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Preparing for take-off

Prin Shasiharan
Commercial editor
ITR

Tax lawyers are the unassuming superheroes of Brazil. According to the World Bank, a Brazilian company on average takes longer to prepare, file and pay taxes than anywhere else across the globe. Alongside national charges, there are regional taxes imposed by 27 states and more than 5,500 municipalities. Predictably, there is one word on every policymaker's mind: Reform.

ITR brings you practical insight, in English and Portuguese, into some of the most significant recent developments from the Brazilian tax world.

The guide takes on a journey across a range of topics on reform, considering the main objectives and challenges that lay ahead. In addition, the much-debated opinion regarding the offsetting of tax losses in the termination of companies is also discussed.

Brazil is simultaneously undergoing the most radical changes to its transfer pricing (TP) regime in decades. By taking a novel approach, policymakers have sought to adapt the country's historically formulaic TP framework to align with international standards.

This guide explains the importance of Brazil's convergence towards the OECD's model and evaluates its merits. Meanwhile, further trends, inspired by global adherence, including the tax implications of increased cost-sharing agreements and the utility of US-inspired tax transactions to resolve disputes, are analysed.

Digital technology continues to transform the order of business in Brazil. Manufacturers have stepped up their investment in research and development and the government has incentivised innovation through the form of tax-deductible financial credits.

The guide considers how Brazil has dealt with the growing digitalisation of its economy, while looking deeper at how beneficial tax laws are helping fintechs disrupt traditional banks. In contrast, the gap between legislation and reality is also discussed, especially when taxing transactions involving digital goods and services.

Brazil's tax world is set to blossom in the 2020s. We hope that you enjoy hearing from the tax experts leading the progression in our first Brazil Special Focus.

ITR

STJ to decide on controversial tax loss limit upon termination of companies

A single vote in 2020 looks set to end 25 years of confusion surrounding corporate income taxes and the offsetting of tax losses when companies terminate operations. Ana Lúcia Marra and Stephanie Makin of Machado Associados take a closer look at the much-debated 30% tax loss limit upon termination of companies and the pre-impact of the upcoming decision.

Almost 25 years have passed since the 30% limit for the use of tax losses was enacted, but its application in the case of terminating a company, including due to a merger, remains controversial. As of March 2020, the Superior Court of Justice (STJ) is one vote away from a decision that may significantly impact restructuring transactions if it opts to conclude that the 30% limit should not apply upon the termination of companies.

The 30% limit for the use of tax losses upon calculation of Brazilian corporate income taxes has been shrouded by controversy since it was introduced in 1995 and was later extended to all tax periods during 1996. Prior to the creation of such a limit, the entire amount of tax losses could be offset within a period of four years. That particular time limit was revoked when the 30% limit was introduced.

The use of all remaining tax losses upon termination of a company is a relevant matter for mergers and other restructuring transactions involving Brazilian companies who calculate their corporate income taxes according to the actual profit system, which is generally adopted by medium- and large-sized companies.

Overview of Brazilian corporate income taxes

Brazilian companies' profits are subject to corporate income tax (IRPJ) and to social contribution on net profits (CSLL). Despite the different names and diverse tax species, both IRPJ and CSLL are levied on the income earned by Brazilian companies through similar assessments.

IRPJ and CSLL may be calculated according to three different systems, namely the actual profit, the deemed profit and the arbitrated profit systems.

Under the actual profit, the taxable income is the net profit reported in the company's financial statements according to the Brazilian generally accepted accounting principles (BR GAAP), subject to certain adjustments set forth by applicable tax legislation. BR GAAP is generally aligned to the International Financial Reporting Standards (IFRS), however, for tax purposes, accounting rules introduced after 2015 must be tax neutral. In addition to adjustments to ensure such tax neutrality, main adjustments should correspond to the additions of costs and expenses which may not be deducted on a permanent or temporary manner and exclusions of revenues released from taxation or deferred for future taxation.

The calculation of IRPJ and CSLL according to the actual profit system may result in the assessment of tax losses. Since 1995, tax losses may be carried forward without any statute of limitations and may be offset up to 30% of the taxable profit of any given period. No carry-back is permitted under Brazilian rules.

Some other specific restrictions apply to the use of tax losses:

i) Non-operating tax losses (i.e. negative results from the disposition of fixed assets, investments and intangibles) must be separately controlled from operating tax losses and may be offset only against non-operating profits, subject to the 30% limit;
ii) Offsetting is not allowed if, from the date of the accrual of the tax losses to the date of their offsetting, a change in the control of the company and in the company's business activities has occurred concurrently;
iii) In case of a spin-off, tax losses are forfeited proportionally to the spun-off part of its net-worth; and
iv) Tax losses of a company merged into another company cannot be used by the surviving company.

