Brazil enacts new rules impacting dividend withholding, interest deductions, goodwill amortization, and CFCs

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In brief

The Brazilian government on May 14, 2014 enacted Law No. 12.973/2014, converting into law Provisional Measure 627/2013 (PM 627).

The key provisions of the enacted law are the revocation of the Transitional Tax Regime (RTT) and new rules regarding the treatment of dividends, interest on net equity (INE), amortization of goodwill, and controlled foreign corporations (CFCs).

The new law will take effect January 1, 2015, but taxpayers may elect to apply it effective January 1, 2014. This election, if made, is irrevocable.

In detail

Background

Law No. 11.638/2007 amended the Brazilian accounting rules to align Brazilian generally accepted accounting principles (GAAP) with International Financial Reporting Standards (IFRS), effective January 1, 2008.

To ensure that this accounting change was tax neutral, the RTT was introduced in Law No. 11.941/2009.

In September 2013, the Brazilian Revenue Service (RFB) issued Normative Instruction (NI) 1,397, which required taxpayers to maintain two sets of books, one for accounting purposes and another prepared in accordance with the old accounting principles (referred to herein as the 'Tax Balance Sheet'). NI 1,397 also explained how certain differences between the two sets of books should be treated for tax purposes.

On November 12, 2013, the Executive Branch of the Brazilian government published PM 627, which revoked the RTT and amended other aspects of the tax law.

During the extensive legislative approval process, several amendments were made to PM 627 before its conversion into Law No. 12.973/2014.

Dividends and INE payments

According to NI 1,397, any portion of a dividend paid in excess of the amount calculated using the Tax Balance Sheet should be subject to withholding income tax at 15% (or 25% if the beneficiary is located in a tax haven). Similarly, any portion of INE paid in excess of the amount calculated using the Tax Balance Sheet should not be deductible for Brazilian income tax purposes. These provisions gave rise to intense debate over the legality of NI 1,397.

By revoking the RTT, the new law eliminates the requirement for taxpayers to maintain separate tax books for dividends and INE.

Under the new law, dividends from profits generated between January 1, 2008, and December 31, 2013, that are greater than the amount calculated using the Tax Balance Sheet are not subject to tax. In the original version of PM 627, this rule was limited to dividends paid by November 12, 2013, if the company made an election to apply the new law from January 1, 2014. The new law removes this limitation.

Note: Taxpayers that do not elect to adopt the new law as of January 1, 2014, still must take into account NI 1,397 with respect to dividends based on profits accruing between January 1, 2014, and December 31, 2014. The debate on the legality of NI 1,397 therefore will continue with respect to earnings accruing during 2014.

By giving Brazilian companies the option to use the new accounting principles starting in 2008 for INE purposes, the new law effectively grants a waiver for any portion of an INE payment greater than the amount calculated using the Tax Balance Sheet. PM 627 granted the waiver only to taxpayers that elected to apply the new law beginning January 1, 2014. The new law revokes that requirement.

Goodwill assessment and amortization

Under prior law, when the cost of a share acquisition was higher than the net equity value of the acquired company, taxpayers typically booked the difference as goodwill, provided the nature and economic reason for the goodwill were properly documented. Following a merger between the purchaser and the acquired company, the full amount of any goodwill allocated to future profitability then was amortized over a period of not less than five years.

Under the new law, which is consistent with current Brazilian accounting standards based on IFRS, the acquisition cost of investments must be separated into:

- the net equity of the acquired company
- the fair market value of the net assets
- the goodwill derived from future profitability, which is the remaining balance from items (i) and (ii).

As under the old rules, goodwill following a merger can continue to be amortized for tax purposes over a period of not less than five years, provided certain conditions are met.

The main requirements for this treatment are that:

- an independent report be prepared and filed with the RFB/Register of Deeds and Documents to support the fair value of the net assets
- the transaction be carried out among unrelated parties.

PM 627 included an additional requirement for taxpayers to document that the goodwill did not arise from a transaction involving an exchange of shares. This requirement has been removed.

