THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 2.11 – BRAZIL OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

At its first stage, operations would represent merely import of services by Brazilian residents. The exporter (service provider) would not have local presence and all activities would be performed abroad. The only connection with Brazil would be the client, source of payments.

Therefore, all remittances would be subject to Brazilian taxes on import of services: Municipal services tax (ISS) and federal social contributions PIS, COFINS and CIDE. Because the remittance represents income earned in Brazil, the foreign provider of services will also be subject to income tax under withholding procedures. Not all taxes are cost for the Brazilian counterpart, unless the service agreement prescribes that all price is free from tax at source.

ISS: Brazilian federal constitution and federal legislation (LC 116) provides that the rendering of services triggers a Municipal tax that may vary between 2% and 5% of the gross revenue (price of the services). Such tax is also applicable on import of services. The local client is the taxpayer responsible for its payment, so no withholding mechanism applies[1]. The actual rate will depend on city regulations, since ISS is a tax regulated by federal LC 116, but subject to specific local law. Only activities listed by regulations are subject to ISS, but since such list is quite broad, the "professional services" rendered by GAS HQ are probably subject to tax. Since ISS is owed by the client in Brazil, it will affect the cost of such services (its value increases the cost with retaining the foreign provider).

PIS and COFINS: Social contributions PIS and COFINS are federal taxes traditionally due over gross revenues (Laws 9718, 10637 and 10833). Since 2004 (Law 10865), Brazil also impose a 9.25% tax on import of services. There is no need to identify the nature of services in any list, as it happens with ISS. Virtually all kind of services imported by local taxpayers is subject to PIS/COFINS, that will be due at the price payment. Since the local client is the taxpayer, no withholding is needed and the contributions represent cost for the taxpayer (Brazilian client). However, if the taxpayer is under the so called non cumulative regime for such social contributions, and the services imported comply with some requirements (basically, if they are deemed to be an essential input for the customer operations), the amount paid may be used as a credit to be offset with future PIS and COFINS owed on gross revenues. Therefore, such taxes may or may not be a cost for the importer, depending on its actual tax regime and the nature of such expenses when core business is taking into consideration.

CIDE: Federal tax CIDE is a social contribution that is due on remittance of funds for the payment of technical services (Law 10168). There has been some dispute regarding the actual obligation when no transfer of technology is present, but currently CIDE applies to basically all technical and administrative assistance provided by non residents to local companies. The Brazilian customer is the taxpayer and should collect 10% of the price remitted as CIDE to the Federal Government. There is no withholding procedure and CIDE represents a cost to the Brazilian client.

IRRF: finally, since the remittance of price represents income earned by GAS and paid from a Brazilian source, it will be subject to federal income tax, under withholding procedures. IRRF is a tax owed by the income earner (GAS) and therefore does not represent a cost for the Brazilian client, unless a gross up is due because the actual service agreement prescribes that price is free from local taxes in Brazil. IRRF is owed at 15% rate over the price, meaning that actual remittance will be of 85% of the agreed value.

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[1] This is a controversial issue as the legislation is not crystal clear on this matter. Therefore, there is room to support that the ISS on imports of services should be viewed as a withholding tax rather than a cost borne by the importer.

Part 2

At STEP #2 a local subsidiary is incorporated, meaning that the relationship with Brazilian clients is going to be a local one. The only foreign operation is one of investment, where GAS HQ is the controller of the Brazilian subsidiary GAS Brazil.

GAS Brazil is going to be a regular taxpayer in Brazil and, therefore, should pay all taxes owed by its businesses in the country. Its profit after taxes may be remitted abroad as dividends to GAS HQ. Dividends are tax exempt from income tax in Brazil, even when the beneficiary is a foreign investor. However, since dividends payment demands remittance of funds abroad, a foreign exchange transaction (buying of foreign currency) will occur. In such transactions another federal tax will be due – tax on financial foreign currency exchange ("IOF Exchange"). Currently, IOF Exchange is subject to a zero rate for dividends remittance. Therefore, GAS HQ should not expect any cost related to Brazilian income tax on its dividends flow.