The actual profit system may be calculated on a quarterly or annual basis. Most companies choose the annual basis, while also considering the effect of the 30% limit for the use of tax losses. Under the calculation on a quarterly basis, tax losses from a certain quarter may be used to offset against profits of future quarters limited to 30% of the taxable profits of each of the future quarters, even those within the same year.

There are some situations in which the adoption of the actual profit system is mandatory, including when the total revenue of the company in the prior year has exceeded BRL 78 million and if the company earns profits, income or capital gains derived from abroad.

In comparison to the actual profit system, there are no tax losses in the deemed profit and in the arbitrated profit systems, as they are both based on a percentage of the gross revenues of the company plus other income (such as capital gains), without considering costs and expenses incurred by the company. The deemed profit is a simplified system that may be chosen by companies that do not fall into any of the situations in which the actual profit system is mandatory. The arbitrated profit system is generally imposed by tax authorities in the case of a lack of compliance of ancillary obligations connected to the actual profit and deemed profit systems (such as those connected to bookkeeping), calculated at a higher percentages than those applied in the deemed profit system.

In any of the systems, IRPJ is generally due at the 15% rate, plus a surcharge of 10% applicable for taxable profits exceeding BRL 240,000 per year (or BRL 20,000 per month in case of base periods shorter than one year). CSLL is due at a 9% rate, except for financial entities that are subject to a 15% rate.

Controversies surrounding the 30% limit

As mentioned, the 30% limit has always been a controversial matter. The discussions have mainly focused on: (i) the right of taxpayers to use tax losses incurred in the past to reduce taxation in the future; and (ii) the unconstitutionality of the limit considering the concept of income for tax purposes. In this sense, taxpayers and scholars have claimed that the 30% limit would lead to the taxation of amounts in excess to income. Such a claim is based on the understanding that taxable income only exists after the tax losses are fully absorbed. In accordance with the said position, the limit would result in the taxation of the net-worth of the company.

The controversy on the alignment of the 30% limit to the constitutional principles and rules have been submitted to the analysis of the Federal Supreme Court (STF) in two different proceedings.

In the first one, ruled in 2009 in the course of *Extraordinary Appeal No. 344.994/PR* (RE 344.994), the analysis was limited to the IRPJ, not comprising the CSLL. In this decision, the STF concluded by a majority of votes that the offsetting of accumulated tax losses originated from prior years is a tax benefit granted to the taxpayer and, as such, it could be reviewed and changed by the federal government. In such a ruling, the understanding that the taxpayer does not have a right to use tax losses prevailed. The decision was also based on the position that the taxable income is the income assessed on an annual basis and, as such, the results of previous years would be irrelevant.

The second ruling on the matter was issued by the STF in 2019 in the judgment of *Extraordinary Appeal No. 591.340/SP* (RE 591.340), which was focused on the application of the 30% limit to the CSLL. Such a decision reaffirmed that the limit for the offsetting of tax losses is constitutional. RE 591.340 was analysed under the general repercussion procedure and, therefore, the decision must be followed by lower courts when analysing the same matter.

It is important to note that *RE 344.994* and *RE 591.340* have not analysed the constitutionality of the 30% limit in case of the termination of the company. This is clearly stated in the decision in *RE 591.340*.

Impact of the 30% limit on termination

When the company continues to exist, the 30% limit postpones the use of the tax losses, but its use remains possi-

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Ana Lúcia Marra is a partner of Machado Associados with 23 years of experience in tax consulting in audit companies and law firms, managing projects and teams to advise local and multinational companies in Brazil and foreign companies across various sectors.

She has broad knowledge in tax matters, with a specific focus on direct taxes and international taxation. In addition, due to her background in the review of calculations and procedures and assistance in accounting matters, she is also able to provide a practical view of tax matters.

Her practice includes extensive experience in the assessment of tax impacts of complex operations/structures, identifying alternatives for tax burden optimisation and tax risk mitigation, as well as advising on the application of Brazilian controlled foreign corporation (CFC) rules, Brazilian transfer pricing rules and the taxation of international transactions. Also, she assists clients on tax audits and litigation cases in her areas of expertise.

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Stephanie Makin is a partner in the tax consulting area at Machado Associados, focused on direct taxes, international taxation and transfer pricing areas. She has built her career at Machado Associados and during her 10 years at the firm, she has worked on major corporate restructuring cases and M&A transactions involving several countries.

