ECI *versus* non-ECI in Code Sec. 871(a) and (b). The ruling recognized that both the regular income tax and the Non-Domiciliary Levy taxed U.K.-source and non-U.K.-source income and gains. An important difference, however, was that the regular income tax imposed tax on worldwide income and gains that arose or accrued in a particular taxable year. In contrast, the Non-Domiciliary Levy subjected income to tax only on U.K.-source income and gains and on non-U.K.-source income or gains that were remitted in a particular taxable year, regardless of the year in which such items arose or accrued. Thus, the taxable bases of these levies were "different in kind, and not merely in degree." The Non-Domiciliary was therefore considered a separate levy from the regular income tax.

In proposing regulations in 2020, Treasury determined that the regulatory rule that applied in Rev. Rul. 2011-19—that the base of the separate levy must be different in kind, and not merely in degree—created an "unclear" standard, as the same rule (in the very same sentence) also found separate levies so long as different classes of taxpayers were subject to each levy, "regardless of whether the base of two levies is different in kind."[39] The 2020 proposed regulations attempted to clarify this standard by identifying "separate levies as those that include different items of income and expense in determining the base of the tax, but in certain circumstances separate levies may result even if the taxable base of each levy is the same."[40] Thus, the general rule for separate levy status did not necessarily—but could—depend on each levy's application to a separate class of persons. Another implication of the change was that, if the taxable base is different as applied to different taxpayers, those taxpayers are considered to be in "separate classes" as a result of that different treatment.[41] The final regulations issued in 2022 implemented these changes to the separate levy rules.[42]

The Elective Regime, when analyzed under this framework, could be interpreted to be analogous to Example 10. In Example 10, different classes of taxpayers were subject to levies that did not combine the taxable base. This was the case even though the ultimate numerical outcome of the oil tax levy—the cap on interest deductions on taxpayers in the oil business—was the same result as that in Example 9. The difference was that all of the taxpayers in Example 9 computed their income for the same corporate income tax—and then the oil and gas taxpayers merely altered their computation for that same corporate income tax with respect to a single item because companies engaged in the extraction, production, or refinement of oil or natural gas were subject to a cap on interest deductions. It is conceivable that the taxpayers opting into the Elective Regime, constituting a separate class of taxpayers, are now subject to a modified version of the corporate income tax—one that applies the arm's length standard for related party transactions—as compared to the class of taxpayers that remain subject to the regular corporate income tax until the arm's length rules become mandatory in 2024.

It is admittedly unclear, however, whether the electing corporate taxpayers would be considered a "different class" compared to the non-electing corporate taxpayers. All of the relevant taxpayers, whether making the election or not, are Brazilian corporations without any characteristics that would obviously differentiate one type from

another—in contrast to, say, the oil and gas companies *versus* all other companies in Example 10. Interestingly, Reg. §1.901-2(d)(1)(ii) does list as examples levies that apply to the same class of taxpayer—for example, nonresident individuals in Code Sec. 871(a) and (b), or foreign corporations in Code Secs. 881 and 882—but that are nevertheless considered separate levies because they subject those taxpayers to tax on different types of income (ECI *versus* non-ECI). Likewise, Rev. Rul. 2011-19 deals with a single class of taxpayer, non-domiciliaries, but the ruling involves separate levies because one levy applied a different system of taxation with respect to non-U.K.-source income. This implied lack of emphasis on the different class prong of the rule indicates, consistent with the preamble to the 2020 proposed regulations, that having classes of taxpayers that fall into discrete identifying categories (*e.g.*, according to industry, residential status, *etc.*) is not critical for a separate levy determination. It can be the different application of the tax rules, as in Rev. Rul. 2011-19, that differentiates between one type of taxpayer and another type of taxpayer. Thus, it is conceivable that the single class of Brazilian corporations could be sufficiently differentiated because of their separate status of electing, or not electing, to subject themselves to a different taxation regime in the form of the Proposed Transfer Pricing Rules.

