ADIT

Chartered Institute of Taxation
Excellence in Taxation

THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2019

MODULE 2.11 – BRAZIL OPTION

ADVANCED INTERNATIONAL TAXATION (JURISDICTION)

TIME ALLOWED – 3¼ HOURS

This exam paper has **three** parts: **Part A**, **Part B** and **Part C**.

You need to answer **five** questions in total.

You must answer:

- **Both** questions in **Part A** (25 marks each)
- **One** question from **Part B** (20 marks)
- **Two** questions from **Part C** (15 marks each)

Further instructions

- All workings should be made to the nearest month and in Brazilian Reals, unless otherwise stated.
- Start each answer on a new page and clearly indicate which question you are answering. If you are using the on-screen method to complete your exam, you must provide appropriate line breaks between each question, and clearly indicate the start of each new question using the formatting tools available.
- Marks may be allocated for clarity of presentation of your answers.
- The time you spend answering questions should correspond broadly to the number of marks available for that question. You should therefore aim to spend approximately half of your time answering Part A, and the other half answering questions in Parts B and C.
- The first 15 minutes of the exam is reading time. You will be allowed to annotate the question paper during this time; however, you will **not** be permitted to start writing or typing your answer. The Presiding Officer will inform you when you can start answering the questions.

PART A

You are required to answer BOTH questions from this Part.

1. A multinational group, Global Group (GG), is planning to expand one of its business divisions (GAS) into Brazil, one of the few countries in which GG has not yet developed a commercial relationship. GAS is headquartered in Danzu, a high-income country in Africa, and is responsible for rendering worldwide advisory services on a wide range of economic activities.

   Regarding Brazil as a key country in the South American market, GG's management have decided that it is time to deliver GAS services in Brazil as other global competitors have begun to exploit GG's absence in the country.

   Due to perceptions of political instability and their inexperience with the complex Brazilian market, GG's management have decided to adopt a conservative two-step strategy in their Brazilian expansion.

   As a local tax expert, you have participated in a conference call with GG's chief executive officer (CEO) and GAS's board members, who seek your assistance in evaluating their expansion project from a Brazilian tax perspective. During the conference call, you were provided with the following plans and information:

   <u>Step 1</u>

   Brazilian customers, typically large retail companies, are to engage in a standard service provision agreement with GAS. All services will be performed in Danzu, at GAS's headquarters (GAS HQ). Fixed monthly payments will be remitted abroad by Brazilian clients.

   <u>Step 2</u>

   If the Brazilian market proves fruitful for GAS, and certain revenue and profit thresholds are met, GG's expansion project into Brazil will involve the incorporation of a local subsidiary (GAS Brazil), fully owned by GAS and controlled by GAS HQ. New offices will be built or leased by GAS Brazil, and all necessary licenses obtained. Local staff will be hired directly by GAS Brazil for its administration, sales and operational activities. The Brazilian operation is expected to function independently of GAS HQ at this stage. Brazilian clients will engage exclusively with GAS Brazil, including for compensation purposes.

   Despite being its controller, GAS HQ expects to have no active role in GAS Brazil's operations. The controller expects only to collect dividends from the Brazilian operation, and eventually to collect interest on possible loans funding the establishment of the subsidiary.

   <u>Step 3</u>

   At the end of the conference call, some important confidential information was shared. The current CEO has been arguing for a radical reorganisation of the group business structure. Her plan is to sell each of GAS's operational subsidiaries to a rival global enterprise. Besides aiming at a good price for the sale agreement (multiple times the actual cost of each business unit), she anticipates a long-term stream of royalty revenues, since GAS HQ and the buyer would also enter into a license agreement regarding GAS's intellectual property.

Continued

1. Continuation

You are required to:

1) Describe whether, and, how Brazilian taxes will be assessed on payments from Brazilian clients to GAS HQ during Step 1, and the effect on tax costs for the Brazilian counterpart. (5)

2) Describe the likely consequences for GAS HQ, in relation to local taxation and the stream of funds, of the planned establishment of GAS Brazil under Step 2. (5)

3) Advise on whether GAS HQ will incur any additional Brazilian tax exposure in relation to:

a) a possible sale of GAS Brazil to a third party; and
b) any royalties received abroad from a Brazilian corporation. (5)

4) How would your answers to 1), 2) and 3) change if Brazilian regulations were to identify Danzu as a low-tax jurisdiction, and/or GAS HQ as benefitting from a privileged tax regime? (5)

5) How would your answers to 1), 2) and 3) change if Brazil and Danzu had entered in a double taxataion agreement according to the OECD Model? (5)

Total (25)

2. Mr Sander is a wealthy individual who has always lived in Europe. While on holiday in the Brazilian Pantanal twenty years ago, he was extremely impressed by the Pantanal's stunning ecological diversity. A local entrepreneur convinced Mr Sander to invest in a startup company developing a technique to manufacture organic makeup products from plants collected by local communities. The idea of supporting an environmentally friendly company motivated Mr Sander, and he became a shareholder in Pantamac Ltda, a company established in Bonito, Brazil, incorporated according to local laws.