Also, any interest paid by GAS Brazil to GAS HQ is going to be subject to Brazilian income tax at a 15% rate, under the withholding procedure. Besides IRRF, the federal tax currency exchange transactions (IOF/Exchange) is also due. If the interest payment is related to a loan with a deadline shorter than 180 days, a 6% IOF will be due by the Brazilian counterpart. If the debt is longer than 180 days, a zero tax rate is currently applicable. At last, if the interest paid is related to Interest on Net Equity legal - option available in Brazil - ("Juros sobre Capital Próprio", or "JCP"), a 15% income tax is going to be withheld, but no IOF is due since a zero tax rate is currently applicable as well. Therefore, the flow of interest is always subject to income tax WHT at 15% rate. GAS HQ may expect IOF from zero to 6% depending on the nature and term of payment, but such tax is not owed by the foreign counterpart, but is rather a cost borne by the Brazilian source – *i.e.,* GAS Brazil.

Finally, interest paid by GAS Brazil to GAS HQ are subject to transfer pricing control and thin capitalization limits in Brazil, but such rules would never impose a direct burden at GAS HQ's level, but only potentially to GAS Brazil deductibility from its own Brazilian income tax.

Therefore, although no Brazilian income tax will be owned by GAS HQ on any Brazilian dividends, it should expect a 15% cost on its income from interest received from Brazil. Such tax may be subject to a foreign tax credit at Danzu, under the reciprocal treatment principle, which allows countries to offset foreign federal income taxes paid at source, even when there is no specific tax convention between the States.

Part 3

Capital gains earned by non residents from the disposal of Brazilian assets are subject to income tax under the same rules applicable to Brazilian residents, even if the buyer is also a non resident (Law 10833, art. 26 + Law 9249, art. 18). GAS Brazil shares were not acquired under regular capital market operations (shares bought in local stock market), so the regular regime will apply.

Therefore, if GAS HQ sells its participation in GAS Brazil, the gain resulting from the transaction would be subject to federal income tax from 15% to 22.5%, depending on the size of such capital gain. The basis is going to be assessed as the balance between GAS HQ investment cost versus total price of the deal. Capital Gains are taxed as follows:

Gain amount (prices minus cost):	Rate
of up to R$ 5 million	15%
from 5 to R$10 million	17.5%
from10 to R$30 million	20%
Over R$30 million	22.5%

The income tax on capital gains is subject to withholding procedure, meaning that the acquirer is responsible for its deduction from price and payment, even if the acquirer is also non resident (in this case, its legal representative in Brazil would be responsible for performing the withholding).

Cost of foreign investments are usually registered at the Brazilian Central Bank. The cost should be considered in foreign currency, not Brazilian currency (Reais), to avoid taxing exchange variation[2]. If part of the capital was invested in Reais (i.e., in Brazil), the capital gain calculation will follow the proportions of foreign investment (calculation in foreign currency) and national investment (assessment in Brazilian currency). The question does not open details on such proportions, so the assessment would basically follow the assumption that all investment is foreign (registered at Central Bank).

Currently, Brazilian legislation does not impose capital gains taxation in case of indirect transfer of Brazilian shares/quotas. Therefore, if the ultimate beneficiaries sell their stake in GAS HQ rather than transferring GAS Brazil directly, most likely no capital gains taxation would be triggered in Brazil, unless the Brazilian tax authorities are able to demonstrate that the transaction was somehow abusive/fraudulent.

Any future royalties received by GAS HQ would be subject to Brazilian income tax under withholding procedures. A 15% income tax will be collected by source, and unless a free of tax price is agreed, GAS HQ will have to expect such cost. However, the income tax withheld in Brazil may be used as foreign tax credit, even if there is no tax treaty between Brazil and Danzu (if reciprocity rule applies). Federal social contribution CIDE will also be levied at 10% rate, but that is a cost for the Brazilian counterpart (GAS Brazil).

<u>Part 4</u>

If Danzu is regarded as a low tax jurisdiction all IRRF (income tax under withholding procedure) will be raised from regular 15% rate to 25% rate. That will affect any interests, royalties and income from services paid from a Brazilian source.

The 25% rate will also be applicable to any Brazilian income tax for capital gains. Therefore, any income paid from a Brazilian source – except for dividends which would continue to be tax exempt – would be subject to a higher income tax rate if Danzu is regarded as a low tax jurisdiction, or GAS HQ as under a privileged tax regime.

However, no increases of tax rates would apply in case GAS HQ is regarded as under a privileged tax regime, because such increases only apply to payments performed in favour of low tax jurisdictions.

