International Bar Association Annual Conference 2023

Recent Developments in International Taxation

Brazil

Teresa Meyer

BMA Advogados, São Paulo

tenc@bmalaw.com.br

Overview

The Brazilian political and legal environment is going through a heated-up period in which the main agenda is the alignment with international policies and tax reforms. A new government has taken the office in 2023 and it is pushing the indirect taxation reform, with is on the process of passing the National Congress, and the direct taxation reform, whose scope is still unclear, but may include taxation of dividends, extinction of Net Equity Interest (*Juros sobre Capital Proprio – JCP*), *CFC regime* for individuals that hold interests in companies and trusts offshore, and taxation of close-held private funds.

Regarding the international tax policy, Brazil has signed new tax treaties with Norway, United Kingdom, Poland and Colombia and protocols to the existing treaties with India, China and Chile. Also came into force the treaties with Singapore and Uruguay. Highlights must be given to the United Kingdom Tax treaty, which deviates from the treaties signed with Brazil. Moreover, the transfer pricing rules have been changed into rules aligned with the OECD standards and shall come into to force mandatorily in 2024.

Domestic Tax Aspects

1. Indirect Taxation Tax Reform

The current indirect tax system in Brazil adds several complexities and a lot of compliance burden to business activities. For many years, there have been discussions on a reform that would simplify and unify the indirect taxes and obligations in connections to it, however, until this moment the visibility on the reform was very limited due to the conflict of Federal, State and local interests.

In 2023, pushed by the political agenda, the Bill of Law No. 45/2019 has been put into vote in the Chambers of Deputies and followed to the Senate, where it still needs to be voted. The bill of law provides for the unification of the local Service Tax (ISS), State Goods Tax (ICMS), Federal Industrialized Product Tax (IPI) and Social Contributions (PIS/COFINS) into a Value Added Tax (VAT) system and an excise tax.

The VAT shall be composed of a dual tax system collected by federal entity and state/local entities and its combined tax rate has not been determined yet, but it should not express an overall tax revenue lower than the current indirect tax collection. The excise tax is to be mainly imposed on goods or services that harm the environment or the public health.

Another main difference is that the proposed VAT shall not provide for as many special regimes, exemptions and favored or zero tax rate as the current tax regime.

2. Direct Taxation Tax Reform

The reform on the direct taxation system is posed as a second step of the new government political tax agenda – i.e., after the new VAT system pass in the Congress. Currently, there is some Bill of Laws in the Congress that propose (i) taxation of dividends (currently exempt), (ii) extinction of the JCP; (iii) inclusion of more and higher tax brackets in the progressive taxation of Personal Income Tax (IRPF) and (iv) taxation of exclusive and close-end investment funds. It is most likely that the latter shall have more success in the Congress, as not only it is one of the fewest investment funds that the investment is only taxed when the investor withdraw or redeem its shares, but also it is mostly used as an investment vehicle for individuals with a high net worth.

Moreover, there is a Provisional Measure nº 1.171/23 in force until late August - when it should be voted by the Congress and converted into Law, otherwise it loses its effects – that provides for changes in the taxation of interests abroad held by tax residents in Brazil by means of financial assets, properties, entities, or trusts. The main change brought by the Provisional Measure is the taxation of those assets on a CFC-like basis, in which the positive variations shall be deemed as disposed or distributed to the resident on December 31^{st} of each year.

International Tax Aspects

1. Tax Treaties

In 2022, Brazil has signed new double tax treaties with Norway, Poland, Colombia and United Kingdom, as well as protocols on the existing treaties with India, Chile and China. The already signed treaty with Singapore and Uruguay came into force in 2022 and 2023, respectively.

In most of them, except for Chile and China, there is a specific article for technical services, which has been a long-lasting issue in Brazil when interpreting the previous treaties.

The Norway and United Kingdom treaties present an article for offshore activities and, apart from the Polish treaty, all of them present a limitation of benefits clause that encompasses the simplified Limitation of Benefits (LOB) – as perceived by the OECD BEPS Project – and a Principal Purpose Test (PPT). The Polish treaty have a PPT clause and a LOB, which does not bring the concept of qualified person neither the derivative benefits test.

