International Taxation of Cross-Border Trade and Investments in BRICS: the Brazilian Experience

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- BRICS
  - Common Domestic Problems
    - Consumption Taxation
    - Diversity within the territory
    - Federalism
  - An Independent Treaty policy
    - Capital Importers or Exporters?
    - Sovereignty and Development
    - Investment Attraction

Federalism and distortions to foreign trade: the Brazilian consumption taxation

Brazilian Federalism

- 3 Levels:

Federal Union

States

Municipalities

Allocation of tax jurisdiction in Brazil

- Brazilian Constitution divides the tax jurisdiction among Union, States and Municipalities

	Income	Consumption	Property
Union	Income Tax (IRPF and IRPJ) CSLL	IPI PIS COFINS	ITR
States		ICMS	IPVA ITCMD
Municipalities		ISS	IPTU ITBI

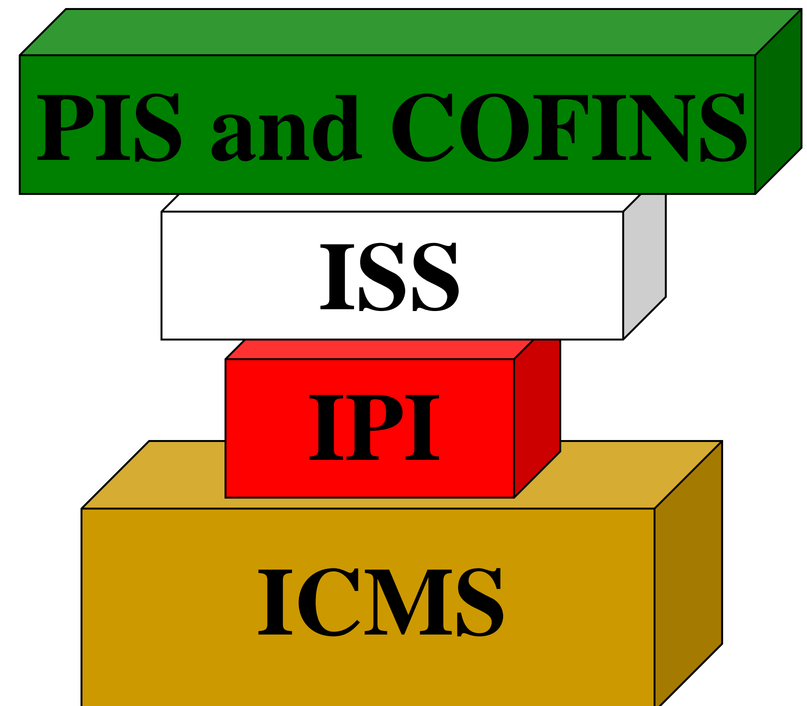
Distortions of the Brazilian tax system

- Major distortions of the Brazilian tax system caused by the structure of fiscal federalism
  - Complexity
  - Lack of neutrality
  - Mutiplicity of taxes and tax regimes on goods and services (PIS/COFINS, IPI, ISS, ICMS, CIDE-combustíveis)