In both cases, *i.e,* payments performed either to a low tax or to a privileged regime, would be mandatorily subject to transfer pricing rules for deductibility purposes in Brazil. In addition, provisions similar to those for thin capitalization are also applicable to interest paid or credited by a Brazilian entity. In these cases, the interest expense is only deductible for Brazilian income tax purposes if it is viewed as necessary to the company's activities and the total amount of the Brazilian entity's debt with any foreign party resident or domiciled in a tax haven or in a jurisdiction under a privileged tax regime does not exceed 30% of the Brazilian entity's net equity.

The Law also provides that amounts paid, credited, delivered, used, or remitted under any title, directly or indirectly, to related or unrelated individuals or legal entities that are resident or domiciled in a tax haven or in a jurisdiction under a privileged tax regime will only be viewed as deductible for Brazilian income tax purposes if all of the following conditions are met: (i) the effective beneficiary of the payment is identified; (ii) there is evidence that the payment beneficiary has operational capacity (i.e. substance); and (iii) there is adequate documentation to support the relevant payments and the corresponding supply of goods, rights, or utilization of services.

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[2] This is a controversial issue as the legislation is not crystal clear on this matter. The understanding to exclude exchange variation gains is defendable, however there is a risk of Brazilian tax authorities adopting a different approach.

Part 5

If Danzu and Brazil enter into a tax convention under the OECD model some Brazilian income tax owed at source may be affected.

STEP #1 (question 1): Brazilian income tax would be not owed, since revenues from the provision of services are regarded as profits subject to article 7 of the treaty. Also, as per there is no local presence, there is no permanent establishment in Brazil and all profit should be taxed solely at Danzu. ISS, PIS and COFINS would still be due in Brazil[3].

STEP #2 (question 2): although article 10 of the model convention authorizes both the source country and the resident state to tax dividends (with limits from 5% to 15%), it would not affected GAS HQ, since currently dividends paid from a Brazilian company are tax exempt to any beneficiary. Interest paid by GAS Brazil would also be subject to article 11 provisions, meaning that both Brazil and Danzu may tax it, but Brazilian rate would be limited to 10%.

STEP #3 (question 3): capital gain from the disposal of GAS Brazil shares should not be subject to Brazilian income tax, since article 13 of the model convention only authorizes the source country to tax gains from the disposal of real estate and assets from local permanent establishments. According to article 12, royalties would not be subject to tax at source (Brazil), because there is no permanent establishment of GAS HQ in Brazil at this stage.

[3] Although this is the most accurate understanding, it should be highlighted that the Brazilian tax authorities adopt a different interpretation. And, in addition, commercial banks, who are responsible for settling foreign exchange transactions and enabling the remittances, usually adopt a very restrict understanding – as they me be held joint liable – and tend to require the proof of withholding IRRF to perform the remittance.

Question 2

Part 1

Brazilian regulations regarding tax residency only state that companies domiciled in Brazil will be regarded as local taxpayers, disregard of its purpose, nationality or investors (RIR, 158, I + Art. 159, I). The concept of domicile is found at the Brazilian Civil Code (art. 75, IV), which states that entities will be regarded as domiciled where its administration and executive board are located, or where its own statutes indicate – statutory seat. Since the question states that Pantamac was established in Bonito and incorporated according to local laws, it is assumed that it is a company domiciled in Brazil and, therefore, a Brazilian taxpayer. The fact that key decision were possibly made by conference call does not surely affirm that the company administration and/or board of directors happen in another place, so domicile is Bonito, Brazil and no further consequence derive from that remote meetings.

Part 2

Pantamac's own results are the ones realized by the company direct activities, with no subsidiaries involved. According to the question, they consist of local direct sales to third parties, local sales to Bonitorganic and online sales with assistance of the European team. All total $100,000,000.00 are subject to Brazilian income tax. But only the part derived from the sales performed by the European team may be subject to income tax abroad, if the activities performed by such staff is regarded as equivalent to a Permanent Establishment in the jurisdiction where the sales were performed.

The revenues and profit from sale operations is typically subject to article 7 of the Model Convention, meaning that only the residence state (Brazil) is allowed to tax them, unless a permanent establishment is regarded to exist in the source state. Article 5 of the Model Convention defines permanent establishment as a fixed place of business. Although the European team never got a taxpayer id or official licenses to operate, if their business is deem to comply with the convention parameters and a permanent establishment is regarded to exist, the source countries will be allowed to assess income tax on that portion of Pantamac's results.