Since Mr Sander preferred to participate actively in the endeavor without having to fly frequently between Europe and Brazil, the company by-laws have a specific provision stating that both partners must participate in all key decisions, and that such decisions may be taken during video or conference call meetings. Mr Sander never returned to Brazil, but spent considerable time attending the meetings. Pantamac has become one of the world's biggest makeup product manufacturers. It now has several subsidiaries and affiliates around the world. For 2018, the group members and participations were as follows:

<u>Pantamac</u>

Pantamac manufactures and sells products. Most Brazilian sales are to third parties, but Bonitorganic (see below) also buys from Pantamac to furnish its own stores. Almost all international sale operations are performed in favour of other group members, with proper transfer pricing adjustments. Pantamac also has a sales team based in a European country with which Brazil has a double taxation agreement (DTA) according to the OECD Model. This team consists of ten people, all of whom are resident in the European country, and sells Pantamac's products at temporary fairs and beauty industry events. Sales are made to the general public by fulfilling orders made online via the company's website. Payment may be made with any local or international credit card, and all revenues are booked in Brazil.

This European team operation never sought an official license to act as a branch; no local taxpayer identification number was issued. Pantamac's results for 2018 show a profit of $310,500,000. The company administration divides its profits between 'own business' ($100 million from direct sales, sales to Bonitorganic and sales through the European team) and 'other business units' ($210,500,000 booked as profits derived from its controlled and affiliate investments).

<u>American Islands</u>

American Islands resells makeup products for some central America markets, and also holds all of the group's international patents and brand rights. American Islands' results for 2018 show a profit of $50 million, 10% of which derived from trading goods and 90% from royalties.

<u>Eden Co</u>

Eden Co is incorporated in an Asian country which does not levy taxes. Eden Co's results for 2018 show a profit of $100 million, all of which are related to its controlled company, Oceania. Results are distributed as dividends to Eden Co, but not redistributed to Pantamac.

<u>Oceania</u>

Oceania is fully controlled by Eden Co. Oceania's results for 2018 show a profit of $100 million, all of which relate to the import and resale of Pantamac products to the Australian market. At the end of the year, all profit was distributed as dividends to Oceania's parent company, Eden Co.

Continued

2. Contination

Tangomac

Tangomac is located in a country that has a DTA with Brazil which follows the OECD Model and taxes income at a 25% rate. Tangomac's results for 2018 show a profit of $60 million, of which $51 million relates to its own resale activities, $6 million from its controlled company (Bonitorganic), and $3 million from a second controlled company (Bonitorganic 2). Bonitorganic and Bonitorganic 2 results are accrued and recognised on Tangomac's balance sheet, but have not been distributed as dividends.

Bonitorganic

Bonitorganic is incorporated in Brazil. It owns stores located in shopping malls in Brazil and resells Pantamac products throughout the country. Bonitorganic's results for 2018 show a profit of $10 million, which has not yet been distributed as dividends. Pantamac has a 40% direct participation in Bonitorganic, plus 60% through Tangomac.

Bonitorganic 2

Bonitorganic 2 is incorporated in Brazil. It is involved in a promising professional business. Bonitorganic 2's results for 2018 show a profit of $3 million, which has not yet been distributed as dividends.

Tokyo Co

Tokyo Co, the newest member of the group, is a joint venture with a third party Japanese group known for its electronic products. Tokyo Co's results for 2018 show a profit of $10 million, which has not yet been distributed. Pantamac owns 10% of Tokyo Co's shares.

Mr Sander's home country does not have a DTA with Brazil. He is concerned that his current tax advisers may be mistaken about the group's current tax exposure in Brazil and seek your assistance.

You are required to:

1) **Identify the consequences, if any, which may arise from the fact that Pantamac's administration has been partially performed abroad.** (4)

2) **Determine how much of Patamac's 'own results' are subject to income tax in Brazil, and whether any part of it could also be subject to income tax abroad.** (4)

3) **Assess the Brazilian corporate income tax treatment of the results of each of the following business units:**

   a) **Tokyo Co;**
   b) **American Islands;**
   c) **Eden Co;**
   d) **Oceania;**
   e) **Tangomac;**
   f) **Bonitorganic; and**
   g) **Bonitorganic 2** (12)

4) **Identify any changes to your answer to 3), in the event that any of the business units records a loss for 2018.** (5)

Total (25)

PART B

You are required to answer ONE question from this Part.