Brazilian Consumption Taxation

Europe

Brazil



Cumulative effect of taxes on consumption in Brazil

– IPI, ICMS and ISS do not offer mutual tax credits

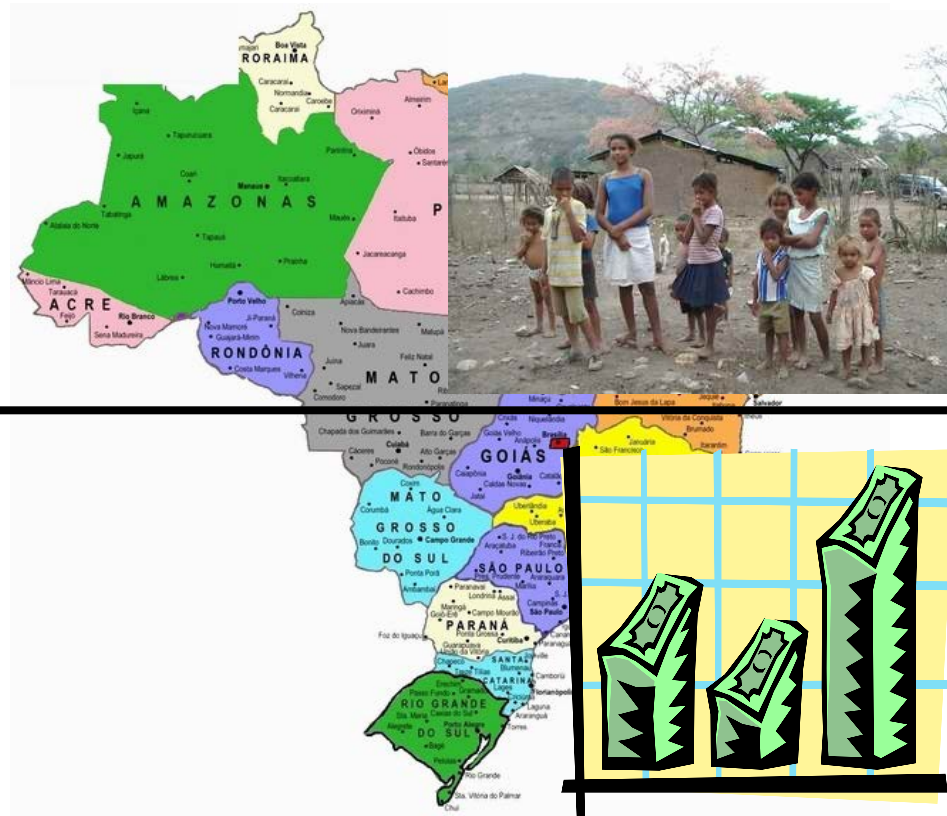
– The three charges may be incurred in different levels of production, and may be incident on one another