Importantly, the regulations provide that "[i]ncome included in the taxable base of a separate levy may also be included in the taxable base of another levy (which *may or may not* also include other items of income)." The emphasized language suggests that the tax bases of two separate levies may look substantially identical. Thus, while the Elective Regime applies to the same items of income that are taxed under the regular income tax, the Elective Regime subjects those items to an alternate method of calculation (i.e., the arm's length principle) and could still constitute a separate levy.

Contractual Modification

The contractual modification rule has been a part of the Code Sec. 901 regulations for 40 years, and the final regulations issued in 2022 did not materially alter the rule.[43] The regulations, unfortunately, do not provide any examples illustrating the application of the contractual modification rule. The Service has evaluated the contractual modification rule in several instances of non-precedential guidance.[44] Generally, these private letter rulings address taxpayer-specific agreements entered into with a foreign country. For example, in LTR 9835008, the Service seemed to conclude that the taxpayer, who derived income from oil and gas exploration and production and entered into an agreement with a foreign country, was subject to the regular tax laws of the foreign country as amended by a "schedule" to the income tax law:

> Profits and gain from oil and gas exploration and production are taxable under the general rules of the Tax Law, as adjusted under a separate schedule ("Schedule") dealing with oil and gas taxation. The Schedule provides that where any person (including a corporation) carries on or is deemed under an agreement with Country X to carry on any business which consists of or includes exploration and production of petroleum, the profits or gains of such shall be computed separately from the income, profits or gains from any other business. Furthermore, the sum of payments to Country X and taxes on income subject to the provisions of the Schedule shall be as provided for in the agreement with the assessee.

Applying the same rationale, it may be arguable that a taxpayer that applies the Elective Regime is entering into an agreement with the Brazilian government to modify the corporate income tax as applied to electing taxpayers, even if in general the Elective Regime is treated as the same levy as the generally applicable corporate income tax. If the Service interprets the provision narrowly and insists on hewing to fact patterns similar to those that were the subject of the available non-precedential guidance, however, it is possible that a taxpayer opting into the Elective Regime would not be treated as entering into a "contract" in the manner contemplated by the contractual modification rule. In that case, the Service may require some kind of separate, formal contract or agreement, similar to those entered into in the private letter rulings. There is no indication, as of yet, that taxpayers electing to apply the Proposed Transfer Pricing Rules would do so by entering into an actual agreement with the Brazilian tax authority. If the Brazilian government truly is motivated to enable foreign investors to claim a U.S. foreign tax credit with respect to taxes paid under the Elective Regime, it may consider establishing some type of formal agreement mechanism so that U.S. taxpayers may establish that they effected a contractual modification of the corporate income tax. Even absent this kind of formal process, however, it seems reasonable that the contractual modification rule could be interpreted more broadly to view the election, itself, as an agreement

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between the taxpayer and the Brazilian government. That is, the taxpayer agrees to apply the Proposed Transfer Pricing Rules, and Brazil agrees to apply the arm's length principle as proposed in those rules. This seems to be a reasonable interpretation, particularly considering the dearth of guidance establishing the boundaries of what is meant by a "contractual modification."

Compulsory Payment

Assuming the Elective Regime is a creditable income tax, the question arises as to whether electing into the Elective Regime causes a taxpayer to pay a noncompulsory amount in excess of foreign tax liability that is not treated as a creditable foreign income tax under Reg. §1.901-2(e)(5). A taxpayer may establish that a payment is compulsory by satisfying a two-pronged test. First, the foreign payment must be determined by the taxpayer in: (a) a manner consistent with a "reasonable interpretation and application of the substantive and procedural provisions of foreign tax law," and (b) in such a way as to reduce, over time, the taxpayer's "reasonably expected" foreign tax liability. Second, the taxpayer must exhaust all "effective and practical remedies," to reduce, over time, the taxpayer's foreign tax liability. A taxpayer is permitted to take costs into account in determining whether it has exhausted all effective and practical remedies to reduce foreign tax liability. In particular:

> [A] taxpayer is not required to reduce its foreign income tax liability to the extent the reasonably expected, arm's length costs of reducing the liability would exceed the amount by which the liability could be reduced. For this purpose, such costs may include an additional liability for a different foreign tax (but not U.S. taxes) that is not a foreign income tax only to the extent the amount of the additional liability is determined in a manner consistent with [the non-compulsory payment rules].[45]

Where the foreign tax law provides an option or election whereby an electing taxpayer would permanently decrease its foreign income tax liability, generally, the taxpayer is obligated to make the election.[46] Thus, if electing into the Elective Regime causes a taxpayer to *increase* its foreign income tax liability, and defaulting to the regular, non-creditable corporate income tax *decreases* foreign income tax liability, a taxpayer's election to apply the Elective Regime appears to run afoul of the requirement that a taxpayer minimize its foreign tax liability.

