# Preface to the Fourth Edition: What's New?

Brazil Tax Guide for Foreigners is the leading reference work in the English language for those interested in foreign investment and business in Brazil. No other publication offers the same coverage and analysis of the Brazilian tax system. The first three editions have reached multinational companies, entrepreneurs, tax practitioners, government officials, and diplomatic services in more than 45 countries on all continents, quite a feat for a publication that is not sold in bookstores and that has limited advertising and marketing.

The *first edition* of the Guide, published in October 2011, focused mainly on corporate taxation with a few sections addressing personal taxation.

After suggestions from readers, the *second edition* was released in 2013 bringing more topics on personal income tax, particularly issues affecting expatriates working and living in Brazil. The *second edition* also addressed new topics for corporate taxpayers, such as the 2012 transfer pricing rules, the new social security tax on monthly gross income, new special tax regimes,–tax incentives for the 2016 Summer Olympic Games in Rio de Janeiro, the 2012 money laundering statute, among others.

In 2014, the *third edition* updated the topics in the previous editions and expanded the content even further. An appendix unrelated to taxation was added to explain the limited liability company (the so-called *limitada* ), the most popular type of business entity used by foreign investors. The appendix included a sample articles of association in English, with useful comments and footnotes for a better understanding of how this type of entity works. It has been very helpful to new comers.

After three years, the *fourth edition* comes fully revised, updated and expanded even further. Hundreds of footnotes have been added to allow readers to identify right away the legal basis of topics under review; the chart 'basis legal framework' at the end of each section has been kept, though.

Sections have been rearranged and the book is now divided in four parts. Part 1 (*First Steps to Understanding Brazil's Tax System*) receives a new section that explains the most important constitutional principles applicable to tax matters. This is a helpful tool for readers to have a better understanding of the tax disputes described throughout the book.

Part 2 *(Taxation of Individuals & Companies)* is the Guide's core with matters concerning domestic taxation of individuals and companies. The section on personal taxation *(IRPF - Personal Income Tax)* has been further expanded to include the so-called 'tax exit' or waiving Brazilian tax residency. In recent years not only many expatriates have returned to their home countries because of the crisis that arrived in Brazil since 2014, but also thousands of Brazilians have left the country and become non-resident for tax purposes. The 'tax exit' procedure, however, requires careful preparation and the taking of measures to ensure the exit is acceptable by the tax administration. Otherwise, a person may continue being taxed in Brazil and in her new country of residence.

The section on corporate income tax *(IRPJ - Corporate Income Tax)* has a new interesting and important section dealing with the tax aspects of the final adoption by Brazil of IFRS standards, which is now mandatory to most businesses. Section *CPRB - Social Security Tax on Monthly Gross Income* includes the changes made to that tax in 2017 that removed most businesses thereof and required them to return to the 20% social security tax on payroll. Despite this change, the section brings a new chart explaining the complex set of rules, change of rates, etc. that applied to dozens of businesses in recent years. Section *Taxation of Payments Abroad* brings the latest changes to Brazil's black list of low tax jurisdictions and favorable tax regimes, while section *Tax Treatment of Royalties, Technical Assistance and Services Paid Abroad* addresses the recent interpretation on how the business profit clause in tax treaties should apply to service payments abroad to a level that no withholding tax may be applicable at all.

Still in Part 2, subpart *Other Relevant Federal Tax Matters* now contains interesting new topics on automatic exchange of information, including FATCA, CRS, BEPS and tax returns created to ensure reporting takes place efficiently. Other new sections include the *2016 & 2017 Voluntary Disclosure Programs* and a fully revised and expanded section of *Foreign Trusts and Foundations* and the legal and tax issues arising from the fact that the concept of trust in non-existence in Brazilian legislation.

As for state and municipal taxation, section *ITCMD (Causa Mortis Property Transmissions and Donations Tax)* has a special schedule with the tax rates in place in all 27 states after the rounds of tax increases of 2015 and 2016. Section *ISS or ISSQN (Service Tax)* updates the latest on taxation of imports/ exports of services and brings the new list of ISS taxable service as amended in late 2016.

Part 3 *(Foreign Trade: Taxes, Procedures & Special Regimes)* focuses on foreign trade and updates the latest changes in the field, including new charts on calculations of imports of goods, services and royalties after the increases in P.I.S.-Import and COFINS-Import tax rates.

Part 4 *(Taxation of Foreign Investments)* has been fully revised to include dozens of footnotes on registration of foreign transactions (capital, loans, portfolio, leases, etc.), tax rates on financial investments made by foreigners, disputes and interpretation on application tax treaties, and an update of tax treaties in place and pending approval.

At the end of the Guide, Appendix 1 (*Calculation of employee's compensation*) was revised and now includes sample calculation over employees' total annual cost to employers including the main labor rights like the $13^{th}$ salary and paid vacation.