– The problem is still unresolved in the Brazilian tax system

– Prevention: the division of powers: fiscal federalism

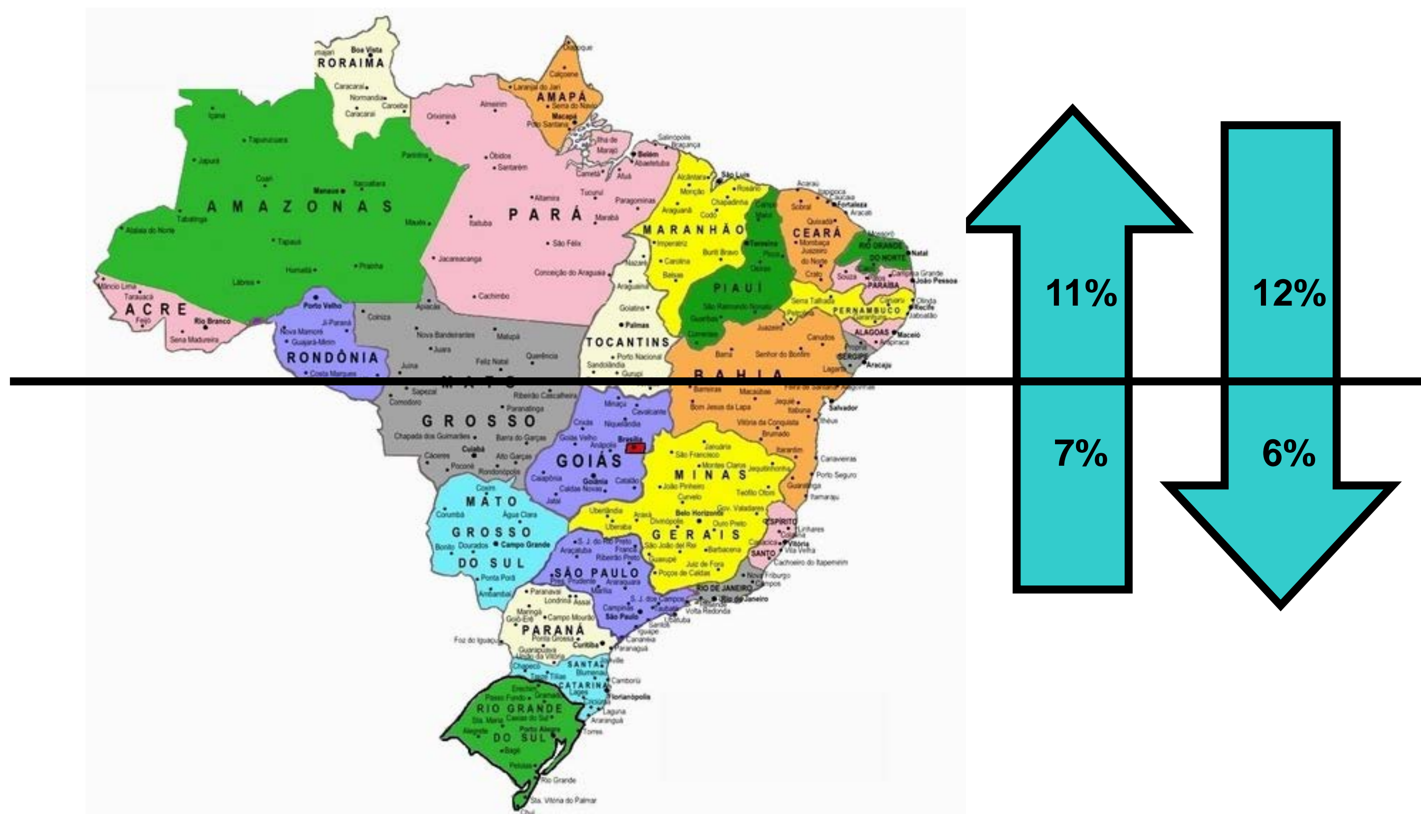
ICMS: horizontal revenue division

- ICMS: taxed by States
- Problems: regional inequality and State taxation



Revenue horizontal distribution

- Regional balance: transactions between two States and more than one taxpayer of ICMS (horizontal division)

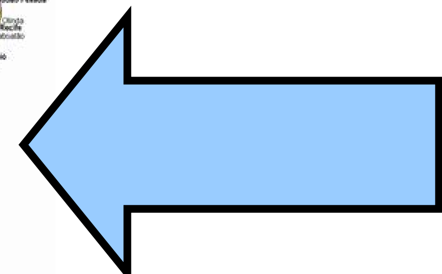


Taxation on imports

- Taxes on import:
  - Import duty (regulatory tax)
  - IPI (manufactured products excise tax)
  - ICMS
  - PIS and COFINS (federal contributions on gross receipts)

Taxation on imports - services

Services import



ISS **PIS**

COFINS **IRRF**

CIDE

Taxation of imports - goods

Goods import

ICMS PIS

COFINS

IPI II

Major distortions of ICMS in foreign trade

- Fiscal war

- Facilitated imports at the expense of domestic production
  - Imports: the tax is payable only to the state of the importer. Incentive to grant the benefits of tax on imports

- Difficulty on taxing exports: accumulation of tax credits by exports
  - The exporting State does not want to allow the use of accumulated credits. Reason: the accreditation of the ICMS tax colletion can be used in other States

Taxation of foreign trade - imports

- ICMS: import’s effect
  - Collection is not distributed among Federal States

All ICMS is retained by importer State

Revenue horizontal distribution

- Senate Resolution no. 13/2012

Local industrialization
(minimum 40% of imported content)

Taxation of foreign trade – exports

- Taxes on export:
  - Export duty (regulatory tax)
  - Income tax
  - CSLL (Social contribution on net profit)
- IPI, ICMS, PIS and COFINS are not due on exports

Effect of taxation of exports to ICMS

Export: BA should restitute amount collected by MG

Taxation in MG

Comsumption Taxation: Conclusions

- Fiscal Federalism may entail distortions to foreign trade
- Indirect Taxes are of major concern for taxpayers in Brazil
- Conflicts in the Federation may harm the interests of taxpayers
- Harmonizing measures x autonomy of the entities

Brazilian Direct Taxation: the deemed profit regime

Corporate income tax regimes

- Real Profit
- Deemed Profit
- Tax authorities' determination of profits

Corporate income tax regimes

- Deemed profit
  - Application of percentages on gross receipt according to the activity:
    - 1.6% in relation to the sale, for consumption, of petroleum derivatives and natural gas
    - 8% on the sale of goods, industry and hospital services
    - 16% on transport (except cargo services - 8%)
    - 16% for financial institutions
    - 32% for other services and rents
  - Tax rate of 15% (and additional of 10%)

Corporate income tax regimes

- Deemed profit
  - Other taxes and contributions:
    - CSLL - tax rate of 9% (basis for calculation is 12% and 32% for services)
    - PIS - tax rate of 0.65%
    - COFINS - tax rate of 3%

Corporate income tax regimes

- Real profit
  - Accounting profit adjusted for tax purposes
  - Losses originated in an accounting period may be carried forward for relief against future profits (limit of 30% of the profit)
  - Tax rate of 15% (and additional of 10%)

Corporate income tax regimes

- Real profit
  - Other taxes and contributions:
    - CSLL - 9%
    - PIS - 1.65% (non-cumulative regime)
    - COFINS - 7.6% (non-cumulative regime)