She also assists clients making foreign investments and doing business in Brazil, as well as Brazilian clients investing abroad, with a strong focus on the impacts of Brazilian CFC rules and the effects of the double tax treaties signed by Brazil. Her practice also focuses on the preparation/review of transfer pricing calculations and solving transfer pricing issues for clients doing business internationally. On a regular basis, she also works with clients on litigation matters involving her areas of practice.

ble. On the contrary, the 30% limit on the final IRPJ and CSLL calculation made by a company upon termination may render the use of tax losses impossible. Indeed, if the balance of tax losses exceeds 30% of taxable income assessed on the calculation of the final IRPJ and CSLL, taxes due upon termination are increased and the exceeding tax losses amount can no longer be used.

The same effect is expected in the case of a merger considering the 30% limit on the final IRPJ and CSLL calculation of the merged company, as well as the forfeiture of the remaining balance of tax losses of the merged company, which prevents the surviving company from using them.

Justice Luiz Fux's vote in *RE 591.340* has referred to this situation when pointing out that the 30% limit by itself would not render the offsetting of tax losses impossible, in comparison to the effect caused by the limit in case of the termination of a company.

The unlimited offset of tax losses upon termination may result in a reduction of the final IRPJ and CSLL amounts due. Furthermore, in the case of a merger, it may result in the possibility that the merged company would assess IRPJ and CSLL credits that could be used by the surviving company.

Administrative and judicial case law

Even if the termination has not been analysed by the STF, *RE 344.994* has impacted decisions made at the administrative federal tax level.

Prior to the STF's decision at *RE 344.994*, the former Taxpayers' Council and the Superior Chamber of Tax Appeals had understood in several cases that the 30% should not apply upon termination of the company. Such positions were primarily based on the explanatory note that accompanied the provisional measure that first introduced the 30% limit, according to which the limit ensured a relevant level of tax revenues for the federal government, without eliminating the right of the taxpayers to offset tax losses. The note may lead to the understanding that the limit should postpone the offset, but not prevent it.

Nevertheless, administrative case law has gradually changed in view of the decision of the STF in *RE 344.994* and also within the context of the replacement of Taxpayers' Council by the Administrative Court of Tax Appeals (CARF). According to the existing position adopted by CARF, the 30% limit applies upon the termination of the companies.

At the federal judicial lower courts, there are precedents in favour of the taxpayer, concluding that the 30% limit is not applicable to companies upon their termination.

Pending decision at the Superior Court of Justice

In this context, the analysis of the matter by the STJ raises a new chance of reverting the adverse effect of the 30% limit, at least to companies that cease to exist.

The STJ analyses this issue in the course of *Special Appeal No. 1.805.925* (REsp 1.805.925) that refers to the unlimited use of tax losses upon the merger of a company. In December 2019, four of the five justices of the First Panel of the First Session of the STJ casted their votes and reached a tie. Two justices have understood that the offsetting tax losses is a tax benefit and that the 30% limit applies since there is no rule expressly authorising the unlimited offset upon termination. On the other hand, two justices voted favourably to the taxpayer, claiming that the limit in the termination scenario leads to the taxation of the net-worth of companies. It is expected that the final justice will vote in 2020 and decide the outcome of the tie.

At present, the position that the First Panel of the First Session of the STJ will take on the Special Appeal is still uncertain. Also, the STJ's decision may not definitively settle the matter as the parties to *REsp 1.805.925* have filed extraordinary appeals to the STF in parallel, which may be required to provide further analysis.

Final remarks

The adverse effects of the 30% limit in the case of termination of companies, including as a result of mergers and other restructuring transactions, are clear and have not been addressed by the STF when deciding that the offset of tax losses is a tax benefit.

A decision by the STJ may be the first higher court position on the matter and may lead to an analysis by the STF from a different perspective.

This is certainly an issue to be closely followed by taxpayers, especially those involved in past and future restructuring transactions.

VISION THAT MAKES A DIFFERENCE

who we are

Our firm was founded in 1990, with the objective of offering legal an tax services of the highest quality, with efficiency, security and agility. We perform our services with a unique business vision as our partners have an in-depth knowledge of our clients, their businesses and goals, allied to extensive knowledge and experience in local and international transactions.

what we do

We are leaders in the tax area, being thus recognized by clients, peers, partners, and by the most respected publications. The excellence in the tax sector has extended to our other areas of activity, which have achieved the same recognition and reputation.