Part 3

As the controlling company, Pantomac is subject to CFC (controlled foreign companies) regulations in Brazil. It means that all results realized from its subsidiaries (controlled companies – entities under control of the Brazilian party) and affiliates (companies where the Brazilian party has influence, but not control) will be subject to income tax in Brazil. A foreign company under no direct control may still be regarded as equivalent to CFC if the control by the Brazilian party is exercised through other affiliated enterprises.

Current regulations (Law No. 12,973) states that Profits realized by a controlled foreign company (CFC) of a Brazilian company are subject to income taxation on 31 December of each year regardless of any actual distribution by the CFC. Under the regime, qualifying CFCs are taxed on an entity-by-entity basis (that is, individually regardless of the design of the corporate structure outside of Brazil).

If proper conditions are met, a tax consolidation of CFCs´ results can be performed. This consolidation occurs at the level of the Brazilian shareholder, through which the accounting losses of a qualifying CFC may offset taxable income of another CFC. Under regulations issued by the Brazilian tax authorities (Ordinance 1,520/2014), the Brazilian shareholder can elect which non-Brazilian entities are subject to tax consolidation.

The conditions are:

- the foreign results derive from countries with whom Brazil have formal exchange of information channels (including exchange of information clause prescribed by conventions that follow the OECD model);

- the foreign results does not derive from privileged tax jurisdictions (i.e., where results are taxed at rates lower than 17%);

- the foreign results derive from entities that have more than 80% of their results from "active" businesses; and

- the controlling Brazilian company adopt proper controls to identify all results segregated for each entity.

Passive income, as interest, royalties and dividends, are not regarded as derived from active businesses and, therefore, are not eligible for consolidation.

Qualifying non-CFC entities are subject to tax in Brazil on an actual or deemed dividend distribution to a Brazilian shareholder. A deemed credit of 9% of the CFC income subject to tax in Brazil is available for qualifying entities.

The Brazilian corporate income tax on CFC income may be subject to installment payments over a period of eight years (12.5% payment per year), but the deferred tax liability is subject to adjustment based on London Interbank Offered Rate plus the US dollar currency exchange variation.

A foreign tax credit is available to Brazilian companies on income taxes paid overseas. In general, the foreign tax credit is limited to the amount of Brazilian income tax on the foreign-source income.

Therefore, each business unit have its own result and may or may not be considered as a CFC (controlled) or affiliate (under influence, but not controlled).

"Tokyo Co" will not be regarded as a CFC because Pantamac has only a 10% participation in it. It could not be regarded as equivalent to a CFC also because the Japanese investors who owns the other 90% are third parties not under Pantamac influence. Therefore, Brazilian income tax will only be due when the corresponding profits (10% of $10,000,000 = $1,000,000) are distributed as dividends. Since it did not happen, there is no Brazilian income tax due over Tokyo Co results.

"American Islands" is fully owned by Pantamac and therefore is a CFC. It means that the $50,000,000 profit are subject to Brazilian income tax on 31 December of 2018, regardless of any actual distribution by the CFC. Since only 10% from the results are derived from active businesses (trading goods), such profits are not subject to consolidation, meaning that Pantamac could not offset possible losses from other subsidiaries.

"Eden Co" is a CFC and its results will also be subject to Brazilian income tax on 31.12.18. Since it is domiciled in a country regarded as a tax haven by Brazilian regulations, because it does not tax income, Eden Co results are not eligible for consolidation.

"Oceania" is also a CFC, because it is fully controlled by Eden Co, which is fully controlled by Pantamac. Since its results for 2018 were already distributed as dividends to Eden Co, they were already considered for Brazilian income tax purposes. They would be taxed in Brazil even if they were not distributed and disregard of its actual active business (import and resell of goods) because Oceania is controlled by a tax haven resident.

"Tangomac" derives its results in part from own active business (reselling of goods) and in part from its controlled Bonitorganic and Bonitorganic 2. Since Tangomac is fully owned by Pantamac, it is a CFC and will be subject to Brazilian income tax in 12.31.18. However, the results deriving from Bonitorganic and Bonitorganic 2 are excluded from income tax at Pantamac because they relate to profits already taxed in Brazil (where both Bonitorganic and Bonitorganic 2 are established). Finally, since Tangomac is located in a country that has a Double Tax Treaty with Brazil that follows the OECD Model Convention, most of is results derive from its own active businesses and there is no privileged tax regime, Tangomac results are eligible for tax consolidation.

“Bonitorganic” is a CFC. However, since it is incorporated in Brazil, its results were already subject to income tax in Brazil and will not be considered again for Pantamac tax assessment.

