BRAZIL 2017: TAX DEVELOPMENTS FOR BUSINESS TRANSACTIONS

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INTRODUCTION

The year 2017 saw many important developments in Brazil regarding cross-border and intrastate business. This article focuses on three areas: B.E.P.S., categorization of software transactions to expand withholding tax exposure, and intrastate transactions.

BRAZIL AND THE B.E.P.S. ACTION PLAN

On May 29, 2017, Brazil formally requested entry to the O.E.C.D. Since 1994, Brazil has actively cooperated with the O.E.C.D., and it has been a key O.E.C.D. partner since May 2007 via an "enhanced engagement" program. Brazil already participates in 31 O.E.C.D. legal instruments, including the B.E.P.S. Action Plan, having signed the Declaration on B.E.P.S. in May 2013.

Brazilian tax legislation has evolved in the past few years in a way that often converges with international standards. This can be seen in the way Brazil has implemented most, but not all, B.E.P.S. actions and objectives.

B.E.P.S. Action 1: Addressing the Tax Challenges of the Digital Economy

No concrete measures were adopted. Nevertheless, Brazil has taken independent steps to address the way the digital economy is taxed, particularly with regard to B.E.P.S.

B.E.P.S. Action 3: Designing Effective Controlled Foreign Company ("C.F.C.") Rules

In November 2013, the Brazilian government published a provisional law that introduced new rules regarding the taxation of profits earned by branches and controlled or affiliate companies overseas.[1] The Brazilian provisions on profits earned overseas have broader reach than international standards, addressing all types of income earned by an foreign controlled or affiliate company.

B.E.P.S. Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments

Brazil has introduced rules on thin capitalization[2] intended to prevent Brazilian companies from being funded by excessive debt held by related parties abroad. If the related lender is located in a country that is not a tax haven or is not subject to a

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1 Provisional Measure 627, later converted into Law 12,973/2014.

2 Law 12,973/2014.

privileged tax regime, the debt-to-equity ratio cannot exceed 2:1. If the lender is located in a tax haven or is subject to a privileged tax regime, the related-party debt cannot exceed 30% of the equity (*i.e.*, a 0.3:1 debt-to-equity ratio).

B.E.P.S. Action 5: Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance

B.E.P.S. Action 5 was implemented through two regulations issued by the Brazilian Federal Revenue Service:

- Normative Instruction 1658/2016 updates the list of tax havens and countries with privileged tax regimes, initially established under Normative Instruction 1037/2010, and introduces the concept of "substantive economic activities" for holdings in foreign subsidiaries.
- Normative Instruction 1689/2017 establishes procedures regarding the exchange of information between countries with which Brazil has in effect tax information exchange agreements covering matters such as transfer pricing and permanent establishments ("P.E.'s").

The Brazilian Federal Revenue Service system relies on the Public Digital Bookkeeping System ("SPED") and other systems to obtain information on taxpayers:

- SPED allows for a thorough online exchange of information between the Federal Revenue Service and taxpayers, providing great transparency and oversight.
- State and municipal authorities also have similar systems that allow local tax authorities to have access to the billing systems of businesses.
- Within Brazil, there are mechanisms allowing for a broad exchange of information involving the registration of vehicles, deeds, and service providers.
- Oversight of financial transactions is carried out on a regular basis by banking and tax authorities.
- Normative Instruction 1634/2016 sets forth the obligation to identify the beneficial ownership of companies.

This data is available to tax authorities in partner jurisdictions.

B.E.P.S. Action 7: Preventing the Artificial Avoidance of P.E. Status

So far, Brazil has not indicated that it intends to adopt Action 7 regarding the taxation of business profits. Questions regarding the P.E. concept are common among foreign companies interested in doing business in Brazil. Despite the absence of a formal P.E. concept in Brazil, several income tax rules[3] broadly reflect internationally accepted P.E. principles:

- Actual or *de facto* branches of foreign companies are regarded as legal entities for Brazilian tax purposes.[4] The existence of an independent division that trades or renders services on a regular basis through employees and

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[3] *E.g.*, Decree 3000/1999.

[4] Article 147 II.

local management can result in the existence of a *de facto* branch that is subject to taxation in Brazil even if a formal branch is not registered.

“The Brazilian tax authorities have little experience with P.E. issues. As a result, the imposition of Brazilian tax on foreign companies without formal branches is rare.”