I sincerely hope you find this new edition helpful for your business or professional activities. Enjoy the reading!

# Introduction

Brazil has, probably, one of the most complex tax systems in the world, where federal, state, local governments have taxing powers over transactions expressly contemplated in the federal Constitution.

Like few other countries, Brazil's tax system is fundamentally based on the Constitution. The Constitution does not create taxes per se; instead, it lists all taxes that each taxing power is entitled to create by means of their corresponding legislative powers. An exception exists at federal level, where the Executive Branch also creates and/or changes taxes by means of the so-called provisional measures.

Provisional measures are legal acts issued by the federal Executive Branch with immediate effect, where review, amendment and approval are carried out by the Legislative Branch after the act has become valid and enforceable. Over the years, tax 'legislation' created or changed through provisional measures has become routine as they have the advantage of having immediate effect and enforceability. Congress has tried to limit the use of provisional measures by the Executive Branch by approving changes to the Constitution, but in practice the use of measures for tax issues has not been reduced.

The complexity of Brazil's tax system also derives from the fact that the Constitution does not limit its provisions to a mere list of taxes that taxing powers can create. It goes further by establishing specific constitutional principles and rules which must be followed by the taxing powers. Some principles and rules apply to the creation or change of tax rules in general; others apply to certain taxes only.

Principles and rules may come as a general guideline for a specific tax, such as the one that requires income tax, whenever possible, to observe the taxpayer's capacity to pay taxes. The expression 'whenever possible' withdraws any possible power that a principle like that could have in the 'real world'.

An example of a general rule is the one that requires that taxes can be created or changed only by means of a law approved by the Legislative Branch. Even such rule has exceptions in the Constitution: some taxes, like the federal excise tax (IPI), import and export tax, and the financial transactions tax (IOF) may have their rates increased or reduced by a mere presidential decree. But, again, it is the Constitution that creates the rule and the exception (or exceptions).

The Constitution has one entire chapter (*Of the National Tax System*) exclusively dedicated to the tax system, which includes provisions for federal, state and municipal taxes. This chapter contains no less than 14 different articles with dozens of rules, principles, guidelines, taxpayers' rights, limitations, etc. But tax provisions are not limited to the tax system chapter in the Constitution; a few separate, tax-related provisions can be found elsewhere in the Constitution, such as those dealing with individuals' rights and the social security system and taxes.

Social security is also an interesting topic. Although not specifically addressed in this book, social security taxes, commonly named 'social contributions', are regulated in the social security chapter of the Constitution. That is the case, for example, of some taxes described in this book, such as CSL and COFINS.

For Brazilian tax purposes, taxes and social contributions are not the same. While taxes (in Portuguese, *impostos*) are generally collected to finance the government's general obligations and duties and do not have a direct public activity towards the taxpayer, social contributions (*contribuições sociais*) are usually associated with some public activity from the government towards the taxpayer, whether directly or indirectly. That is the case, for instance, of the payroll tax paid by individuals and corporate taxpayers to the Social Security; the tax is destined to cover social security rights of individuals and employees, such as retirement, maternity leave, labor accidents, public health, etc.

Other so-called social contributions are not easily identified with a public activity towards the taxpayer. That is the case of the CSL; notwithstanding its social contribution name (*contribuição social sobre o lucro líquido* – social contribution on net income), it has all aspects of a corporate income tax with very similar tax base, rules and very little in terms of public activity towards taxpayers.

Classification of Brazilian taxes and social contributions is not easy and is not limited to the two categories above. Scholars still debate the legal nature of other levies established by the Constitution, but which are not relevant to the purpose of this book.

Over the years, some 'social contributions' have been used as a means to bypass a constitutional obstacle that requires the federal government to share revenues from federal taxes with states and municipalities[1]. Because the same requirement does not apply to (federal) social contributions, the federal

[1] Constitution, Article 159.

administration is constantly tempted to increase social contributions, leaving true taxes almost unchanged. Examples of this strategy can be noticed with CSL (increase of the tax rate from 15% to 20% for financial institutions[2]) and COFINS and P.I.S. (creation of a noncumulative regime with higher rates for certain companies). On the other hand, income tax rates have been virtually the same for over 20 years.

The federal tax system is by far the most relevant to taxpayers in general as compared to states and municipalities. Around 68.4% of Brazil's overall tax burden originates from federal taxes, followed by states (approximately, 25.4%) and municipalities (6.2%)[3].

Over the years, federal tax revenues have constantly increased, while state and municipal revenues have been practically stable. The revenue stability for states and municipalities is partially explained by the fact that those taxing powers have less flexibility in terms of generating tax revenues. While the Constitution expressly provides means for the federal government to create new taxes, states and municipalities do not have such opportunity. Also, the number of taxes constitutionally authorized for states and municipalities to create (three for each) is significantly smaller than the number of federal taxes expressly contemplated in the Constitution (seven[4] ordinary taxes and at least four[5] ordinary social contributions).

