Brazilian Federal Government proposes income tax reform

July 8, 2021

In brief

The Brazilian Federal Government announced on June 25 the second phase of its proposed comprehensive tax reform, focusing on income tax. The government published the first phase of the proposal in August 2020. The authorities announced at that time that the second phase would be submitted to Congress within one month; early one year later, PL 2.337/2021 has been released. If approved, the law is intended to be effective on January 1, 2022.

This proposal is in addition to the more than 20 tax bills that were already being intensively debated in the National Congress, particularly in the Senate. As such, PL 2337/2021 likely will be revised by Congress, alongside the debate over Brazil’s broader tax reform covering VAT and other consumption-based taxes.

**The takeaway:** The government’s current proposal for corporate tax reform and/or reintroduction of a dividend withholding tax would significantly increase the Brazilian tax burden on many businesses, particularly on foreign investors.

Even though the proposal may undergo relevant changes by Congress, companies should assess the possible consequences, and reconsider their corporate structures, value chains, transfer pricing, and financing of their Brazilian operations. Business-led corporate, operational, and/or financial restructuring, within Brazil or internationally, may be needed to address the impacts of the current government proposal.

In detail

Corporate and withholding tax

Highlights from the government’s proposed income tax reform include the following.

- Reintroduction of a (final) withholding tax on dividends, at a rate of 20%:
  - Exemption for profit distributions by ‘micro and small businesses’ (representing distributions of up to approximately USD 1 million per year to business owners) up to the limit of approximately USD 4,000 per month per Brazilian resident owner
• Increased rate of 30% for beneficiaries in ‘tax havens’ or subject to a ‘privileged tax regime’ as defined under Brazilian law

• No provision for non-incidence of withholding tax (IRRF) on intra-group distributions, even where profits are reinvested and not distributed up to shareholders, and

• Withholding tax to apply to distributions of all accumulated profits, including those earned through 2021 and that already have been taxed at 34% (or more).

• Reduction of the corporate income tax rate (IRPJ) from 25% to 22.5% in 2022, and to 20% in 2023. Brazil’s other corporate tax, the so-called ‘social contribution on net profit’ (CSLL) would remain unchanged at 9% (or 20% for financial institutions in 2022), resulting in a combined tax burden of 31.5% for 2022 and 29% from 2023 (42.5% for financial institutions for 2022 and 40% from 2023).

• Interest on net equity (INE) paid or credited to shareholders no longer would be deductible.

• Quarterly determination of the corporate income tax, maintaining the indefinite NOL carryforward rule, but allowing a full offset in the three subsequent quarters, while the 30% cap remains applicable thereafter.

• Expenses related to equity-based compensation or profit-sharing payment plans granted to partners and directors would become nondeductible.

• Elimination of goodwill deductions for acquisitions of equity interests occurring from January 1, 2022:
  • Goodwill already paid prior to 2022 and amortized for accounting purposes prior to deductibility-triggering events (e.g., mergers, spin-offs) no longer would result in a tax benefit, and
  • Goodwill amortization, however, would not reduce outside investment basis for capital gain purposes.

• Assets and rights transferred to shareholders in the context of corporate reorganizations would have to be considered at market value, triggering capital gains or losses (i.e., such transfers no longer would be regarded at historical cost or carryover basis for tax purposes even when executed at book value under corporate law).

• Taxation of capital gains earned on indirect transfers abroad (even if not ‘artificial’) of assets located in Brazil.

• Fixed term for the amortization of intangible assets at 20 years in general, for assets acquired on or after January 1, 2022.

Personal income tax

• Adjustment of the personal income tax (IRPF) brackets, increasing exemption range for individuals from R$ 1,903.98 (USD 379.38) to R$ 2,500.01 (USD 498) per month, while the maximum rate remains at 27.5% for monthly earnings above R$5,300.01 (USD 1,055.78).

• Limitation of the ‘simplified deductions’ system for taxpayers with income of up to R$ 40,000 (USD 7,968.13) per year.

• Option to ‘step-up’ the values of real estate acquired until December 31, 2020, with the gain subject to a 4% tax (announced at 5%), instead of the 15%-22.5% generally applicable.
• Full-inclusion rule for profits earned through offshore entities in ‘tax havens’ or subject to ‘privileged tax regimes’ (no deferral irrespective of whether income is active or passive, or substance of offshore entity).

Financial Investments

• Introduction of a single fixed rate of 15% for financial investments through multiple investment funds, also applicable in the sale, amortization, or redemption of units in closed-end funds, with elimination of regressive taxation rates (currently under a decreasing schedule going from 22.5% to 15% according to the term of the investment).

• ‘CRI,’ ‘LCI,’ ‘LCA’ types of investments remain exempt, with the same treatment (under which certain exceptions apply).

• Tax-free amortization and redemption transactions (‘come-cotas’) for open funds no longer would be available.