The British treaty is considered a milestone for the Brazilian international tax policy, as it deviates from Brazilian previous treaties in a number of aspects. It provides for a regressive taxation at the source country depending on the term of service agreement (i.e., 2 years – 8%; 3-4^{th} year – 4%; and after the 4^{th} year – 0%); source taxation of royalties up to 10% and interest taxation at source country up to (i) 7% on interest paid to a bank or insurance company granting loan of at least 5 years for the financing of infrastructure projects and public utilities (ii) 10% on paid to (a) non-associated banks or insurance companies (b) issuer of bonds or securities traded in stock exchange, or (c) seller on credit paid by the purchaser of machinery and equipment to the seller; (iii) 15% in all other cases and (iv) Governmental bodies and pension scheme exempt.

Regarding capital gains, the gains associated with (i) ships and aircrafts and (ii) assets that are in neither Brazil nor United Kingdom (i.e., indirect sale of assets) are limited to residence taxation, whereas the gains derived from the either jurisdictions, the tax should only be due in the source country. As for the dividends article, it provides for source taxation limited to (i) 10% of the gross amount of the dividends if the beneficial owner holds directly at least 10% of the capital of the company paying the dividends for a holding period of 365 days; (ii) 15% of the gross amount of the dividends in all other cases and (iii) exemption of pension schemes.

The United Kingdom Treaty not only portrays a unique scenario for Brazil in regard to commercial relationships with the United Kingdom but also might influence some other treaties with Brazil that have a most favored nation clause, such as Israel, Portugal and Belgium.

2. Transfer Pricing Rules

Brazil has been known to have its own transfer pricing legislation that deviated from any OECD or international practices. The rule favored the legal certainty principle, by establishing the transfer pricing method and fixed margins to be applied by a given economic sector and a specific transaction, rather than capturing the business and economic nuanced realities of a case-by-case analysis in observation of the Arm's Length Principle.

Notwithstanding, since Brazil has shown interest to become an OECD Member State since 2017, it decided upon request to move its transfer pricing rules towards the OECD standard. On July 14th, 2023, has come into force the Law No. 14,596 that provides for the new transfer pricing rules and, alto, new disposition on the deductibility of royalties as well as on the determination of Low Tax Jurisdictions and Privileged Tax Regimes. The rules are optional for 2023 and mandatory for 2024 forth.

The main differences in regard to the previous regime are:

- Adoption of the Arm's Length Principle according to the OECD Guidelines.
- Restriction of the fixed margins only to safe harbor rules: the law has only introduced the possibility of establishing safe harbor dispositions, yet the dispositions have not been determined. The tax authorities have indicated the intention of setting 5% markup over low value-added services as a safe harbor. This rule would compromise the currently cost sharing agreements (CSA) put in place between Brazilian companies and

its related parties abroad, as the CSA imply no profit margins between the related parties;

- Transactional Methods: introduction of the Transactional Net Margin Method and Profit Split method;
- Specific dispositions on the definition of commodities, intangibles, intragroup services, business restructuring, financial transactions, guarantees, cashpooling and insurance.
- Documentation requirements and fines on the failure to comply those requirements: introduction of local and master files requirements. Should be noted that there is an ongoing discussion on whether the Brazilian tax authorities should require more information than the OECD standards provide for.

The main differences in regard to the OECD Guidelines are the lack of provision on secondary adjustments and the disposition on related parties that encompasses independent parties, in which one is resident of a Low Tax Jurisdiction or Privileged Regime.

The Law also lifts the previous limitations on the deductibility of royalties but requires that the income is included in the tax basis of the recipient in order to allow the deductibility. Lastly, it determines that the Low Tax Jurisdictions and Privileged Tax Regimes are the ones that has a maximum tax rate inferior to 17% (e.g., previously, there were cases in which the rate was 20%).