

# GENERAL BRAZILIAN TAX SYSTEM<sup>1</sup>

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## • ***Introduction***

Business activities in Brazil are subject to a three-tiered tax incidence, including the Federal, State and City levels.

As a general accessory rule for the incurring taxes, buyer shall be dully registered at Federal, State and local Tax Departments in order to obtain the necessary licenses and Enrollment numbers.<sup>2</sup>

Regarding Federal enrollment, the Brazilian company must be (as the foreigner quotaholder) registered before the National Register for Legal Entities of the Treasury Department (Cadastro Nacional de Pessoas Jurídicas do Ministério da Fazenda - "CNJP/MF").

Additionally, the company may be obliged to be registered before the State enrollment (generally if it sells goods) and must be registered before the local (municipal) authorities viewing the issuance (even if it does not render services) and obtain a local license for its headquarters.

## • ***Federal***

In general terms, at the Federal level, all business activities are subject to the following impositions: of tax, social security or labor nature. Labor and social security charges and obligations will be dealt in another specific paper.

Federal tax system is exceedingly complex. The brief notes below are destined to simply acquaintance you about the bare system working. You may also check the Brazilian Federal IRS website (in English):

<http://www.receita.fazenda.gov.br/principal/Ingles/SistemaTributarioBR/Taxes.htm>

### ***a) Income Tax (IRPJ) and Social Contribution on Profits (CSLL)***<sup>3</sup>

The rate applicable at the moment is 15% up to a monthly tax base of R\$ 20.000,00 (twenty thousand reais). The tax base in excess of such level is taxed at a rate of 25% (15% plus an additional of 10%) (article 228 of RIR/99). The extreme complexity of this tax requires specific treatment of each issue at stake.

In the real profit system the profit will result from the company's gains and revenues, after some law-defined adjustments, including the deduction of operational costs (custo) and operating expenses (despesa operacional) (observing certain limits in our

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<sup>1</sup> 2010.

<sup>2</sup> Depending on the company's activity there might be need to only register before the local or state authority. The Federal registration is mandatory.

<sup>3</sup> The rates presented for Federal taxes Income tax are the ones based on a "real profit" system. Another rate system is applicable in a "estimate profit" accounting system.

legislation). Hence, you may deduct only up to 30% of the company's profit (tax base for the income tax) in each fiscal year with its accumulated loss.

Brazilian companies with foreign partners may choose between the real profit system (lucro real) and the deemed profit system (lucro presumido) – since 1999 (art. 14 of Law 9.718/98 and art. 246 of RIR/99).

For some companies the real profit system is mandatory, which seems not to be the case of PGS's affiliates, as long as they observe the following requirements (and keep the present business purposes):

- a) The company's revenues in the previous year shall not be higher than R\$ 48 million in the year or R\$ 4 million per month;
- b) The law establishes that no amounts shall be received from abroad. Later on, the Brazilian IRS clarified that, of course, in case of export of services and/or products, the Brazilian company may receive amounts from abroad<sup>4</sup>; and
- c) No tax benefits regarding the exemption or reduction of the income tax may be used.

In the deemed profit system, taxation is levied on the company's monthly declared gross revenues pursuant to a profitability margin "assumed" by the authorities, depending on the company's activities. A presumed tax basis of the gross revenues is established (for services it is 32%) and the IRPJ tax rate – and CSLL – will levy on the resulting amount. Indeed, this results in the payment of IRPJ – and CSLL – on a 3 month basis (4 times a year). There is no accumulated loss to be deducted in this case.

CSLL is a social contribution and is calculated upon the same basis and almost under the same method of the IRPJ. The applicable rate is of 9% (article 37 of Law 10.637/02). Contributions may be assigned to specific purposes and as a rule are not shared among the Union, states and cities.

As so, the explanations regarding the real profit system and deemed profit system (IRPJ) are applicable to the CSLL, including the rate of 32% in case of the deemed profit system.

- IR-FONTE Income Tax withheld at Source:

- i) incurs upon all domestic payments due to resident officers, employees, and all individual Independent Contractors according to a Table issued by the Federal Tax Authority (SRF) – nowadays the rate is between 15% and 27.5%;
- ii) over the payments made to some professional corporations (this one at the rate of 1.5%);
- iii) over various payments, like leasing fees, due to resident persons, on various rates;

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<sup>4</sup> Ato Declaratório Interpretativo SRF nº 5, de 31 de Outubro de 2001.