“Bonitorganic 2” is also a CFC, because Pantamac controls it through Tangomac and its own share participation. However, just like “Bonitorganic”, since it is incorporated in Brazil, there is no tax exposure on Pantamac as CFC concerns.

Part 4

A negative result (loss) from one CFC may be offset with future positive results from the same entity. There is no authorization to offset such foreign loss with local positive results of the controlling entity. Such losses would not trigger Brazilian income tax under the CFC regime at the year when realized, and would reduce future Brazilian income tax exposure for that same CFC. This would not affect Tokyo Co because it is not a CFC and would only be subject to Brazilian income tax when dividends are distributed, and such dividends would naturally be net of losses. Bonitorganic and Bonitorganic 2 are not subject to CFC because they are companies already taxed in Brazil. So a negative result (loss) would only have this effect (offset with future profits of the same entity) for American Islands, Eden Co, Oceania and Tangomac.

If the CFC is eligible for the consolidation option, its negative result would enable Pantamac to offset the corresponding amount from other CFCs profits. As explained before, only Tangomac is eligible for consolidation, and therefore its profits could only be offset against its own profits, meaning the consolidation would not have practical effects.

Question 3

Part 1

The player would be considered as a resident for Brazilian tax purposes. An individual is deemed to be a resident in Brazil for tax purposes if he is a Brazilian citizen who acquired the status of non-resident and returns to the country with a definite spirit, on the date of arrival.

Part 2

Brazilian legislation prescribes that income might be taxed on accrual or cash basis. The cash basis recognizes revenues when cash is effectively received by the beneficiary (disponibilidade econômica). Under the accrual basis, revenues are recorded and taxed when they are earned, regardless of when the money is actually received (disponibilidade jurídica).

As such, if we consider the cash basis the soccer player taxation would be due only when the sportsman actually received all the back wages owed for the services rendered abroad. On the other hand, as per the accrual basis, taxation would be due when the compensation for the services were earned, regardless of when the money is actually transferred. Such difference is important once each criterion would consider a different tax residency to the athlete.

In general, the accrual method is required for taxation purposes. However, for Brazilian tax resident individuals cash basis is mandatory.

Part 3

Income tax is payable on the Brazilians individual's worldwide income, on cash basis, regardless of whether or not the income is remitted to Brazil (with a foreign credit for taxes paid abroad - subject to an applicable tax treaty or bilateral reciprocity). Earnings from employment are considered taxable income.

Income derived from non-Brazilian sources are subject to income tax through the compulsory monthly tax (carnê-leão), subject to progressive tax rates of 7,5%, 15%, 22.5% and 27.5%.

Question 4

Brazil has a long tradition of tracing its own path in terms of international taxation parameters.

From the perspective of the Operational Company, i.e., the jurisdiction that remits royalty payments abroad, Brazil has never been a jurisdiction that provided great opportunities for the erosion of the tax basis and for the transfer of profits abroad.

As a general rule, Brazil has always demanded the collection of heavy taxes at source on payments abroad, such as withholding income tax (IRRF), CIDE, IOF-Exchange, and sometimes PIS/COFINS-import and Municipal Services Tax (ISS). In practice, any benefit derived from the potential deductibility of royalties expenses tends to be significantly mitigated or even neutralized by the taxes that the Brazilian operating company has to bear when remitting royalties abroad.

In addition, the deductibility of royalty expenses in Brazil paid for the use of patents or technology in general is limited to fixed margins of 1% to 5% on net sales in Brazil. In this sense, royalties, as a general rule, are not subject to transfer pricing rules.

Although payment for certain intangibles may not fit into the specific royalty-deductible rules, our transfer pricing legislation also leaves little room for tax planning involving intangible assets. Unlike OECD countries, where transfer pricing are based on assets, risks and functions, Brazilian rules have always been subject to fixed methods and margins. These margins are applied to calculate the maximum deductible expenses in case of payments abroad (imports) as well as the minimum taxable income in case of exports. Thus, contractual arrangements that legally allocate risks or functions between companies belonging to the same economic group, as a rule, produce little impact for the application of Brazilian transfer pricing legislation.

In addition, although Brazil already has a network of approximately thirty treaties to avoid double taxation, few have the power to reduce or limit the applicable WHT (IRRF) rate on royalties remitted abroad. In other words, the Legal Owner of the intangible is also heavily taxed at source in Brazil.

