Tax Incentives

Sergio André Rocha

International Tax Services Partner at EY.
Professor Dr. at Rio de Janeiro State University

Rio2016
APOIADOR OFICIAL
TM Rio 2016

EY
Building a better working world

Summary

- Constitutional Overview
- Fiscal Responsibility
- Income Tax and Foreign Investments
- Domestic Income Tax Incentives
- State and Municipal Incentives
- Tax Treaties and Tax Sparing

Constitutional Overview

- Brazilian taxation is based on an **egalitarian principle** according to which every entity or individual in the same situation has to pay the same amount of tax (articles 5 and 150, II, of Brazil's Federal Constitution).
- Tax incentives are exceptions to this general principle. Therefore, tax incentives are only compatible with the Federal Constitution to the extent that they reflect constitutional principles, rules, and goals.
- One of the criterion established in the Constitution for distinction between taxpayers is the **ability to pay principle** (article 145, paragraph 1, of the Federal Constitution). An example of a tax exemption based on this principle is the income tax exemption for individuals that have earned less than R$ 1,710.78 per month.

Constitutional Overview

- Brazil's Federal Constitution also establishes other criterion that legitimize tax incentives, such as:
  - Taxation based on the essential nature of the good or product, which allow higher VAT taxation on voluptuary consumption (articles 153, paragraph 3, I and 155, paragraph 2, III of the Federal Constitution).
  - The use of tax incentives to foster the economic and social development of underdeveloped regions of the country (article 170, VII, of the Federal Constitution).
  - Small and medium size companies, as established by law (Complementary Law no. 123/2006) can be subject to a more favorable tax regime (article 170, IX, of the Federal Constitution).
  - Exports are subject to a different tax treatment in comparison to domestic transactions (articles 149, paragraph 2, I, 153, paragraph 3, I, 155, paragraph 2, X, "a", and Article 156, paragraph 3, II).

Fiscal Responsibility

- Limits and requirements for the enactment of tax incentives are established in Complementary Law no. 101/2000 (Fiscal Responsibility Law). Such requirements include (article 14):
  - An estimation of the budgetary impacts of the incentive on the year it will enter into force and the two following years.
  - The demonstration that the incentive has been considered in the budget **or** that there will be a increase of revenue to offset the impact of the revenue reduction due to the tax incentive.
- The concept of incentive in Law no. 101/2000 is very broad, including any amnesty, exemption, deemed credit, subsidy, or reduction in tax rate or the calculation base of the tax.
- If the financial impacts of the incentive will be offset with a tax increase the former will only be effective once the latter is.

Fiscal Responsibility

- There is a huge distance between constitutional and fiscal responsibility requirements and the practice in Brazil.
- Estimations of financial impact in practice look more like a compliance item than something base on the actual impact of the tax incentive.
- Tax incentives that are not in compliance with the egalitarian principle are also granted.

Income Tax and Foreign Investments

- The use of the Income Tax as a tool for attraction of investments is not commonly used in Brazil.

- It is quite the opposite. Foreign investors establishing subsidiaries in Brazil are often puzzled by the complexity of Brazil's federative tax system and the volume of ancillary obligations they must comply with once they are operating in Brazil.

Income Tax and Foreign Investments

- Perhaps the most relevant income tax incentives for non-resident investors are:

  - The withholding tax exemption that applies to investors in the private equity funds called FIPs ("Fundos de Investimento em Participações"). The investor cannot hold more than 40% of the fund and cannot be resident in a low tax jurisdiction (article 3 of Law no. 11312/2006).

  - The withholding tax exemption on capital gains earned by non-resident investors on the sale of stock of publicly held corporations in the stock exchange. The investment must have been made in accordance with Resolution CMN no. 2689 and the investor cannot be resident in a low tax jurisdiction (article 7 of Law no. 9959/2000).

Domestic Income Tax Incentives

- Even though not targeted to attract foreign investments, there are some domestic tax incentives that end up having this effect. Examples are:

  - R&D tax incentives established by articles 17 to 26 of Law no. 11196/2005.

  - Regional tax incentives granted to companies in the SUDAM* (Complementary Law no. 124/2007) and SUDENE** (Complementary Law no. 125/2007) areas, as well as tax incentives granted to companies established in the Manaus Free Trade Zone ("Zona Franca de Manaus"). See also Provisional Measure 2.199-14/2001, articles 1 and 2.

* SUDAM includes the following states: Acre, Amapá, Amazonas, Mato Grosso, Rondônia, Roraima, Tocantins, Pará and part of Maranhão.

** SUDENE includes the following states: Maranhão, Piauí, Ceará, Rio Grande do Norte, Paraíba, Pernambuco, Alagoas, Sergipe and Bahia. Some areas of the states of Minas Gerais and Espírito Santo are also included.

State and Municipal Incentives

- Brazil is immersed in VAT (“ICMS”) harmful tax competition between states.
- According to the Federal Constitution ICMS incentives can only be granted via agreement between the states (article 155, X, “g”).
- This rule is ignored by the States that regularly grant unilateral incentives to companies established in their territory.
- Such incentives are unconstitutional and are regularly cancelled by Brazil's Supreme Court.
- However, they are part of the investment landscape in Brazil, as foreign investors often consider them in the development of their business plan.

Tax Treaties and Tax Sparing

- Tax sparing has been one of the distinctive features of Brazil's treaty policy.
- There is no data to confirm whether a new treaty with a developed nation would contemplate tax sparing. It seems that Brazilian authorities have already conceded that a convention with the US would not include a tax sparing provision. The negotiation of a new treaty with Germany would be an opportunity to confirm if there has been any change in Brazil's treaty policy.
- On the other hand, it is worth mentioning that Brazil does not usually reduces its withholding tax rates.
- There are exceptions which are used by companies for planning purposes. However, in most cases these are legitimate planning strategies not abusive schemes.
- Professor Schoueri's take on tax sparing.