3. A famous Brazilian soccer player played for a European club from 2014 until the end of 2018. The club are based in a country which does not share a double taxation agreement with Brazil. The club recently encountered financial difficulties, and owed salaries to the player for a period of six months.

   The player's contract ended on 31 December 2018, and at the beginning of 2019 he signed for a leading Brazilian club, moving back to Brazil.

   Since the beginning of 2019 the European club's financial health has improved and the club has entered into an agreement with the player to pay the back wages owed for services rendered during his contract. The payment was transferred to a bank account outside of Brazil, directly held by the player.

   You are required to:

   1) Explain whether the soccer player is currently considered a Brazilian tax resident. (5)

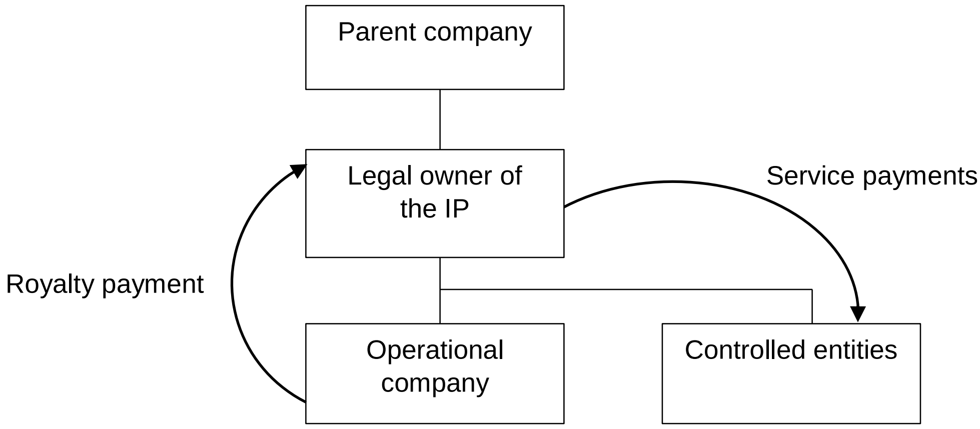
   2) Describe the triggers for income taxation prescribed under Brazilian legislation, and its implications in this case. (8)

   3) Explain any tax treatment applicable to the compensation received by the player from the foreign club. (7)

Total (20)

4. Multinational groups have on many occasions adopted a standard structure to obtain tax efficiency in connection with intangible assets.

These groups often segregated the legal ownership of the intangible assets from their original source of financing or decision making, as well as from the location in which the research and development activities responsible for the creation of those intangibles were carried out. The schematic chart below illustrates this situation:



In this scenario, the legal owner holds exclusive rights over the intangible assets in jurisdictions other than the jurisdiction of the parent company. The income from the exploitation of these intangibles are ultimately allocated to the legal owner, which may be domiciled in a low tax jurisdiction and/or entitled to a special tax regime for income arising in connection with intellectual property assets.

Although there is some economic substance in the legal owner, strategic decision-making related to the exploitation of intangibles remains at the parent company. In most cases, the CFC rules of the parent company's jurisdiction do not allow taxation of income or profits derived by the legal owner. A double taxation agreement (DTA) between the parent company’s jurisdiction and the legal owner’s jurisdiction may also be useful, to rule out or defer the applicable taxation in the jurisdiction of the parent company.

The legal owner licenses the use of the intangible assets to the operational company, which economically exploits the asset and sells to the consumer market of its jurisdiction, which may be a high tax jurisdiction. The structure becomes even more advantageous if this jurisdiction has a DTA with the legal owner’s jurisdiction, limiting or waiving taxation at source on the royalties remitted abroad. Another consequence is that the royalties remitted abroad are commonly treated as deductible expenses for purposes of calculating corporate income tax in the operational company’s jurisdiction.

With the profits derived from the royalty payments, the legal owner enters into service contracts with other subsidiaries of the group located in jurisdictions that have specialised productive force and/or attractive tax regimes for companies setting up research and development centres in their territory.

You are required to explain why this structure might not be as tax efficient from a Brazilian tax perspective as in other countries. You should assume that the operational company is a Brazilian tax resident. (20)

PART C

You are required to answer TWO questions from this Part.