The regulations provide an example, however, permitting a taxpayer to elect to pay a creditable foreign income tax where the alternative option would be paying a higher non-creditable tax.[47] In the example, corporations resident in Country X are subject to two levies: (1) a 20% corporate income tax that is a creditable foreign income tax for U.S. tax purposes and (2) a "base erosion tax," qualifying as a separate levy, equal to 25% of certain deductible payments above a specified threshold made to related parties that are not residents of Country X. CFC, a Country X corporation, makes payments to nonresident related parties $100 in excess of the base erosion tax's specified threshold. If CFC claimed the payments as deductions, it would result in $25 of base erosion tax liability, and CFC would have $60 of income tax liability. On the other hand, if CFC elected to forgo the deductions, CFC's base erosion tax liability would be zero, but its income tax liability would increase to $80. Thus, the taxpayer had to choose between a $25 increase to its non-creditable tax liability or a $20 increase to its creditable tax liability.

The example concludes that CFC's decision to increase its liability for the creditable income tax does not create a noncompulsory payment even though CFC could opt, instead, to deduct payments that trigger liability for a non-creditable tax. Note, however, that in this example the total incremental non-creditable tax ($25) is greater than the total incremental creditable tax ($20). Put another way, the example permits a taxpayer to increase its creditable income tax liability, provided the total tax cost from doing so is less than opting to pay the non-creditable tax ($80 of income tax *versus* $85 of total liability for income and non-income tax). The result is therefore consistent with the regulations' allowance for a taxpayer to take costs—including non-income tax costs—into account in minimizing its foreign income tax liability. If the incremental income tax liability were higher than the alternative non-creditable tax liability, however, the additional income tax liability would be a noncompulsory payment and, thus, non-creditable.[48]

Applying this analysis to the Elective Regime, assuming it is a separate levy that is an income tax, the regulatory example indicates that a taxpayer may apply the Elective Regime, provided it is trading a higher non-income tax amount for a lower income tax amount. The example discussed above shows that a taxpayer appears to have a clear path to crediting income tax even when the taxpayer elects to pay income tax that would have been zero absent the election, provided the total tax and cost burden is less than not making the election. It is plausible that many taxpayers will see their aggregate Brazilian income tax liability under the Elective Regime *decrease* relative to their

tax liability under the current rules that apply fixed margins. Establishing this as a matter of fact would be helpful for those taxpayers seeking to claim a foreign tax credit under the Elective Regime. Given the complexities and interdependencies of the Brazilian tax system, this could be a complex exercise—for example, applying the arm's length principle could result in deductible payments out of Brazil, which could in turn trigger additional withholding and value-added tax liability. But even in cases where the income tax amount under the Elective Regime is the same or higher than the non-income tax amount, it would be an absurd result for the United States to penalize taxpayers electing into a foreign corporate income tax regime that strives to comply with the rules that Treasury itself has set forth as establishing the only acceptable standard for a corporate income tax.

Conclusion

The Elective Regime presents an opportunity for willing taxpayers to apply a version of the Brazilian corporate income tax that would conform to Treasury's new requirements in the regulations under Code Sec. 901. It is reasonable to conclude that Brazil's compliance with Treasury's demands has made the modified Brazilian corporate income tax a creditable income tax for those taxpayers that elect to apply it for the 2023 transition year. This would clearly be the right approach, given Brazil's status as a major trading partner with the United States and Brazil's unequivocal stated intent to comply with the U.S. rules as quickly as possible. Nevertheless, the technical analysis with respect to the Elective Regime's status as a separate levy, as well as potential issues under the noncompulsory payment rules, raise some questions as to whether the Elective Regime can be treated as a creditable foreign income tax.