- *Commissionaire* arrangements can result in branch taxation for the foreign principal. The law defines a *commissionaire* as a company or individual, holding independent status with regard to the principal, that acts in its own name but for the account of a principal when selling goods. The *commissionaire* is responsible for calculating the profits of the foreign principal that supplies the goods and collecting tax under the rules applicable to branches of foreign companies.[5]

- Agents resident in Brazil concluding direct sales in Brazil for foreign companies must compute profits and collect tax on behalf of principals. This rule does not apply when the agent is an independent party or a mere intermediary acting under a grant of authority that is limited to obtaining purchase offers that are forwarded to the principal. The law defines an agent as a person that represents another party in return for a fee. When an agent is involved in a sale, the agent does not conclude contracts in its own name.

  As is apparent, the Brazilian rule for independent agents is not dissimilar to the rule in the O.E.C.D. model. The agent must not have and regularly exercise the power to bind a foreign principal. Thus, an agent is not a P.E. of its principal when acting independently, without powers to bind the foreign principal, and without a pattern of activity in which it executes agreements on a regular basis.[6]

In practice, the Brazilian tax authorities have little experience with P.E. issues. As a result, the imposition of Brazilian tax on foreign companies without formal branches is rare. Even when an entity is characterized as a P.E., the Brazilian tax system may mandate taxation but does not provide the means for paying the tax. Moreover, the risk of P.E. characterization is extremely low for service providers because Brazil imposes very high withholding taxes on payments for the import of services. Tax authorities express greater interest in collecting withholding tax from payments to foreign service providers than in collecting net tax from the profits of an unofficial Brazilian branch. Even in the context of a P.E. and an applicable income tax treaty, Brazilian tax authorities tend to focus on collecting withholding tax when Brazilian enterprises pay service fees to Brazilian offices of foreign businesses.

B.E.P.S. Action 8, 9 and 10: Aligning Transfer Pricing Outcomes with Value Creation

If approved, Brazil’s membership in the O.E.C.D. could have a significant impact on the Brazilian transfer pricing rules in a few years. Brazil chose to adopt, as of 1997,[7] transfer pricing rules inspired by the O.E.C.D. Transfer Pricing Guidelines but mostly based on objective criteria. Although the application of these criteria is relatively straightforward, more often than not the result is not necessarily an arm’s length price, due to the use of predetermined profit margins (which can amount to 40% for certain activities).

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5 Article 398.

6 Articles 399 and 539.

7 Law 9430/1996.

B.E.P.S. Action 12: Mandatory Disclosure Rules

No concrete action has been taken. Nevertheless, in 2015, the executive branch attempted to pass a bill to address mandatory disclosure of aggressive tax planning.[8] However, the Brazilian Congress vetoed significant portions of the legislation thereby eviscerating the proposal.

B.E.P.S. Action 13: Transfer Pricing Documentation and Country-By-Country Reporting

Country-by-Country reporting has been adopted.[9] However, legislation has not been enacted mandating the submission of master files and local files.

B.E.P.S. Action 14: Making Dispute Resolution Mechanisms More Effective

Procedures authorizing Brazilian participation in Mutual Agreement Procedures ("M.A.P.'s") related to Brazilian income tax treaties.[10] Brazil has in effect income tax treaties with the following countries:

Argentina	Mexico
Austria	Norway
Belgium	Netherlands
Canada	Peru
Chile	Portugal
China	Philippines
Czech Republic	Russia
Denmark	Slovakia
Ecuador	South Africa
Finland	South Korea
France	Spain
Hungary	Sweden
India	Trinidad and Tobago
Israel	Turkey
Italy	Ukraine
Japan	Venezuela
Luxembourg	

As can be seen from the list, Brazil does not have a comprehensive income tax treaty with the U.S. in effect.

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[8] Provisional Measure 685/2015.

[9] Normative Instruction 1681/2016.

[10] Normative Instruction 1669/2016.

B.E.P.S. Action 15: Multilateral Convention to Implement Tax Treaty Related Measures to Prevent B.E.P.S.

No concrete steps have been adopted. The tax authorities have stated that Brazil may opt to renegotiate each treaty bilaterally.

Final Note on B.E.P.S.