Besides limitations in the number of taxes they can create, states and municipalities are sometimes limited in terms of the maximum rates they can apply. That is the case of the state gift and donations tax (ITCMD), which maximum rate of 8% is established by the Senate in 1992[6]. Also, the maximum rate for the municipal service tax (ISS) is 5%, while the minimum rate is 2%. The minimum rate is important because it limits the municipalities' ability to enter into harmful tax competition with other (usually nearby) municipalities to attract businesses into their borders.

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[2] Law No. 13169/2015.
[3] Figures for 2015. Source: Federal Revenue Department (http://idg.receita.fazenda.gov.br/dados/receitadata/estudos-e-tributarios-e-aduaneiros/estudos-e-estatisticas/carga-tributaria-no-brasil/ctb-2015.pdf). Access on April 15, 2017.
[4] Import tax, export tax, income tax, IPI, IOF, ITR and the large fortune tax.
[5] CSL, P.I.S., COFINS and the payroll tax, the latter converted into a gross revenue tax for certain business sectors (see section *CPRB - Social Security Tax on Gross Income* for mode detail.)
[6] Senate Resolution No. 9/1992.

The official story is that Brazil needs tax revenues to offer good quality public service and social assistance to the poor. However, despite an overall tax burden similar to many developed countries, Brazil still offers public services similar, or even worse, than its emerging counterparts.

A tax reform would be the natural way to resolve the complexity of the tax system by making it more rational, just and efficient. However, it is far from being a reality; no matter how strong the federal government, state governors and state representatives in Congress would hardly accept waiving their existing rights and revenues in favor of others. That certainly would be used by their local opponents and could represent the end of their political careers.

Over the years, many have tried to propose tax reforms: none of them succeeded, not even former president Luiz Inácio Lula da Silva with more than 80% of approval rates among Brazilians. The latest serious attempt at tax reform was proposed by President Lula da Silva at the time of his first term in office in early 2003. Early that year, the President and the 27 state governors met to discuss the main points of a tax reform proposal, which resulted in a letter stating that the tax system should promote fiscal justice and increase economic efficiency and competitiveness by relieving exports and stimulating production and productive investments.

One of the most important items discussed was the conversion of Brazil's 27 existing ICMS taxes into a single VAT-type tax under a single piece of (federal) legislation. Another ICMS-related issue to be resolved by the tax reform was the question of which state(s) would be entitled to the new ICMS levied on interstate transactions, a great source of revenues for producing states, such as the southern and southeastern states. States without major industries (most of them in the northern and northeastern regions) wanted ICMS to be payable to the recipient state, while states with many industries want the tax to be payable to the state of origin.

In May 2003 the Executive Branch submitted to Congress a constitutional amendment proposal to implement the tax reform. Less than four months later, the House of Representatives concluded its review and voted on the tax reform keeping most of the points originally proposed by the Executive Branch. But as soon as the proposal reached the Senate, where the Executive Branch could not secure a majority, problems began to arise with respect to proposed ICMS issues and the tax reform was never concluded.

Political disputes like those over the 2003 tax reform obstruct simplification of Brazil's tax system. But because the administration needs to fund its activities,

the only solution is to create new levies and taxes, making the tax system even more complex. That is exactly what happened after the failure to approve the 2003 tax reform. COFINS, a gross receipt tax that for years had been regulated virtually by one single law, suffered a major change when a noncumulative (debit-credit system) was created effective February 2004 (P.I.S., another gross receipt tax, became noncumulative one year earlier as a trial test for COFINS.) Because the debit-credit system for P.I.S. and COFINS was not perfect, countless of exceptions, special regimes, zero-rates, single-phase levies, etc., were created making those two taxes, historically very simple and straightforward, into the most complicated Brazilian taxes in terms of rules and regulation.

In 2005, P.I.S. and COFINS were extended to reach imports of goods and services and another set of complex rules and regulations was necessary.

The lack of a tax reform caused the government to have very limited room to create a favorable tax environment generally applicable to new investments. As a consequence, the only solution was to start creating special tax regimes excluding certain selected investments from the general tax rules. That is the case of certain infrastructure projects, exporters, ports, civil construction, aircraft, and automobile industries, and others better detailed further in this book.

Those special regimes have the disadvantage of not being applicable to all productive investments in general, but only to those sectors the government, at a given moment, decides to encourage. They also have the disadvantage of making tax rules more complex and very difficult to follow.

With recession hitting Brazil hard in 2016 with constant losses of tax revenues, the federal administration has started to review and eliminate a number of special tax regimes but not with the intention to simplify the tax system, but rather to generate more tax revenues to cover mandatory public expenses.