We recommend that Treasury and the Service clarify in guidance that the Elective Regime is creditable. Very recently, the Service issued similar guidance when there was uncertainty about the creditability of taxpayers' electing into a creditable foreign income tax when the alternative option became non-creditable. In 2011, the Service issued a notice provisionally allowing taxpayers to take the position that the Puerto Rican excise tax was creditable.[49] After the final regulations were issued in 2022, the Puerto Rican excise tax was non-creditable. The Service issued Notice 2022-42,[50] revoking the 2011 notice and providing additional interim guidance pending the issuance of new proposed regulations. Notice 2022-42 provided that the Service would not determine that taxpayers made noncompulsory payments if they amended their existing tax decrees, agreed with Puerto Rico, to replace the existing income tax and royalty withholding tax framework with a new income tax and royalty withholding tax framework meeting the creditability requirements. We urge the Service to issue a similar notice granting creditability, and not challenging compulsory payment status, for the Elective Regime. Alternatively, Treasury and the Service should delay applicability of the attribution rule as applied to foreign taxes imposed on residents to January 1, 2024. As U.S. multinational companies are already underway computing their first quarter tax provisions for 2023, this guidance cannot come quickly enough.

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ENDNOTES

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1 Medida Provisória No. 1.152, de 28 de Dezembro de 2022 [Provisional Measure No. 1,152, of December 28, 2022], *www2.camara.leg.br/legin/fed/medpro/2022/medidaprovisoria-1152-28-dezembro-2022-793582-publicacao original-166687-pe.html*.

2 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022 29–91 (Jan. 2022), *www.oecdilibrary.org/docserver/0e655865en.pdf?expires=1673907488&id=id&accname=oid162118&checksum=20CD0196C2BE7F6AB8B56DFCBBA10805*.

3 Accession to the OECD would reduce the premium demanded by foreign investors for financing the Brazilian public debt, and signal Brazil's adoption of market-friendly policies. *See* Tatiana Falcão, *Is Brazil's Tax System Ready for OECD Accession?*, 89 Tax Notes Int'l 181, 181 (Jan. 8, 2018).

4 It is unclear whether President Luiz Inácio Lula da Silva will prioritize the accession process Brazil has followed in recent years. *See* Leanna Reeves, *TP Directors Fear Brazil-OECD Alignment Delays After Lula Win*, Int'l Tax Rev. (Nov. 3, 2022), *www.internationaltaxreview.com/article/2au6ivew5tfz2w0lenim8/tp-directors-fear-brazil-oecd-alignment-delays-after-lula-win*.

5 We note that the stated purpose of the Proposed Transfer Pricing Rules to make the Brazilian corporate income tax a creditable income tax for U.S. tax purposes, which could conceivably raise a soak-up tax issue. In addition, the Proposed Transfer Pricing Rules contain provisions that would deny deductions for certain royalty payments, which could raise additional questions about whether the Proposed Transfer Pricing Rules satisfy the arm's length principle. Analysis of these additional matters is outside the scope of this article.

6 T.D. 9959, IRB 2022-2, 328.

7 Proposed Reg. §1.901-2, 85 FR 72078, 72131–72139 (Nov. 12, 2020). Commentators, including the authors, have published numerous pieces examining the noteworthy changes proposed in 2020. *See, e.g.*, Julia Skubis Weber *et al.*, *Three Taxes, Two Pillars, One Credit?*, 48 Int'l Tax J. 59, 59–67 (2022).

8 Proposed Reg. §1.901-2(c), 85 FR 72078, 72133 (Nov. 12, 2020).

9 Reg. §1.901-2(b)(1).

10 Reg. §1.901-2(b)(5).

11 Reg. §1.901-2(b)(5)(i).

12 Reg. §1.901-2(b)(5)(ii).

13 T.D. 9959, IRB 2022-2, 328.

14 Letter to Secretary of the Treasury Janet Yellen, All. for Competitive Tax'n 1 (Feb. 24, 2022),

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www.actontaxreform.com/media/gpuh55nj/act-letter-to-treasury-2021-final-ftc-regs_20220224-final.pdf.