Overall, Brazil has been a pioneer in championing B.E.P.S. objectives, especially regarding the actions towards fiscal transparency and exchange of information. Although some actions and formalities have not yet been implemented, most have been addressed by Brazilian legislation. Once Brazil becomes a full member of the O.E.C.D., further implementation of the B.E.P.S. Action Plan is expected.

BRAZILIAN VIEW ON SOFTWARE TRANSACTIONS

In recent months, the General Tax Coordination ("C.O.S.I.T.") has issued several tax rulings regarding cross-border and domestic transactions involving software. Tax policy in this area is quite controversial due to the different levels of Federal units interested in collecting taxes (municipalities, States, and the Federal Union). Policy has not kept up with new technologies and developments in high-tech solutions offered in the market. As a result, rules are inconsistent and surprises are prevalent.

Payment for Off-the-Shelf Software

One example of inconsistent treatment relates to a previously resolved issue involving the taxation of standard software imports.[11] In the past, tax authorities understood that remittances made abroad for the licensing of standard software involving off-the-shelf products was not subject to Brazilian withholding income tax ("W.H.T."). This understanding was in line with Federal Supreme Court ("S.T.F.") case law, which established a rule treating a payment for standard software as the purchase of a product. As a result, the payment is not considered to be a royalty. Standard software is defined as multiple copies manufactured on a large scale, in a uniform manner, and intended for use by an undetermined number of users.[12] If standard software were considered as a product, its import would not subject to W.H.T., even if delivery is effected by download from the internet.

In its ruling,[13] C.O.S.I.T. reached the following conclusions:

- The licensing of the right to *sell and distribute* software, which is usually transacted between Brazilian distributors and foreign companies, differs from the licensing for the right to *use* the software. The latter is generally applicable to transactions between Brazilian distributors and end consumers.
- For cases involving licensing to sell and distribute software, the S.T.F. case law mentioned above is not applicable, as this precedent only refers to cases of licensing for the right to use the software. Thus, the characterization of standard software would be irrelevant to the commercial/distribution relationship between the Brazilian distributor and the foreign company.

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[11] C.O.S.I.T. Conflict Resolution Ruling 18/2017.

[12] Extraordinary Appeal 176.626-3.

[13] Conflict Resolution Ruling 18/2017.

- Payments made abroad by Brazilian companies for the right to sell the software fall under the concept of royalties, which are subject to (i) 15% W.H.T. (increased to 25% if the recipient is based in a tax haven) and (ii) 10% Contribution for the Intervention in the Economic Domain ("C.I.D.E.") in the context of a technology transfer. In a technology transfer, the source code of the software is provided, and the acquirer of the license is able to modify the program. The C.O.S.I.T. ruling stated that C.I.D.E. is not levied if a technology transfer does not occur.

As a result of the C.O.S.I.T. ruling, all taxpayers face greater tax exposure because the ruling is binding on all Federal tax authorities. Taxpayers caught by the ruling must be prepared to pursue review at administrative and judicial levels.

The position expressed in the C.O.S.I.T. ruling – that the payment has the character of a royalty – is applied to other Federal taxes, as discussed below. However, licensing of off-the-shelf software for local end users remains unaffected by the C.O.S.I.T. ruling.[14]

Software as a Service

In terms of new technologies, C.O.S.I.T has addressed the tax treatment of remittances made abroad for the provision of "Software as a Service" or "SaaS"[15] in a ruling involving a Brazilian company engaged in the sale, maintenance, and development of data processing systems.

In the ruling, a Brazilian company made payments to a foreign company for password authorization to access and use two different SaaS packages. One package was a utilities package protecting against computer viruses and spam. The other package was a virtual platform enabling database access and participation in conference calls, meetings, and training sessions. The Brazilian company subsequently provided access and authorization to Brazilian users.

In the ruling, C.O.S.I.T. concluded that the license to use a SaaS should be regarded as the provision of a technical service that was subject to W.H.T. and C.I.D.E. The rationale for the conclusion is as follows:

- The user did not acquire any software and did not have the software installed on its hardware. Rather, it paid periodic fees for access to the utilities package that was hosted in the cloud at an unknown location or locations.
- The Brazilian company was not allowed to modify the program's characteristics. Rather, the foreign company retained exclusive responsibility for management and maintenance of the software and provision of helpdesk services.
- The Brazilian company paid for access to a service, not for use and control of intangible property.
- The agreement between the Brazilian company and the foreign company provided that the payments were compensation for rendering a package of services.