Taxpayers wishing to apply the prior rules for goodwill amortization to acquisitions made on or before December 31, 2014, will have until December 31, 2017, to complete the merger. Under PM 627, taxpayers had until December 31, 2015, to complete the merger.

Other general measures to regulate the tax impact of the new Brazilian accounting standards

The new law also proposes amendments to the general Brazilian tax law regarding Corporate Income Tax (IRPJ), Social Contribution on Net Income (CSLL), and contributions on gross revenues (PIS and COFINS). The aim of these measures is to align Brazilian tax rules with the Brazilian accounting standards that are based on IFRS.

The main issues addressed by the new law include:

- fair value adjustments of capital subscriptions, mergers and acquisitions, and general restructurings
- present value adjustments
- amortization of intangibles
- treatment of interest expenses and financial instruments
- treatment of depreciation
- stock options and share based payments
- impairment
- leasing
- concession contracts for public services.

These changes generally are designed to ensure that the legal and contractual nature of the transactions must prevail for tax purposes, irrespective of the accounting treatment. The law provides mechanisms to ensure the changes are tax neutral, but also provides conditions for these rules to apply as well as various exceptions. The new law also imposes additional electronic reporting and accounting obligations, such as requiring taxpayers to maintain sub-accounts in which they recognize and control adjustments, in order to secure tax neutrality or achieve tax deferral.

Important amendments to the Brazilian CFC legislation

The old Brazilian CFC rules charged tax on undistributed profits of foreign controlled or affiliated companies that were available to the Brazilian parent on December 31 of each calendar year. The new rules distinguish between controlled and affiliated companies.

Controlled companies

The new law will apply to both directly and indirectly controlled entities (the 'top down look through approach'). Any investment in a controlled foreign entity therefore must be adjusted yearly to reflect the change in the investment value relating to the profits or losses of the controlled entity.

The change in investment value must be apportioned based on the Brazilian parent's share ownership. IRPJ and CSLL then apply annually to any profits calculated under the accounting standards of the controlled entity's jurisdiction.

Taxpayers will be allowed to consolidate profits and losses until 2022 if certain conditions are met. Under PM 627, this provision expired in 2017.

Taxpayers that do not choose to consolidate may offset losses only against future profits of the same foreign entity. Under PM 627, taxpayers had only five years to use these losses. This limitation has been removed, so taxpayers may use losses accrued before the new law takes effect with no time restriction.

If certain conditions are met, taxpayers may choose to pay income tax due on the foreign profits when the profits are actually distributed to the Brazilian entity. In the first year, however, even when there is no distribution of profits, 12.5% of the profits will be deemed to be distributed to the Brazilian parent (down from 25% under PM 627). If no further profits are distributed, the remaining profits will be deemed to be distributed in the eighth year (as opposed to the fifth subsequent year under PM 627). Taxpayers choosing to postpone income tax payments should consider the impact of interest rates and foreign exchange fluctuations on their tax liabilities.

Under the old CFC rules, taxpayers normally mitigated double taxation through the use of foreign tax credits granted in Brazil for income tax paid on the foreign entity's profits. The new law expressly extends such foreign tax credits to withholding income tax paid abroad on profits distributed to the Brazilian parent, with no time limitation.

Affiliated companies

The new law imposes a tax charge only on distributions of affiliated companies' profits. Profits earned by a Brazilian entity through a foreign affiliate therefore generally will be taxable in Brazil only on December 31 of the year in which they were actually distributed to the Brazilian entity, provided that the affiliate satisfies certain conditions set forth in the new law.

Other measures

The new CFC rules will not apply to activities related to oil and gas exploration in Brazil undertaken by directly or indirectly controlled foreign entities and affiliates.

PM 627 contained provisions that applied the CFC rules to individuals. Those provisions were not enacted as part of the new law.

The takeaway

US multinational companies with operations or investments in Brazil should study the provisions of the new law — especially the changes from PM 627 — carefully to determine its potential impact.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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