[15] 85 FR 72078, *supra* note 8, at 72088 ("Foreign transfer pricing rules that allocate profits by taking into account as a significant factor the location of customers, users, or any other similar destination-based criterion will not satisfy the jurisdictional nexus requirement. Comments are requested on whether special rules are needed to address foreign transfer pricing rules that allocate profits to a resident on a formulary basis (rather than on the basis of arm's length prices), such as through the use of fixed margins in a manner that is not consistent with arm's length principles.").

[16] *See id.* ("For example, there is significant concern as to whether the Brazilian income tax or the services and royalty withholding taxes imposed by many South American countries would be creditable under the Final Regulations.").

[17] *See* Eduardo Baistrocchi, *The International Tax Regime and Global Power Shifts*, 40 Va. Tax Rev. 219, 234–43 (Winter 2021). The arm's length principle was first crystallized by a League of Nations draft in 1933, and was first adopted by the OECD in 1963. *Fiscal Committee Report to the Council on the Fourth Session of the Committee art. 5*, League of Nations Doc. C.399M.204 1933 II. A. (1933); OECD, Draft Double Taxation Convention on Income and on Capital 47 (Oct. 19, 1963), *www.oecd-ilibrary.org/docserver/9789264073241en.pdf?expires=1673720490&id=id&accname=oid162118&checksum=9512EF8FFE3A6733D83920C3EB5B5C93*.

[18] *See, e.g.*, Romero J.S. Tavares *et al.*, *The Intersection of EU State Aid and U.S. Tax Deferral: A Spectacle of Fireworks, Smoke, and Mirrors*, 19 Fla. Tax Rev. 121, 123 (2016) ("[A]llegation[s] that … firms avoided billions of dollars of U.S. (and possibly non-U.S.) tax was documented and brought to the public eye by the U.S. and U.K. legislatures in 2012. These events and resulting public outrage … prompted G20 leaders to call on the OECD in November 2012 …").

[19] *See* Baistrocchi, *supra* note 18, at 251–54.

[20] Under the Brazil resale price method, a 20–40% gross profit margin is required for certain industries whenever a Brazilian company incurs deductible import prices relating to acquisition of property, services, or rights from a foreign related party. *PKF Transfer Pricing Documentation Standards 2020/21*, PKF Int'l Ltd. 30 (Dec. 15, 2020), *www.pkf.com/media/mi4djoay/tp-documentation-standards-2020-21-v1.pdf*.

[21] Tatiana Falcão, *Ask Not What the OECD Can Do For Brazilian Transfer Pricing*, 96 Tax Notes Int'l 163, 164 (Oct. 14, 2019).

[22] *See id.*

[23] Stephanie Soong Johnston, *OECD, Brazil to Discuss Tax and Accession Process, Saint-Amans Says*, Tax Notes (Aug. 29, 2017), *www.taxnotes.com/beps-expert/international-taxation/oecd-brazil-discuss-tax-and-accession-process-saint-amans-says/2017/08/29/1w9w6*.

[24] OECD Council, Roadmap for the OECD Accession Process of Brazil 2 (June 10, 2022), *www.oecd.org/latin-america/Roadmap-OECD-Accession-Process-brazil-EN.pdf*.

[25] *Id.* at 15.

[26] *See* Tatiana Falcão, *supra* note 22, at 182 ("Some countries accede slowly because it takes them a long time to change domestic legislation to conform to OECD-based practices. Brazil, however, has a high index of conformity with OECD rules—58 percent of its rules are compatible."); Stephanie Soong Johnston and Alexander F. Peter, *Brazil Drafting Law for OECD-Aligned Transfer Pricing Revamp*, Tax Notes (Apr. 13, 2022), *www.taxnotes.com/tax-notes-today-international/transfer-pricing/brazil-drafting-law-oecd-aligned-transfer-pricing-revamp/2022/04/13/7dcqt*.

[27] Provisional Measure No. 1,152, of December 28, 2022, *supra* note 2, Chapter II Section I.