Question 5

Part 1

According to Brazilian tax legislation, capital gains derived in Brazil by a non-resident should be determined and taxed in accordance with the rules applicable to individuals who are tax residents in Brazil. Accordingly, tax legislation imposes income tax for any sale of Brazilian assets by a non-resident. It should be noted that a Brazilian entity would be regarded as an asset for such a purpose.

Part 2

As per Brazilian law, non-residents are taxed under the source criteria. Therefore, payments derived from a Brazilian source triggers local taxation. Regarding non-residents capital gains, the legislation prescribes an agent, resident in Brazil, that would be liable for calculating and collecting the taxes due by the non-resident.

Specifically considering Beta transaction, Brazilian tax law provides that (a) the acquirer, individual or legal entity, resident or domiciled in Brazil, or (b) the attorney-in-fact, when the acquirer is resident or domiciled abroad (Brandenburg), is responsible for withholding and collecting income tax on the capital gain received by a natural or legal entity resident or domiciled abroad that disposes of assets located in Brazil.

As such, the official taxpayer would be Alpha (seller), but Brandenburg´s (acquirer) attorney-in-fact would be the agent liable for calculating and collecting the taxes due by Alpha.

Part 3

According to tax regulations, capital gains correspond to the positive balance between the value of the alienation and the cost of acquisition of a given asset or right. In this sense, the legislation provides that the cost basis used by the foreign investor for purposes of the capital gains calculation must be evidenced by proper and reliable documentation. Foreign direct equity investment registration is carried out through BACEN's electronic system ("SISBACEN") by means of the declaratory electronic registration (the so-called Registro Declaratório Eletrônico de Investimentos Externos Diretos – "RDE-IED"). Therefore, the RDE-IED registry might be used to determine the cost basis of the asset or other supporting documentation to prove the actual cost of the asset in Brazil (i.e contracts, etc).

As from January 1, 2017, capital gains tax will apply at the following progressive rates: 15% on gains less than BRL5,000,000, 17.5% on gains equal to or greater than BRL500,000 but less than BRL10,000,000, 20% on gains equal to or greater than BRL10,000,000 but less than BRL30,000,000, and 22.5% on gains equal to or greater than BRL30,000,000. Although it is not the case, it should be noted that capital gains perceived by non-residents residing in tax haven jurisdictions are taxable at 25% rate.

Question 6

Part 1

In general, service fees remitted abroad are subject to the following taxes in Brazil: (i) WHT at 15% (in the case of technical and administrative service fees, and to the extent that the foreign beneficiary is domiciled in a regular tax jurisdiction); (ii) CIDE at 10%; (iii) PIS/COFINS-Import at 9.25%; (iv) ISS at rates varying from 2% to 5%; and (v) IOF-Exchange at 0.38%.

Brazilian tax authorities have embraced the understanding that amounts paid, credited, delivered, used or remitted to related entities abroad due to cost-sharing agreements are also subject to WHT, PIS/COFINS-Import, ISS and IOF-Exchange. Moreover, if such compensation encompasses the provision of technical services, administrative assistance and other similar services, it would also be subject to CIDE. [4]

However, in the case of cost-sharing agreements, there is a line of reasoning to support that, to the extent that certain requirements are met, the reimbursements of costs remitted abroad should not be subject to most of such taxes, except for IOF-Exchange, which, in general, applies to remittances abroad of any nature.

There are no regulations in Brazil expressly addressing the tax treatment applicable to the reimbursements of costs remitted abroad under cost-sharing agreements. In this context, one must analyze the private rulings issued by the Brazilian tax administration and the Brazilian case law to identify the requirements to characterize a cost-sharing agreement and its corresponding tax treatment.

Although the taxation applicable to cost-sharing agreements is a matter still unsettled in the Brazilian case law, based on rulings issued by the Brazilian tax administration[5] and on certain administrative and judicial decisions, there are arguments to support that no WHT should be levied on reimbursements remitted abroad. The rationale behind such line of reasoning is that cost-sharing agreements do not have a profitable goal and are intended to generate efficiency in avoiding duplication of intragroup supporting activities. Therefore, the reimbursements would not represent an increase to the wealth of the company that provides the supporting activities.