- iv) over all payments of interests, royalties, fees, etc. due to nonresident persons, at rates that may be 15% or 25%, depending on the payment nature (internal and most Double Taxation Treaties rate). Since 1996, no withholding is due under this requirement on payments for profits or dividends.

The CIDE of 10% is imposed on technical services (art. 2, paragraph 2 of Law 10.168/00 and art. 10, subsection III of Decree 4.195/02), although they are not royalties and levy even on services not regarding or non-related to the transfer of technology.

The CIDE Contribution is not covered under the Double Taxation Treaties and there are no CIDE credits regarding the payments for specialized technical services, but only for royalties regarding patents and trademarks (art. 4 of Provisional Measure 2.159-70/01).

***b) Social Integration Program (PIS) and Social Contribution on Gross Sale (COFINS)***

These contributions levy on company's gross revenue amount and the rates changes according to the cumulative (mandatory for companies taxed by the deemed profit system) or non-cumulative (mandatory for companies taxed by the real profit system) methods. In the non-cumulative method the rates are higher, but you may use credits to reduce the amount to be collected (non-cumulative Pis/Cofins).

Pis is imposed on gross receipts as defined by the income tax laws at the rate of 1,65% (non-cumulative) or 0,65 (cumulative). Cofins Federal Tax rate is of 7,6% (non-cumulative) or 3% (cumulative) calculated upon the gross value of the services rendered or the items sold by the company.

The legislation regarding the non-cumulative Pis<sup>5</sup>/Cofins<sup>6</sup> refers to credits, among others, for the:

- a) Electric energy used in the establishments of the legal entity;
- b) Lease of real estate properties, machines and equipments paid to legal entities and used in the company's purposes;
- c) Machines, equipments and other assets (accounted as fixed assets) acquired to render services; and
- d) Inputs acquired from Brazilian legal entities or imported with the payment of Pis-Importação and Cofins-Importação. This is the most controversial one, especially for companies which main purpose is to render services.

Brazilian legislation does not allow credits for amounts paid to individuals, including, as so, the wage paid to employees, usually the highest expenses for almost all services companies. Also, Brazilian labor law protects the employee in order to avoid the companies to hire other legal entities instead of individuals as employees. As, in general, the main purpose of a company must be performed by individuals, there is no

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<sup>5</sup> Article 3 of Law 10.637/02 (Pis).

<sup>6</sup> Article 3 of Law 10.833/03 (Cofins).

credit for the non-cumulative Pis/Cofins (difference must be made if the individuals are partners or not, but this is another subject matter).

Thus, in order to make things even more complicated for service companies, the Brazilian Federal IRS enacted rules under a limited interpretation of the law and is trying to limit the credits for service inputs to the ones almost exclusively used and consumed in the services rendered. It is not exactly as so, but it is almost like only the operational costs may be considered inputs, with operating expenses being not considered as such.

As an example, the amount paid to a Brazilian company hired to provide transportation (unless for engineering services in another city or state) and food for all employees may be deducted from the income tax as an operating expense, but will not result in credits to non-cumulative Pis/Cofins (is not considered an input), according to the IRS initial understanding. Hence, since the legislation is new, there is no judicial case law regarding it yet and even the administrative *courts of appeal* have not appreciated related cases.

#### ***c) PIS - Import (PIS-Importação) and Cofins - Import (Cofins-Importação)***

We have the PIS - Import (PIS-Importação) (1,65%) and the Cofins - Import (Cofins-Importação) (7,6%), which levy on imported goods and services.

If the company is taxed by the real profit system, resulting in the non-cumulative Pis/Cofins which levies on the company's gross revenues, the Pis-Importação and the Cofins-Importação regarding services as inputs will result in credits to be deducted from the tax base of the non-cumulative Pis/Cofins.

Regarding the cumulative Pis/Cofins, no credits are granted.