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[14] C.O.S.I.T. Ruling Request 303/2017.

[15] C.O.S.I.T. Ruling Request 191/2017.

In sum, C.O.S.I.T. applied rules for the performance of technical services. Under Brazilian tax law, a broad definition is given to technical services, which is quite different from the concept adopted by most other countries. Once categorized as a service, remittances abroad were subject to the general 15% W.H.T. and 10% C.I.D.E. C.I.D.E. is a Federal tax levied (i) on the payment, credit, delivery, use, or remittance of amounts abroad related to a technology transfer (including licensing of patents and/or trademarks and technical assistance agreements and excluding software licensing, as long as the source code is not transferred) and (ii) on a payment abroad related to technical, administrative, and similar services, as well as any royalty payments. The taxpayer is the Brazilian legal entity.

Other taxes typically levied on imports of technical services were not analyzed by C.O.S.I.T. in the ruling.

Domestic Transactions Regarding Software

Imposto de Renda sobre Pessoa Jurídica ("I.R.P.J.") is the corporate income tax in Brazil. *Contribuição Social sobre o Lucro Líquido* ("C.S.L.L.") is one of the social insurance taxes that fund Brazilian social security. Brazilian legal entities may use the actual profit system or the deemed profit system to calculate the tax base for both taxes. The actual profit system computes the tax base by reference to actual results. In comparison, the deemed profit system computes the tax base by reference to percentages of the company's gross revenues. The percentage varies depending on the company's business activity.

To illustrate, the percentage applicable to the sale of merchandise is 8% for I.R.P.J. and 12% for C.S.L.L. For services, the percentage is 32% for both taxes. The taxable base is made up of deemed business profits using the applicable percentage, non-business actual income, and capital gains.

Under the deemed profit system, the sale of standard software can be treated as either a sale of a product or the provision of services. If only minimal modifications or adjustments are made to standard software, the activity is categorized as a sale of merchandise. On the other hand, if standard software is significantly altered and modified, the activity is categorized as a service.

The *Contribuição para os Programas de Integração Social e de Formulação do Patrimônio do Servidor Público* ("P.I.S.") and the *Contribuição Social para o Financiamento da Seguridade Social* ("C.O.F.I.N.S.") are taxes based on the turnover of companies. The P.I.S. is intended to finance the Brazilian unemployment insurance system and C.O.F.I.N.S. is used to fund social security. Next to I.R.P.J., C.O.F.I.N.S. raises the most revenue for Brazil.

With reference to domestic transactions, C.O.S.I.T. ruled on withholding obligations for I.R.P.J., C.S.L.L., and P.I.S./C.O.F.I.N.S. in the context of payments for professional services.

- In one ruling, the issue was whether certain activities should be regarded as professional services that are subject to taxation.[16] The ruling addressed three separate activities. The first was the sale of standard software and updates. The second was the sale of a permanent use or temporary use license related to general and nonexclusive software. The third was the performance of maintenance and technical support regarding the software.

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[16] C.O.S.I.T. Ruling 230/17.

C.O.S.I.T. ruled that the first two items were not considered to be services for purposes of I.R.P.J., C.S.L.L., and P.I.S./C.O.F.I.N.S. On the other hand, the provision of maintenance and of technical support services was considered to be the performance of services. Consequently, payments made for the performance of maintenance and support activities were subject to C.S.L.L. and P.I.S./C.O.F.I.N.S.

- In another C.O.S.I.T. ruling, the performance of technical services focused on maintenance activities for the proper functioning of a computer program. The ruling concluded that the revenue must be characterized as arising from the provision of services, even if the activity is not expressly covered in the agreement.[17]
- In a third C.O.S.I.T. ruling, the resale of permanent and temporary licenses of standard software through download was categorized as the sale of merchandise by a Brazilian company for purposes of the Special Tax Regime for Small Businesses.[18] This ruling is consistent with case law in Brazil.
- Finally, C.O.S.I.T. ruled that partial or total updates on standard software acquired through physical support or through download is properly categorized as a sale of merchandise for the purposes of the levy of Social Security Contributions on Gross Revenues.[19]

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State V.A.T. (“I.C.M.S.”)