5. Alpha is a company organised under the laws of Greece with its principal place of business in Athens. It owns a subsidiary, Beta, organised under the laws of Brazil with its principal place of business in São Paulo. Alpha and Beta are members of a multinational olives and olive oil producing group, the Parthenon Group.

Brandenburg Ltd, a company organised under the laws of Germany with its principal place of business in Berlin, is a food producing company which currently plans to expand its business into Brazil. Brandenburg Ltd is not a related party to any of the Parthenon Group entities.

Alpha and Brandenburg Ltd have recently entered into a sales agreement, under which Brandenburg Ltd is to acquire all shares in Beta. The purchase amount for the sale of Beta is to be transferred directly from a German bank account held by Brandenburg Ltd to Alpha's bank account in Greece.

As a Brazilian tax expert, you have been assigned to participate as the deal counsel, advising both parties on the following questions:

1) If the transaction triggers any capital gain, will it be taxable in Brazil? (3)

2) If so, which of the parties involved is considered the taxpayer and liable for the calculation and collection of taxes? (6)

3) If the capital gain is to be taxed, on what bases and in what manner will the capital gain be calculated (e.g. rates, tax basis, cost of acquisition, etc.)? (6)

Total (15)

6. Tunder Holding GmbH (Tunder) is a company headquartered in Germany which is a related party to Flash Serviços Industriais do Brasil Ltda (Flash Brazil). Tunder's board of directors are evaluating the possibility of implementing a cost-sharing agreement between Flash Brazil and Tunder.

The main objectives of this cost-sharing agreement are to allocate a portion of the costs incurred by Tunder for the provision of certain support activities to Flash Brazil, and to allow the remittance of reimbursements from Flash Brazil to Tunder for costs in proportion to the benefits produced by Flash Brazil.

You are required to:

1) Identify the taxation applicable to the import of services in Brazil and describe the main Brazilian tax implications of implementing a cost-sharing agreement between Flash Brazil and Tunder. (10)

2) Comment on the deductibility of expenses for Brazilian corporate income tax purposes, and recommend procedures and the minimum documentation required for the reimbursements of costs to be deductible. (5)

Total (15)

7. An Indonesian financial institution (Bali Bank) is willing to set up operations in the Brazilian market. The main goal of Bali Bank is to grant loans to Brazilian companies with the potential of becoming global.

Bali Bank has not yet determined the business model which it will adopt in Brazil. In preliminary discussions, Bali Bank's management has focused exclusively on Brazilian tax aspects. The following options were discussed:

1) Organisation of a locally controlled entity: the loan agreements would be executed in Brazil and the interest accrued on the loans would be paid to the Brazilian entity.

2) Setting up of a local commercial office without legal personality: the loan agreements would be executed locally, although the principal amount would be loaned from Indonesia to the Brazilian company and the interest accrued would be remitted directly from the Brazilian client to Indonesia.

3) Dispatching sales representatives: sales representatives would be sent to Brazil, without powers to execute contracts binding Bali Bank, restricting their activity to intermediation of businesses between the Brazilian clients and the Bali Bank headquarters in Bali. The bank would wire the principal amount to the Brazilian clients, and interest accrued would be remitted from Brazil directly to Indonesia.

In addition to the potential levy of withholding income tax on the interest accrued on the loans, Bali Bank's management is also concerned with the risk of a permanent establishment being characterised in Brazil.

You are required to:

1) Describe the scope and nature of taxation applicable to interest remitted from a Brazilian source to a foreign subsidiary. (8)

2) Describe the differences between the three options for Brazilian corporate income tax purposes and the characterisation of a permanent establishment in Brazil. (7)

Total (15)

8. The Chocolate Group, which acts in the trading of chocolate, has management services and support agreements between Chocolate US, a company domiciled in the United States which is the group's indirect parent company, and a number of Chocolate Group entities around the world.

Under each agreement, Chocolate US allocates costs incurred for the provision of the management and support services to the relevant group entity plus a 25% mark-up in consideration of the services indicated in the agreement. The cost allocation plus the mark-up are based on an analysis prepared by a major consultancy firm consistently using the OECD Transfer Pricing Guidelines.

An agreement is not yet in place between Chocolate US and the group's Brazilian entity (Chocolate Brazil), due to potential mismatches between the Brazilian transfer pricing legislation and the OECD guidelines.

1) What are the main differences between the Brazilian transfer pricing rules and the OECD Transfer Pricing Guidelines? (8)

2) What transfer pricing rules and methods will need to be applied in Brazil, to ensure that the payments are at arm's length? (7)

Total (15)