#### ***d) Federal Tax on Industrialized Products (IPI), a value added tax***

This Federal Tax is paid by manufactures on behalf of their customers at the time of sale. The IPI amount is considered on the sale cost and transferred to the buyer. IPI rates vary on different industrialized products<sup>7</sup> (and not on all physical goods, as ICMS); approximately on the same manner and same methods as *ad valorem* tariffs are calculated.

Federal law also disposes on situations where non-manufacturers companies are considered as so for IPI purposes. In order to define whereas IPI will levy on this sale transaction more detailed information would be necessary.

The Federal VAT IPI is not imposed on any merchandise, as its State counterpart, but only on some taxable events concerning industrialized products. Except for this fact, and for its national, and not state, character, the general mechanism of this tax is similar to that described in regard to ICMS.

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<sup>7</sup> Industrialization is characterized by any operation which modifies nature, functioning, finishing, presentation or use of a product, or that in any manner improves a product for consume, such as the one performed on raw material or intermediary product consisting in the obtaining of a new specie (transformation).

IPI is due, among other taxable events, on the importation of industrialized products, in addition to tariffs, and on the departure of such products from an industrializing establishment (or deemed industrializing establishment). Industrialized products are those resulting from an industrializing operation.

***e) IOF - Tax on Exchange and Financial Operations***

Due especially on exchange and some financial operations. The standard rate, since the termination of the CPMF (Tax on Financial Movement)<sup>8</sup>, is of 0.38% per operation, but some are reduced to zero, although this may be changed at any time, as this is a governmental policy instrument.

***f) Tariffs***

Imposed on imported products on various rates.

***g) Tax for the Improvement of Ports and Additional to the Freight of the Merchant Marine***

Those two impositions incur upon the movement in the ports and shipping activities.

***h) ITR Rural Areas Property Tax***

There is tax due when of acquisition of a property and an annual amount is due to the government.

***i) Sundry service or Police taxes imposed on specific services rendered by Federal Authorities***

**• Regional (at the State level)**

***a) ICMS (State value added tax)***

State Value added tax on merchandises, Electricity, Telecommunication and Transport services. Tax rate is federally standardized but there are some exceptions. Intrafirm or nonconsumer operations among merchants are taxed at special “interstate” rates.

ICMS, at the internal regular rate of 18%<sup>9</sup> will be due whenever there is circulation of physical goods or designated service, as established by article 1st of the Complementary Law n° 87/96. Interstate rate from São Paulo to whichever state is may be, depending of the state, of 7% or 12%.<sup>10</sup>

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<sup>8</sup> Previously imposed on most bank operations.

<sup>9</sup> It is important to observe, however, that some provisions of the state legislation (ICMS Regulations) modify the tax burden of the ICMS, through the institution of exemptions, reductions in tax basis, allowance for set-of of special credits, or either, phantom credit, of the anticipation or the delay of the payment of the tax, etc.

<sup>10</sup> This circulation may occur physically (merchandise transfer between establishments, even when there is no property transfer) or Legally (the fiction exit: operation considered by law as the transfer occurred through tax documents change between different establishments with no change at goods location, but a legal circulation by property transfer).

State VAT (ICMS) is imposed on various taxable events, the most relevant of which being the entry in an establishment of imported merchandise and the departure from the establishment of any merchandise. As we mentioned above before, this tax is imposed on physical merchandise, but also on the like taxable events related to Transport, Telecommunication and Electricity services.

ICMS tax amount must be considered for final sale price. By law, seller is charged of ICMS payment on the value added amount, but the total actual expense must rely on final consumer.

The City tax on services may or may not substitute the ICMS (State VAT tax), depending on the classification of service as listed.

The export of industrialized products is not subject to ICMS<sup>11</sup>.

ICMS is covered by the Federal Constitution and by a specific National Law, but many of its provisions, specially, now, those of a procedural or exceptive nature, by Interstate Tax Conventions. For many years, the system lacked a National Law; its basic provisions were supplied by a special Interstate Convention. Each State has its own body of law, which is supposed to conform to the National Standards and Interstate Conventions.

As a value added tax, it is calculated in each operation concerning the circulation of merchandise taking into account the like tax already paid in regard to the same merchandise or its inputs, parts and components as result of prior operations of like nature. Therefore, the value of the tax previously paid in the various phases of the circulation of the merchandise is offset to the value newly due and just the difference is actually brought to the Governments vaults.