• Income distributed to individuals relating to real estate investment funds (FII) with shares traded on the stock exchange beginning in 2022 no longer would be exempt. Taxation of other shareholders would change from 20% to 15% on income distribution, amortization, and disposal of units.

• Taxation of unrealized gains in closed-end funds: the income corresponding to the unrealized gains arising from the investment value and its historical acquisition cost, adjusted for the amortizations that occurred, would be determined and subject to tax on January 1, 2022, at a 15% rate.

• The general closed-end funds regime would not apply to Equity Funds (‘FIPs’).

• The funds obtained from the sale of companies invested by the FIPs, qualified as an investment entity, would become taxable regardless of their distribution to shareholders.

• FIPs not classified as an ‘investment entity’ would be regarded as corporate entities, and taxed under the general regime applicable to legal entities. Income and gains earned that have not been distributed to shareholders by January 1, 2022 would be taxed, on that date, at a 15% rate.

• Quarterly calculation of net gains on transactions on stock market, commodities and futures on the organized over-the-counter market and with the possibility of offsetting losses between all transactions, including day-trades and fund shares traded on the stock exchange.

Observations: The government’s reform project proposes a substantial increase in the tax burden for productive investment and foreign direct investment, in particular due to the limited reduction of the corporate tax rate from 34% to 29% (or from 45% to 40% for financial institutions in 2022,) combined with numerous base-broadening measures (such as the suppression of the INE deduction) and the introduction of definitive withholding taxation at 20% on dividends.

With the adoption of such measures, the nominal tax rate on profits and dividends in capital-intensive sectors would increase from 34% to 45.7% in 2022 and 43.2% in 2023, both for large taxpayers (subject to the ‘actual profit method’), even for midsize companies (that use the ‘presumed profit method’ but operate with margins close to the legal presumptions). Rates can reach up to 49.7% in 2022 or 47.2% from 2023 if applicable to profits accumulated and reinvested until 2021.

In addition to the economic policy that is raising concerns and is informing the proposed changes to the corporate tax rates, methods of taxation of profits and dividend withholding tax, the proposed bill likely would have broad,
perhaps unintended, adverse effects. For instance, rules apparently designed as anti-abuse or anti-avoidance provisions likely could be deemed to create taxable events in corporate reorganizations that are not carried out with any tax-avoidance purpose or component, and as such would represent a burden for business groups operating in Brazil.

The requirement of a market valuation with the corresponding taxation of capital gains in corporate restructurings, which is described as intended to avoid the arbitration of rates between legal entities and individuals in cases of stock or asset dispositions, can ultimately could affect business reorganizations that do not represent direct or indirect dispositions at all. Also, the limitation of the deductibility of goodwill step-up may conflict with Brazil’s own valuation criteria, as the current rules allow asset step-ups stripped of earnings streams to allocate amortizable basis to ‘goodwill’ and do not provide an unjustified incentive for ‘overpricing’ or ‘inflation.’ The revocation of such deductions in third-party acquisitions might be misperceived as a tax distortion or undue tax incentive, when an allocation criteria of asset price to depreciable and amortizable basis. Similarly, the proposals have established a 20-year period for the amortization of intangible assets, which perhaps would be adequate for certain patents, but might be long for many other intangibles (particularly for high-tech or digital assets, among others).

As to the taxation of investment funds, the proposal is silent in relation to the treatment of foreign investors in FIPs. Foreign investors and their custodians might appreciate legal certainty, which currently should be covered by an exemption provided by statute, but which has been broadly challenged by the tax authority. The rule could include an effective beneficiary provision which would reduce uncertainty in the fund industry, currently exposed to substantial writs of infraction and litigation. If, on the one hand, there is a simplification in the taxation of funds by the introduction of a single rate of 15% of ‘IRRF’ for gross income from financial investments, the new proposal of taxing unrealized gains, and the 15% rate itself, still tends to be high for foreign portfolio investors that incur financial and operational expenses at residence and are subject to residual net taxation.

As noted above, the government’s proposals are likely to be revised by Congress as part of the legislative process. It remains to be seen whether, and to what extent, any such revisions may address some of the concerns described above that affected taxpayers are likely to have with the government’s proposals.
Let’s talk

For additional discussion on Brazil’s proposed income tax reform, please contact:

International Tax Services, Brazil

Romero J.S. Tavares, PhD  
+55 11 94176-1136  
romero.tavares@pwc.com

Alvaro Pereira  
+55 11 99922-7393  
alvaro.pereira@pwc.com

Gabriel Buratto  
+55 11 96861-1080  
gabriel.buratto@pwc.com

Tax Leader, Brazil

Durval Portela  
+55 11 3674-2522  
durval.portela@pwc.com

International Tax Services, United States

Luis Vargas  
+1 347-325-4171  
maximo.l.vargas@pwc.com

Maria Bel  
M: +1 646-637-2461  
maria.j.bel@pwc.com