Deemed profit X Real profit

Example

Rendering of services company	
• **Deemed Profit** Gross Receipt 100.000 (x) percentage for services (32%) Tax Base 32.000 **Income Tax** 25%*32.000 = 8.000 **CSLL** 9%*32.000 = 2.880 **PIS and COFINS** 3,65%*100.000 = 3.650 TOTAL: 14.530	• **Real Profit** Gross Receipt 100.000 (-) Expenses (25.000) Tax Base 75.000 **Income Tax** 25%*75.000 = 18.750 **CSLL** 9%*75.000 = 6.750 **PIS and COFINS** 9,25%*100.000 = 9.250 TOTAL: 34.750

Brazilian tax treaty policy

Brazilian treaty network

32 treaties in force:

FINLAND
NORWAY
SWEDEN
CANADA
NETHERL.
DENMARK
UKRAINE
BELGIUM
AUSTRIA
HUNGARY
SPAIN
FRANCE
LUXEM.
CZECH
ITALY
PORTUGAL
TURKEY
JAPAN
CHINA
ISRAEL
MEXICO
INDIA
PHILIPPINES
TRINIDAD AND TOBAGO
KOREA
VENEZUELA
ECUADOR
PERU
CHILE
SOUTH AFRICA
ARGENTINA

Brazilian Tax Treaty Policy

- Matching credit and tax sparing clauses
- Taxation on a reasonable level at source for dividends, interests and royalties
- Broader concept of royalties
- Restrictions regarding royalties deductibility
- Broader concept of permanent establishment
- Taxation of “other income” at source, without limitation

Brazilian Tax Treaty Policy

- 1960 Decade:
  - Brazilian perspective: **territoriality**
    - The Source State must have the exclusive right to tax
    - Taxation at Source: 25%
    - Double taxation: illegitimate intrusion of the Residence State

Brazilian Tax Treaty Policy

- 1960: first Brazilian treaties
  - Military government, foreign investments and development
  - Treaties as tools of economic policy
  - The decrease of the taxation at source must be in favor of the investor
  - **Matching credit** and **tax sparing** provisions

Brazilian Tax Treaty Policy

- 1) Negotiation of Double Tax Treaties with traditional investor countries in Brazil (60's/70's)
  - Sweden, Japan, Norway, Portugal, France, Finland, Belgium, Denmark, Spain, Austria, Germany, Italy, Luxembourg
  - Tax sparing and matching credit provisions
  - Taxation on dividends, interests and royalties at source at higher levels recommended by OECD
  - Inclusion of technical assistance and technical services within the scope of article 12
  - Taxation of "other income" at source

Brazilian Tax Treaty Policy

- 2) Negotiation of Double Tax Treaties with developing countries, especially in Latin America (80's/90's)
  - Ex. Argentina, India, Philippines and South Korea
  - Brazil adopted a different policy
  - Not focused on tax sparing and matching credit provisions
  - Reciprocal matching credit
    - India, Philippines and South Korea

Brazilian Tax Treaty Policy

- 3) Negotiation of tax treaties with countries which are neither traditional investors in Brazil, nor have a regional relationship
  - Ukraine, Israel, Mexico, South Africa, Russia, Venezuela and Peru
  - There are no tax sparing or matching credit clauses (bilateral flows)
  - Adoption of LOB provisions
    - South Africa, Israel, Mexico, Venezuela, Russia and Peru
  - However, when negotiating with developed countries, Brazil will probably require matching credit and tax sparing clauses

Tax Sparing

- Tax sparing aim at (i) assuring that treaty benefits will be maintained or (ii) at maintaining unilateral tax exemptions

(i) Matching credit

25% Internal tax rate

15% Treaty tax rate

25% Tax credit

(ii) Tax sparing *s.s.*

25% Internal tax rate (general)

15% Treaty tax rate

10% Internal tax rate (tax incentive)

15% Tax credit

Tax Sparing

- Report "Tax Sparing: a Reconsideration", 1998
  - Main concerns
    - the potential for abuse offered by tax sparing
    - the effectiveness of tax sparing as an instrument of foreign aid to promote economic development of the source country
    - general concerns with the way in which tax sparing may encourage States to use tax incentives
  - "(…) tax sparing should be considered only in regard to States the economic level of which is considerably below that of OECD member States."

