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Brazil Government's Proposed Income Tax Reforms

By Ricardo Maitto

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Ricardo Maitto of TozziniFreire Advogados summarizes the Bill that proposes landmark changes to income tax regulations in Brazil, including dividend taxation, anti-abuse measures and the end of M&A-related incentives.

On June 25, 2021, Brazil's Ministry of Finance submitted Bill 2,337/2021 (the Bill) to the Congress with proposed changes to income taxation for businesses and individuals. The proposal represents the second phase of a comprehensive tax reform that intends to simplify the Brazilian tax system and reduce a litigation-oriented environment for companies.

The first step took place in July 2020 with Bill 3,887, which replaces the current PIS/COFINS—a social security charge calculated over revenues—by a 12% single rate, pure non-cumulative tax called CBS (Social Contribution on Transactions with Goods and Services). Political instability and high pressure from specific business segments were significant setbacks to such proposed legislation, which still waits for Congress analysis.

This new government initiative reduces the nominal corporate income tax (CIT) rate to 29% and introduces a 20% withholding tax on dividends. Proposed changes also have an impact on corporate reorganization and mergers and acquisitions (M&A) transactions taxation. In addition, the changes simplify financial investments taxation, update personal income tax rules, and introduce some anti-abuse measures. The new regulation will become effective in January 2022 if Congress approves by the end of 2021.

Corporate Income Tax Rate and Dividend Taxation

For most Brazilian companies, the nominal CIT rate is 34%, of which 25% refers to CIT (IRPJ) and 9% to social contribution on net profit (CSLL). Small and mid-size companies—representing over 95% of all registered companies in Brazil—qualify for simplified tax regimes (presumed profit and *SIMPLES*) that reduce the effective income tax rates.

Bill 2,337/2021 proposes a progressive reduction of up to 5% on CIT rate and the introduction of a 20% withholding tax (WHT) on dividends (see below). The Bill does not contain transitional rules, which means that dividend distributions taking place as from January 2022 would be affected even if they refer to profits accrued in previous fiscal years. Contrary to what the Ministry of Finance suggests, the new rates increase the effective tax burden on profits by approximately 27% (33% in 2022).

Under the proposed legislation, the WHT on dividends would be 30% on payments to shareholders located in tax havens or subject to beneficial tax regimes. The list of affected jurisdictions includes countries such as Ireland and Lebanon and certain preferential tax regimes available in Switzerland, Netherlands, Spain, Austria, among others.

Corporate Income Tax Rate and Dividend Taxation

Item	Current Rates	Proposed Rates	
		2022	2023 onward
CIT Rate	34%	31.5%	29%
Taxation on Dividend (WHT)	0%	20%	20%
Effective tax burden on profits	34%	45.2%	43.2%

Notes: CIT rates applied to financial and insurance companies can be as high as 45% and remain unchanged. WHT on dividends paid to shareholders located in tax havens is fixed at 30%.

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To neutralize the (adverse) effect the 20% WHT could cause to economic groups with several corporate layers, the Bill authorizes corporate shareholders to recognize a credit on the 20% WHT applied on dividends received, which are offset against subsequent distributions over the corporate chain. It should be noted that the 20% WHT on dividends paid to foreign shareholders can be reduced to 10% or 15% through the application of double tax treaties. Bill 2,337/2021 also eliminates the possibility for companies to deduct interest on net equity, an alternative form of (tax deductible) profit distribution.

Bill 2,337/2021 also includes the following changes to CIT calculation:

- CIT would be calculated and paid quarterly (not monthly) and tax losses would be used to offset profits without limitation within the fiscal year;
- amortization of intangibles would be subject to a minimum 20-year period;
- share based payments granted to executives would not be tax deductible;
- 5% limitation on royalty deductibility would be extended to CSLL;
- certain real estate and copyright licensing companies would no longer be eligible to the simplified tax regime called presumed profit.

Impact on M&A-Related Tax Incentives (Goodwill) and Corporate Reorganizations

Brazilian legislation provides for a tax benefit that enables investors to amortize the goodwill or to depreciate/amortize the surplus paid in the acquisition of equity interest in Brazilian companies. For such tax benefit to be applied, the investor must justify the goodwill and/or the surplus based on an appraisal report, and cause the Brazilian acquisition entity to be merged into the acquired entity (either a downstream or an upstream merger).

Upon the merger of the acquired company and the acquisition entity, surplus is allocated to the book value of the underlying assets, thereby increasing the basis for tax depreciation/amortization. Goodwill is booked as an intangible asset and is amortized for tax purposes within a minimum period of five years.

The government proposes to eliminate the goodwill amortization benefit, which would apply only to acquisitions concluded up to December 2021 and provided that a merger is implemented by December 2022. In addition, goodwill paid in the acquisition of equity interest would be subject to a presumed, non-deductible realization of 20% per year, meaning that shareholders would automatically lose the tax basis associated with goodwill after five years.

As regards corporate reorganizations, Bill 2,337/2021 introduces a mandatory market valuation for assets transferred under capital reductions or redemptions, which are currently tax neutral. It also updates domestic regulations intended to prevent disguised distribution of profits (DDP). Such rules were designed to force transactions between companies and their shareholders to be conducted at arm's length. New DDP regulations include guidelines that should be followed by companies to prepare appraisal reports that justify the valuation adopted on intra-group transactions.