In some cases, the state law imposes ICMS on a given phases to cover for the succeeding ones when, for instance, taxes on resellers are harder to collect. When this happen, an imputed value added is summed to actual basis.

#### ***b) IPVA***

Or Property Tax on self propelled vehicles, including some ships according to each state law but excluding barges and other non-self propelled vessels.

#### ***c) Tax on the Transfer of Property (ITBI). Gift and Inheritance Tax***

Tax imposed on assessment or trustworthy declared value of real estate transaction, and also other assets transferred on gift and inheritance. The rate is normally 4%.

#### ***d) Sundry service or Police taxes imposed on specific services rendered by State Authorities***

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<sup>11</sup> Constitution Art. 155 § 2º, X, a).

**• Local (at city level):**

***a) ISS - Service Tax***

Due on the services listed in Federal Law and City Law, specifically excluding Telecommunication and Transport services. Since 2002, it is also imposed on imported services and engineering. There is a discussion regarding royalties.

This tax is imposed on the gross values received as result of services rendered. This is not a value-added tax: except for very limited exceptions there is no deduction from the tax basis for prior services rendered for the company by third parties or for materials or other items used in the service.

The tax rate may vary from service to service and from City to City, but as a general standard, municipalities limit most of the services to a 5% level.

The City tax on services may or may not substitute or add to the ICMS (State VAT tax), depending on the classification of service as listed.

***b) IPTU - Real Estate Property Tax***

Incurs upon (among others taxes/fees) real estate property. Rates vary on assessment and location.

***c) Tax on the Transfer of Property***

Tax imposed on assessment or trustworthy declared value of real estate transaction except as a Gift or Inheritance (the latter are State taxes). Rate is usually 2% of the value of the property estimated by the local authority.

***d) Sundry service or Police taxes***

Imposed on specific services rendered by City Authorities like localization taxes, licensing rights etc.

**• Some operations, transactions and other issues:**

***a) General taxation of a Brazilian Company***

Regarding a Brazilian company, its business purpose may be taxed by the service tax (ISS) and/or the State Value added tax (ICMS) and, depending, the Federal Tax on Industrialized Products (IPI). Thus, the company's revenue provided from such services and products will be monthly taxed by Pis and Cofins (Federal Social Integration Program (Pis) and Social Contribution on Gross Sale (Cofins)).

Then, if the company has any profits, such profit will be taxed by CSLL and income tax (IRPJ). The dividend distribution of profits to foreign investor is not taxed. Other payments as royalties and services shall be taxed as mentioned above.

This is just a general overview of the usual tax and contributions. There may be other tax incurrence according to your business operation that would require a more specific analysis.

### ***b) Loan***

The main tax will be the IR-FONTE Income Tax withheld at Source incurring upon the interest payment<sup>12</sup> on international debts. No income tax will levy upon the remittance of the value sent to Brazil (principal).

It must be noted that such interest payments may be deducted by the Brazilian company with some limitations regarding the amount of interest charged<sup>13</sup>, the amount of the debt (thin capitalization<sup>14</sup>) and treatment made by the international affiliate company in its balance sheets are considered.

Another tax incurring upon credit is IOF (Imposto sobre Operações de Crédito, Câmbio e Seguro, ou Relativas a Títulos ou Valores Mobiliários - IOF) due especially on exchange and some financial operations.

The operation must be registered before the central bank system, which has 5 (five) days to agree with the interest rate established by the parties, and the procedure shall be observed in the remittance and payment of the values. This generates bureaucracy and may require time to conclude the operation but there is no additional financial burden other than minor banking and registration fees.

Affiliate companies may loan values to their subsidiaries in Brazil (with limitation for tax purposes). However, there shall be certain limits regarding the amount charged for the loan and other minor restrictions and limits that will have to be observed to maintain, as possible, an arms-length situation. One of the restrictions is mentioned above regarding a minimum esteemed interest rate.