Tax Sparing

State aid to development countries

X

Partial acknowledgment of territoriality (CIN)

Tax Sparing

- Assure the possibility of tax exemption by source country with effective advantages to the investor
- Stimulate capital flows among contracting parties
- Recognize unbalance of flows among contracting parties (developed and developing countries)

Tax Sparing

Tax sparing is a mechanism for the recognition of the limits of States' tax jurisdiction

State A

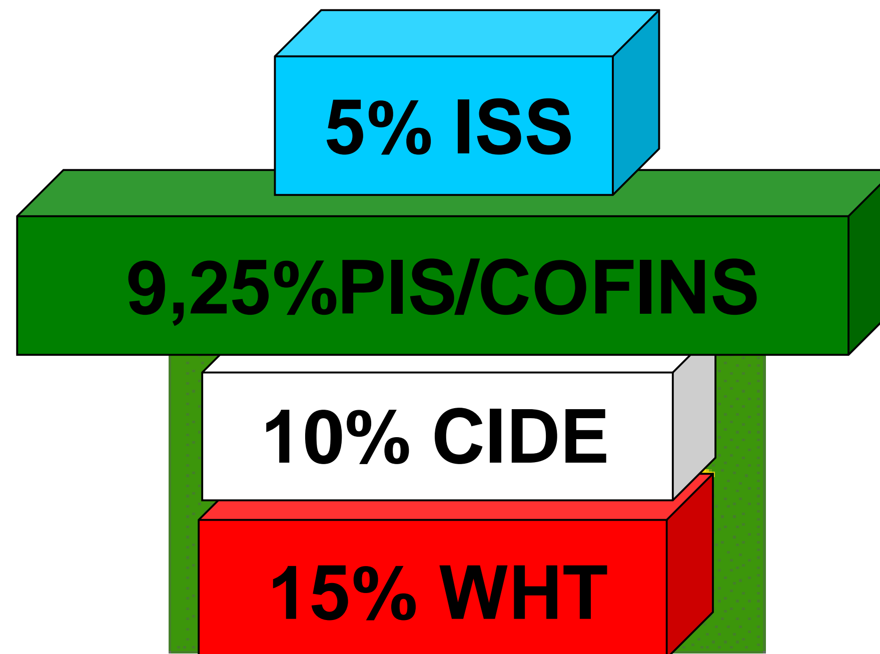
State B

Tax treaty

Royalties and Tax Treaties

- Article 12 OECD-MC
  - Residence State has the exclusive right to tax
- Brazilian Double Tax Treaties
  - Source state has also the right to tax, limited to a 15% rate
- Matching credit of 20% (in some cases 25%)
- Brazil adopts a broad concept of royalties
  - Technical assistance and technical services are usually included in the concept of royalties (protocol)
- Brazil applies WHT based on deductibility of royalty expenses

Royalties Taxation in Brazil



Article 14

- Article 14 was excluded from the OECD-MC
  - Reservation made by developing countries
    - Bruggen: fixed base is “less permanent” than the PE
    - Less possibility of taxation at source

Source taxation in Brazil

- SERVICES:

PRODUCTION

PAYMENT

- Domestic legislation does not define PE

Article 14

- Brazilian tax treaties: deviate from the OECD-MC
  - **SOURCE OF PAYMENT** criterion (exceptions: Japan and Turkey)
  - Example (Brazil-Austria tax treaty):

    Income derived by a resident of a Contracting State in respect of professional services or other independent activities of a similar nature shall be taxable only in that State, **unless the payment of such activities and services is borne by a permanent establishment situated on the other Contracting State or a company resident therein**. In such a case, the income may be taxed in that other State.
  - DTC with China is the only treaty including the concept of service PE

Technical Services

- Brazil used to interpret some rules in a way which conflicted with the international (OECD) standards.

- Technical services could be qualified under:

  - Article 12 (royalties)
    - In Brazilian DTTs both countries would have right to tax;

  - Article 7 (business profits)
    - Only the country of residence should tax.

Technical Services

- Copesul Case (Appeal No. 1.161.467/RS)

  The Superior Court of Justice held that remuneration from technical services is covered under Article 7 whenever it is not covered by Article 12.

- The Department took heed of the opinion and enacted Declaratory Act No. 05/14, according to which technical services would, irrespective of the existence of a technology transfer, fall within:

  - I – Article 12, when the protocol so provides
  - II – Article 14, when the technical service is related to the technical qualification of an individual, except for cases included in (I)
  - III – Article 7 in cases not covered in (I) or (II)

Conclusions

- Is there a common grounds for a BRICS treaty policy?
  - Tax Sparing
  - Source Taxation
  - Broader concept of PE
- Main challenges
  - Eliminating distortions arising from domestic legislation
  - Harmonizing tax collection and investment attraction
  - Finding common interests to increase bargain in future negotiations

Thank you!

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