Part 2

To support the deductibility of the reimbursements for corporate income tax purposes in Brazil, the cost-sharing should adopt, whenever possible, an objective and direct criterion for allocation of costs (i.e. time sheet). However, in certain cases, an indirect allocation is acceptable, provided it is possible to demonstrate that it is reasonable. In this case, this demonstration may be, for instance, supported by an appraisal of an independent company in order to add credibility to the criteria adopted by the legal entity

Also, to invoke such favorable treatment in order for the cost-sharing to have better chances to be accepted for tax purposes, the following requirements must be observed: (i) the reimbursed expenses must be necessary, normal, usual and duly incurred for the benefit of the Brazilian entity; (ii) the parties must execute a contract to regulate the cost-sharing procedures, and the expenses allocated to each one must be calculated based on reasonable and preferably objective/direct sharing criteria; (iii) the expenses must correspond to the effective costs incurred by each company; (iv) the centralizing company, particularly the foreign company, must account as expenses only its share, and the amounts paid by the other companies must be recorded as recoverable credits rights; (v) the cost-sharing expenses must be recorded separately from the remaining expenses of the company; (vi) the activities rendered by a company must not be related to the core business of both the centralized entity and the beneficiary - that is, it is not within the business purposes of both companies; and (vii) the support activities included in a cost-sharing arrangement must be directly rendered by the

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[4] Request for Ruling RFB nº 43/2015.
[5] For instance, Ruling Cosit No. 08/2012 and Ruling Cosit No. 23/2013.

company that concentrates on the support activities, which means that cost with subcontracting should not be included.

With respect to the mandatory documents to support the deductibility of the costs in Brazil, the following documents might be required by the tax administration (not a comprehensive list): the Cost Sharing Agreement that will regulate the arrangement in Brazil, the debt notes with the description of the charges, the proof of remittance of payments abroad under the Cost Sharing arrangement, demonstration that the amounts paid abroad were calculated as per the rules stablished in the Cost Sharing Agreement, and supporting documentation demonstrating that the activities listed in the cost-sharing agreement have been indeed carried out.

Question 7

Part 1

The amounts paid, credited or remitted, as interest accrued on loans, from a Brazilian borrower to a non-resident lender are subject to withholding income tax ("WHT") at the rate of 15% (for lenders located in non-tax haven jurisdictions). The rate is increased to 25% in case the lender is domiciled in a low tax jurisdiction/tax haven. The 15% WHT also applies in case the lender/beneficiary is deemed a privileged tax regime.

The taxpayer of the WHT is the non-resident lender, which is the beneficiary of the income, but the Brazilian borrower is required by law to withhold and collect the tax to the Brazilian Federal government (on behalf of the lender). The parties may contractually agree to shift the WHT burden to the Brazilian borrower, in which case a gross-up calculation would apply. The most accepted understanding with respect to WHT's triggering event is that it takes place by the maturity date of the interest or by the effective remittance abroad, whichever occurs first.

Considering that Japan is not considered a low tax jurisdiction under Brazilian laws, the 25% should not apply. Hence, in principle, the 15% general rate would be applicable.

Part 2

The Brazilian rules on permanent establishment are very limited in scope. Under the domestic rules, a PE exists if (i) a non-resident entity sells products or services in the Brazilian market through an agent; and (ii) such agent has powers to contractually bind the foreign seller with the Brazilian buyers/customers. The applicable legislation provides that:

1. Income tax will be imputed only if the agent in Brazil has powers to contractually bind the seller with the purchaser in Brazil;

2. Income tax shall not be imputed on sales in which the agent acts simply as a business intermediary, collecting and placing orders, or performing other acts necessary to commercial mediation, even if these services are compensated with commissions or other types of compensation, provided the agent does not have powers to contractually bind the seller;

3. The fact that the seller contributes to the capital of the agent in Brazil does not cause the agent to have powers to contractually bind the seller; and

4. The fact that a legal representative or attorney-in-fact of the seller signs agreements in Brazil in the name of the seller, on a non-regular basis, is not enough to determine the application of the provisions set forth in the legislation.

Therefore, scenario (3) of the question should not trigger local corporate income tax concerns or risks of characterizing a permanent establishment provided that the sales representative of Bali Bank does not enter into negotiations on behalf of Bali Bank, sign or conclude any documents on behalf of Bali Bank, or exercise any form of authority as a representative of Bali Bank. In other words, the sales representative should act as mere intermediary between Brazilian clients and Bali Bank in Indonesia.

In scenario (1), the local subsidiary would be taxed according to Brazilian tax legislation, being subject not only to Corporate Income Taxes (IRPJ/CSLL), but also other local taxes (such as PIS/COFINS).