### ***c) Transfer of technology and specialized technical services***

Agreements regarding the transfer of technology (e.g. patents, trademarks and know-how) and specialized technical services (not including, for example, commercial, financial and juridical consultancy), which are services not covered by the definition of technical assistance (it is how our legislation names the transfer of know-how) and, therefore, do not result in the transfer of technology<sup>15</sup>, shall be registered at the Brazilian Patent and Trademark Office (Instituto Nacional da Propriedade Industrial –

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<sup>12</sup> Definition of interest for the purposes of the bilateral treaty - Income from debt-claims of every kind, whether or not secured by mortgage and, in particular, income from government securities, bonds or debentures, as well as other income assimilated to income from money lent by the tax law of the Contracting State in which the income arises.

<sup>13</sup> Lei nº 9.430, of 1996, arts. 22 e 24; Law nº 10.451, of 2002, art. 4º; Law nº 9.532, of 1997, art. 1º, § 3º, amended by art. 3º of Law nº 9.959, of 2000, and by art. 34 of MP nº 2.158-35, of 2001. For loans among affiliated companies the interest is considered the libor rate applicable to deposits in the USA for over 6 months added to 3% annually if the agreements are not registered before the central bank.

<sup>14</sup> Lei 12.249/10.

<sup>15</sup> In the know-how agreement, the technology is transferred (“supplying know-how”), while in the services rendered, the technology is used in the service (“applying know-how to guide the company”). XAVIER, Alberto. *Direito Tributário Internacional do Brasil – Tributação das Operações Internacionais*, 5ª Edição, Forense, Rio de Janeiro, 2002, p. 624.



“INPI”) and the Central Bank of Brazil (Banco Central - “Bacen”)<sup>16</sup> for tax and remittance purposes.

There is a discussion whether royalties shall be taxed as services and therefore subject to ISS, Pis – Import and Cofins – Import. Federal authorities, after indicating the taxation, are now considering that Pis – Import and Cofins – Import do not levy (what may change, again, in the future), as long as the fees for services and royalties are segregated in the agreement, but the municipalities still consider the ISS is due.

Taxes on the payment of services rendered (know-how – technical assistance<sup>17</sup>): (i) Federal withholding income tax (“IRRF”) of 15%; (ii) Pis – Import of 1,65% (the tax base includes other taxes, so it is higher than the nominal rate); (iii) Cofins – Import of 7,6% (the tax base includes other taxes, so it is higher than the nominal rate); (iv) Federal Contribution for Intervention in the Economic Domain (“CIDE”) of 10%; (v) City service tax (ISS); and, maybe, (vi) IOF.

Royalties (trademarks or patents) are levied by: (i) Federal withholding income tax (“IRRF”) of 15%; (ii) Federal Contribution for Intervention in the Economic Domain (“CIDE”) of 10%; (iii) City service tax (ISS); and, maybe, (iv) IOF. We also have a risk regarding Pis – Import of 1,65% (the tax base includes other taxes, so it is higher than the nominal rate) and Cofins – Import of 7,6% (the tax base includes other taxes, so it is higher than the nominal rate).

Not subject to transfer pricing legislation, having a limited deduction (5%) for IRPJ and CSLL purposes.

#### ***d) Intra-group transactions***

Brazilian transfer pricing legislation shall apply.

#### ***e) Black list of tax havens and privileged tax regimes***

Brazil also has a new black list of tax havens and privileged tax regimes:

<http://www.receita.fazenda.gov.br/Legislacao/Ins/2010/in10372010.htm>

<http://www.receita.fazenda.gov.br/Legislacao/Ins/2010/in10452010.htm>

Netherlands and Switzerland already required their exclusion from the privileged tax regimes list. As so, their inclusion was suspended by the Brazilian Federal IRS:

<http://www.receita.fazenda.gov.br/Legislacao/AtosExecutivos/2010/RFB/ADRFB010.htm>

<http://www.receita.fazenda.gov.br/Legislacao/AtosExecutivos/2010/RFB/ADRFB011.htm>

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<sup>16</sup> The certificate issued by the INPI is mandatory for the registration before the Bacen.

<sup>17</sup> Both Federal Income Tax and City level Service taxes consider know how or technical assistance payments as due on account of services rendered.

*f) Double taxation conventions*

Brazil has double taxation conventions with several countries, according to the Brazilian IRS website (in English):

<http://www.receita.fazenda.gov.br/Principal/Ingles/Acordo/DuplaTributDefault.htm>