[28] For example, the Proposed Transfer Pricing Rules, *supra* note 2, provide (i) that the terms and conditions of a controlled transaction shall be established in accordance with those that would be established between unrelated parties in comparable transactions (Chapter II, Section I); (ii) that a controlled transaction comprises any commercial or financial relationship between two or more related parties, established or performed directly or indirectly, including contracts or arrangements in any form and series of transactions (Chapter II, Section II); (iii) the parameters for determining when unrelated party transactions are comparable to the controlled transaction (Chapter II, Section IV); (iv) the controlled transaction must be assessed on the basis of the analysis of the facts and circumstances of the transaction and the evidence of the effective conduct of the parties in order to identify the commercial and financial relations between the related parties and the economically relevant characteristics associated with those relationships (Chapter II, Section V, Subsection II, Art. 7); and (v) the comparability analysis shall be carried out with the purpose of comparing the terms and conditions of the controlled transaction with the terms and conditions that would be established between unrelated parties in comparable transactions.

[29] Letter to the Presidency of the Brazilian Republic from Marcelo Pacheco dos Guaranys, Executive Secretary of the Ministry of Finance of Brazil, para. 101–105, dated December 26, 2022.

[30] Letter to Assistant Secretary of the Treasury Lily Batchelder, Chamber Com. 1, 4 (Dec. 12, 2022) ("[W]e respectfully … request for the immediate withdrawal or suspension of the new arm's length requirement in Reg. §1.901-2(b)(5)(ii)."), *www.uschamber.com/assets/documents/USCC-Comments-to-Treasury-re-Final-FTC-Regulations_FINAL_12.12.22.pdf*.

[31] Proposed Reg. §§1.861-20, 1.901-2, 1.901-3, 87 FR 71271, 71271–86 (Nov. 22, 2022).

[32] Reg. §1.901-2(d)(1)(i).

[33] Reg. §1.901-2(d)(1)(iii).

[34] Reg. §1.901-2(d)(1)(iv).

[35] Reg. §1.901-2(d)(1)(ii).

[36] Reg. §1.901-2(d)(2).

[37] IRB 2011-36, 199.

[38] *Id.*

[39] 85 FR 72078, *supra* note 8, at 72092.

[40] *Id*.

[41] *Id.* ("Proposed Reg. §1.901-2(d)(1)(ii) provides the general rule that separate levies are imposed on particular classes of taxpayers if the taxable base is different for those taxpayers.").

[42] *Compare* Proposed Reg. §1.901-2(d)(1), 85 FR 72078, *supra* note 8, at 72134, *with* Reg. §1.901-2(d)(1) *and* T.D. 9959, IRB 2022-3, 328, *supra* note 7.

[43] *Compare* T.D. 7918, 1983-2 CB 113, *with* Reg. §1.901-2(d)(2), *and* T.D. 9959, IRB 2022-3, 328, *supra* note 7.

[44] *See, e.g.*, LTR 199912010 (Mar. 26, 1999) (determining that a foreign levy on income gained pursuant to a contract authorizing the taxpayer to exploit natural resources in a foreign country was a levy separate from that country's levy on general business income); LTR 9835008 (Aug. 28, 1998) (determining the same); LTR 9326044 (Apr. 2, 1993) (determining that a foreign levy imposed on a domestic taxpayer's profits gained from a contractual joint venture entered into by such taxpayer with the foreign country is a separate levy from the foreign country's general tax on profits because the joint venture agreement substituted the general profits tax for an alternative profits tax).

[45] Reg. §1.901-2(e)(5)(i).

[46] Reg. §1.901-2(e)(5)(iii)(A) ("[W]here foreign tax law provides a taxpayer with options or elections in computing its liability for foreign income tax whereby a taxpayer's foreign income tax liability may be permanently decreased in the aggregate over time, the taxpayer's failure to use such options or elections results in a foreign payment in excess of the taxpayer's liability for foreign income tax.").

[47] Reg. §1.901-2(e)(5)(vi)(G), Example 7.

[48] *See, e.g.*, Reg. §1.901-2(e)(5)(vi)(H), Example 8.

[49] Notice 2011-29, IRB 2011-116, 663.

[50] IRB 2022-41, 276.

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