Anti-Abuse Measures

Over the past years it has become more common to have companies and individuals "re-domiciling" their investments from Brazil to other jurisdictions. The so-called flip transactions are common practice within the startup environment, particularly when such companies arrive at the point where they wish to seek funding from foreign investors, who tend to prefer to invest in U.S. companies as opposed to inject funds directly into Brazil. For companies that have a sizable portion of their revenue coming from abroad, a relocation to another jurisdiction is also a logical progression.

Under Brazilian existing tax rules, flip transactions can be implemented with tax neutrality, that is, shares can be transferred to another entity at cost. Bill 2,337/2021 proposes that whenever such transfer of shares is directed to a foreign entity, shares should be valued at market value and the corresponding capital gains should be taxed in Brazil. In this case, individuals would have the right to pay the tax on capital gain in 60 installments following the transfer.

Anti-abuse regulations are also proposed to counter the indirect sale of Brazilian assets via offshore entities. According to the Ministry of Finance, such regulations are intended to tackle a tax planning strategy that consists of interposing offshore vehicles to artificially allocate capital gains on the sale of Brazilian assets to non-Brazilian entities, thereby avoiding the application of local regulations.

As per Bill 2,337/2021, such indirect transfers would be taxed in Brazil (15% to 22.5%) if, at any time during a 12-month period prior to the transfer, (i) the market value of the Brazilian asset being (indirectly) transferred exceeds in 50% the total market value of the offshore entity and the transfer involves an interest of more than 10% on the offshore entity, or (ii) the market value of the Brazilian asset being transferred exceeds $100 million and the transfer involves an interest of more than 10% on the offshore entity.

While the buyer of the asset is primarily liable to retain and pay the capital gains tax, Brazilian local representatives of both the seller and buyer are also jointly liable. There is no safe harbor for corporate reorganizations or transactions that do not entail indirect change of control.

The government also proposes to extend the scope of controlled foreign corporation (CFC) rules to cover foreign entities held by Brazilian individuals when such entities are based in tax havens or jurisdictions with preferential tax regimes. Profits of such entities would be automatically taxed in the hands of the Brazilian individuals (maximum 27.5% rate) at the end of the entity's fiscal year, regardless of the effective distribution.

Taxation of Financial Investments (Including Investment Funds) and Personal Income Tax

Simplification is one of the key drivers for the proposed changes to the taxation of financial investment, including a single 15% for most transactions, which replaces the regressive rates that currently apply to such investments (see below). Changes are also proposed to the taxation of investment funds, including a 20% WHT on dividends paid to stock funds.

Type of Investment	Current Tax Regime	Proposed Tax Regime
Fixed Income	15% to 22.5% WHT	15% WHT
Variable Income (ordinary)	15%	unchanged
Variable Income (day trade)	20%	15%
Investment Funds (general)	15% to 22.5% WHT (*)	15% WHT
Stock Funds	15%	unchanged
Real Estate Funds	20% (0% for qualified individuals)	15% (no exemption)

(*) Open investment funds are subject to tax anticipations in May and November (come–cotas), which would be replaced by a single anticipation in November to be applied to both open and closed funds.

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Proposed changes also affect the participation investment funds (FIPs), which are frequently adopted by international private equity funds to invest in Brazil due to a tax exemption on distributions made to foreign shareholders. Such exemption, which applies to shareholders not located in tax havens who own less than 40% in the FIP, remains unchanged.

However, the Bill introduces certain requirements to ensure the fund is qualified as a "collective investment vehicle." Failure to comply with such rules causes the FIP to be taxed according to the rules applied to companies. In addition, proceeds from the sale of assets owned by the FIP should be automatically distributed to shareholders (and taxed accordingly) up to the last business day of the month following the conclusion of the sale transaction.

Bill 2,337/2021 also updates the personal income tax brackets according to the income level (see below) and enables individuals to update the cost basis of real estate properties acquired up to 2020. This increase in the cost basis triggers a 4% tax liability for the individual while reducing capital gains taxation on future sales.

Tax Rate	Current (Brazilian Real)	Proposed (Brazilian Real)
Exempt	0 to 1,903.98	0 to 2,500.00
7.5%	1,903.99 to 2,826.65	2,501.00 to 3,200.00
15%	2,826.66 to 3,751.05	3,200.01 to 4,250.00
22.5%	3,751.06 to 4,664.68	4,250.01 to 5,300.00
27.5%	4,664.68 or more	5,300.01 or more

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Market Perception and Next Steps

While President Bolsonaro's administration claims that the changes would lead to a fairer and simpler tax system without increasing the overall tax costs, the Bill has faced immediate and strong reaction from virtually all business sectors, most of which point out that the changes will incentivize speculative rather than long-term investments.

Market specialists also criticize the lack of coherence of the Bill, as the introduction of a 20% WHT on dividends is combined with a small 5% reduction on CIT rates, which ends up increasing the overall tax burden on profits by around 27%.

Not surprisingly, a few days after it was introduced, a Congress member has proposed a replacement to the current Bill. The new version would reduce CIT rates to 24% (2022) and 21.5% (2023 onward) and, while preserving the 20%/30% WHT on dividends, exempts intra-group distributions from such charge. The new version also maintains goodwill tax amortization and eliminates all anti-abuse measures described above.

As previously indicated, new regulations would become effective in January 2022 if approved by the Congress by the end of 2021. While it is advisable for companies and investors to monitor the matter closely, there seems to be consensus that existing political instability and lack of market support will delay the Congress analysis, which makes it very unlikely for the Bill to be approved in 2021.

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