In scenario (2), there is a significant risk of characterizing a permanent establishment (“PE”), in which case the commercial office should assess profits and offer them to corporate income taxes (IRPJ/CSLL) similarly to a Brazilian company. In this case of PE characterization, however, there should no concerns in connection with other local taxes (such as PIS/COFINS), as the PE rules are related only to income tax.

Question 8

Part 1

Despite following the transfer pricing methodology suggested by the OECD Guidelines to some extent, Brazilian legislation deviates from these guidelines in the following ways:

- It adopts fixed margins for the different methods, independent of the specific situation of the taxpayer or the peculiarities of the relevant industry.

- The criteria for searching and adopting comparables and appropriate adjustments are not clearly regulated.

- Advance pricing agreement procedures are generally not allowed.

- The rules are not applicable to cross-border payments of royalties and payments for technical, administrative and scientific assistance services, including those involving the transfer of know-how made by or in favour of Brazilian companies, if such transactions are registered with the Brazilian Intellectual Property Agency.

- The related parties test also encompasses situations involving cross-border transactions carried out between Brazilian companies and parties located in low tax jurisdictions, as defined by the Brazilian tax laws among other situations which do not involve related parties.

- Comparables cannot be applied for definition of profit margins.

- The rules do not allow taxpayers to adopt the transactional net margin or profit split methods.

- There are no specific provisions allowing cost-sharing arrangements.

- There is no functional analysis based on the functions performed, the assets used and the risks assumed by each party in a controlled transaction.

Part 2

Brazilian legislation provides for transfer pricing rules and methods to determine maximum amounts of deductible expenses for Brazilian taxpayers engaged in transactions with related parties domiciled outside of Brazil, or other specific transactions subject to the transfer pricing rules in Brazil (which are basically transactions performed with entities domiciled in low-tax jurisdictions or privileged tax regimes, regardless of being related to the Brazilian party).

In this sense, the cross-border payments made by Chocolate Brazil in consideration for services charged by Chocolate U.S. must observe the limits of Brazilian transfer pricing legislation, as these companies shall be deemed related parties for transfer pricing purposes. Otherwise, in case an excess of expenses is verified, such excess will be considered a nondeductible expense for Brazilian CIT purposes.

The Brazilian transfer pricing rules provide four methods with which to determine maximum deductible expenses, costs and charges related to goods, services or rights imported from a related party. The methods are the following:

- Comparable Uncontrolled Price - CUP;
- Resale Price Less Profits - RPM;
- Production Cost Plus Profits - CPM; and
- Exchange Import Price - PCI.

In principle, Chocolate Brazil may opt to use any of the methods provided in the legislation (with the exception of the PCI method, which is applicable solely and necessarily to the importation of commodities) to evidence compliance with the Brazilian transfer pricing rules in relation to the service fees payable to Chocolate U.S.

In general, the CPM method would be the most appropriate and straightforward method for the case at hand, as it would be based on the costs incurred abroad for the provision of the imported services, with a statutory 20% mark-up. Taking into account that the services are provided by a related party to Chocolate Brazil, it would be feasible to obtain information on the costs incurred for the provision of the services.

Under the CPM method, Chocolate Brazil would comply with the Brazilian transfer pricing rules to the extent that the foreign services provider discloses its costs and the fees charged from Chocolate Brazil contain a maximum mark-up of 20%. If the fees are charged with a mark-up greater than 20%, the difference shall be considered a tax non-deductible expense for Chocolate Brazil.

If the adoption of the CPM method is not possible because the Foreign Service provider does not discloses its costs, the CUP method would be the only feasible and/or less risky alternative for Chocolate Brazil. To apply the CUP method, Chocolate Brazil would need to identify the sales price of similar services in comparable transactions, as defined by the applicable legislation.

The RPM method could not be applied at the case at hand. The RPM can be utilized when the imported services are consumed in further manufacturing or production processes, or when the imported services are resold exactly as imported. In case of management and support services (back-office services), it tends to be difficult to support that they are consumed in the production of the goods sold by a Brazilian entity. In practice, it would be very difficult to calculate the weight of the cost of the services imported for the determination of the price of the goods traded by Chocolate Brazil. Therefore, from a practical standpoint, the RPM does not seem to be a feasible method to be adopted to evidence compliance with the Brazilian transfer pricing rules with respect to the service fees payable to Chocolate U.S.

Likewise, the PCI would not feasible considering that it is only applicable to goods or rights subject to quotation in exchange markets.