Another important topic relates to State V.A.T. (“I.C.M.S.”), where software is potentially subject to taxes on services and on products. To illustrate, the State of São Paulo, for example, recently ruled that I.C.M.S. is levied on transactions with non-customized or tailor-made software involving electronic transfers of data, regardless of whether it is by means of download or through cloud computing.[20] However, this levy is currently suspended. At the same time, the city of São Paulo ruled that a Municipal Tax on Services (“I.S.S.”) should be levied on the download of any kind of software, standard or customized, when the transaction involves electronic data transfer.[21]

Courts have been asked to decide which level of São Paulo’s government is competent to impose tax on transactions with software related to download and cloud computing. Is it a service or the sale of a product? It is possible that each level of government has the authority to categorize the transaction as it wishes (in which case the answer will be that both have competency to impose and collect the tax)?

RECENT CHANGES IN STATE BENEFITS RELATED TO I.C.M.S.

Supplementary Law 160/2017 was recently enacted to address a tax war between the Brazilian states. The Brazilian Constitution establishes that a supplementary

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17 C.O.S.I.T. Ruling 235/2017.

18 C.O.S.I.T. Ruling 231/2017.

19 C.O.S.I.T. Ruling 18/2017.

20 Normative Decision CAT 4/2017.

21 *Id.*

law should define how I.C.M.S. incentives would be granted – Brazil has 26 states, plus a Federal district, with competence to collect this state tax. In the Brazilian legal system, a supplementary law implements a provision set forth in the Constitution and must be approved by a two-thirds majority in both legislative houses, the Senate and the House of Representatives. Thus, the Brazilian Constitution should be seen to establish the policy, and the supplementary law addresses the details.

Supplementary Law 24/1975 established that all tax exemptions, benefits, remissions, amnesties, and tax or financial incentives should be approved by the National Council of Tax Policy ("C.O.N.F.A.Z."), composed of the 27 state treasury secretaries and the finance minister, who represents the Federal government. The quorum for a C.O.N.F.A.Z. meeting is the presence of a majority of C.O.N.F.A.Z. members. All decisions regarding the grant of a tax benefit require a unanimous vote. C.O.N.F.A.Z. decisions authorizing states to grant benefits are formalized by means of a covenant that must be ratified by the respective state's legislative branch.

In spite of a provision stating that benefits granted without the detailed approval process are null and void – meaning the tax remains due and payable, notwithstanding the act of a state – many states have ignored this rule when granting tax incentives. As a result, other states have begun to deny credits where a transaction benefitted from a tax incentive that was not approved by C.O.N.F.A.Z. In addition, several S.T.F. rulings have determined that unilaterally granted state tax benefits are unconstitutional.

Supplementary Law 160/2017 was passed to overcome the uncertainty around established. Its main provisions are as follows:

- States should list all the normative acts granting tax benefits and register them with C.O.N.F.A.Z.
- By means of a covenant executed by C.O.N.F.A.Z.,[22] the states and the Federal district can reinstitute tax credits related to unilaterally granted tax benefits.
- The approval of the covenant will require a quorum made up of two thirds of the states and consisting of at least one third of each region of the five regions of Brazil.
- Approval should occur by the beginning of February 2018.
- After that target date, the term of each incentive may be extended by the governors for up to 15 years for most economic activities, with reduced timelines of eight, five, three, and one year for other activities listed in the covenant.
- It is also possible for governors to grant incentives to other taxpayers located in their states, extending existing incentives under the same terms.
- A state may enact the same tax benefits granted by other states of the same Brazilian region.
- These rules have retroactive effect forbidding states from collecting past tax credits related to tax benefits.

[22] Supplementary Law 24/1975.

- The granting of other tax benefits that are not consistent with Supplementary Law 24/1975 will subject the states to penalties provided under the Fiscal Responsibility Law, such as the prohibition on receiving voluntary transfers, as well as credit restrictions.

Once the covenant is approved, past tax liabilities connected to the lawfulness of the benefits will be settled. Although discrepancies between state tax incentives will continue for up to 15 years, companies can be sure that past situations will not trigger tax assessment notices drawn up by different states.

CONCLUSION

The year 2017 can be categorized as a typical year in Brazil. The country took steps to adopt internationally accepted norms regarding cross-border taxation. At the same time, taxpayers continued to encounter inconsistently applied tax rules and bureaucratic conflicts.

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