New outlook for Brazil on withholding tax on service remittances abroad

Stephanie Makin and **Ana Lúcia Marra** of **Machado Associados** discuss changes to the withholding tax on service remittances abroad and the impact on multinational corporations.

The high tax burden imposed by Brazil on remittances abroad related to the import of services, as well as multiple taxes, various tax rules and taxing authorities' interpretation of double tax treaties (DTTs), are famously known to cause difficulties to multinational groups with presence in Brazil.

Brazil imposes up to six taxes on these remittances regulated by different federal and municipal laws, which contribute to the contentious scenario involving the import of services into Brazil, including discussions on the withholding income tax (WHT).

The effects of the DTTs signed by Brazil to reduce or eliminate the WHT levied on the remittances for the payment of services and the moment in which the WHT should be paid have been surrounded by controversy. In 2020, these important aspects regarding the levy of the WHT on service remittances were analysed by the Superior Court of Justice (STJ), the second highest judicial level in Brazil, bringing new perspectives to be considered by multinational groups.

Effects of double tax treaties on WHT on service remittances

In December 2020, the second panel of the STJ issued a decision, when analysing Special Appeal (REsp) 1.759.081-SP, concerning the qualification of remittances abroad for the payment of technical services under the DTTs signed by Brazil, which has the potential of altering the current scenario regarding the levy of WHT on these remittances vis-à-vis DTTs and adding yet another chapter to this long-standing discussion.

Background for the decision

Historically, Brazilian tax authorities have defended that WHT should be levied on technical service remittances abroad, under the interpretation that these remittances would fall under Article 21 (other income) of the

DTTs. Traditionally, Article 21 of DTTs signed by Brazil allow both Contracting States to tax the remittances. This position was surprisingly upheld by Brazilian tax authorities even in cases in which the specific DTT did not include any article concerning "other income".

In May 2012, a decision issued by the STJ on the subject (Resp 1.161.467 – RS) brought about a complete turnaround in the position of the Brazilian tax authorities. The judges in this case concluded that Brazil was not allowed to tax the remittances based on Article 7 (business profits) of the DTTs. The main argument considered by the STJ in its decision was that service income would be included in the concept of business profits under national law.

Shortly after, the Brazilian Federal Revenue Service (RFB) issued Interpretative Declaratory Act 5/14 (ADI 5/14), according to which the remittances for the provision of technical services to countries with which Brazil has signed a DTT shall fall under:

- Article 12 ('royalties'), if the protocol of the DTT expressly states that technical services and technical assistance are included in the concept of royalties. Article 12 of the DTTs signed by Brazil follows the United Nations Model Double Taxation Convention, allowing Brazil to impose WHT on the royalty payments to contracting states;
- Article 14 (personal independent services), if (a) the rendering of the services relies on the technical qualification of a person or group of people; (b) the DTT allows for the taxation in Brazil; and (c) Article 12 does not apply. Article 14 of the DTTs signed by Brazil would generally grant Brazil the right to tax the remittances under certain situations. Despite the deletion of Article 14 from the OECD's Model Convention, Brazil's policy is to include this article in DTTs signed by the country; and
- Article 7, providing Articles 12 and 14 do not apply. In this case, Brazil would not be allowed to impose WHT unless there is a permanent establishment of the service provider in Brazil.

Most of the DTTs signed by Brazil classify technical services and technical assistance as royalties for the purpose of the DTTs, without defining technical services. Under the Brazilian tax authorities' interpretation, technical services are defined as services that require some type of specific knowledge. From a practical perspective, this definition encompasses almost all services, regardless of any transfer of technology.

It is only recently that Brazil has begun to include its unique and extremely broad definition of technical services into the DTTs (e.g. protocol to the DTT with Argentina signed in 2017, DTT signed with Singapore in 2018).

Since the enactment of ADI 5/14, Brazilian tax authorities have consistently recognised that WHT should not be levied on remittances abroad when the corresponding DTT does not expressly include technical service and technical assistance in the scope of Article 12 (which is the case of France, for example), understanding that the remittances fall under Article 7.

Only in very specific circumstances did the RFB classify remittances under Article 14.

A new chapter in the discussion

In REsp 1.759.081-SP, judged by the STJ on December 18, 2020, the court was requested to determine whether remittances made by a Brazilian company to a Spanish entity for the payment of engineering and administrative assistance services should fall under Article 7 (business profits), Article 12 (royalties) or Article 14 (independent personal services) of the Brazil–Spain DTT.

The Brazil–Spain DTT is one of the DTTs signed by Brazil that expressly includes technical service and technical assistance serviced in the scope of Article 12. Under this article, Brazil may levy a 10% WHT on the remittances made to Spain (in comparison to the 15% general rate).

The definition of 'independent personal services' under Article 14 expressly includes engineering services. Based on this article, Brazil would be allowed to tax the remittances to Spain with no rate reduction.

Under Article 7 of the DTT, on the other hand, Brazil would not be entitled to levy WHT on the remittances made to Spain.

Upon its own analysis of the case, the lower judicial court (Federal Regional Court of the 3rd Region – TRF3) studied the agreements entered into by the parties and concluded that they did not provide for any transfer of technology and, thus, the payments for the engineering and administrative assistance services should not be classified as royalties for the purposes of the DTT.

Rather, in the TRF3's view, the agreements provided for the mere rendering of services by the Spanish entity and so the related remittances should fall under Article 7 of the DTT and could only be taxed in Spain. The TRF3's position in this case is consistent with several other decisions previously issued by the same court, always based on STJ's position on the case judged in 2012 (Resp 1.161.467 – RS) and cases judged by the STJ after that.

The application of Article 14 was not examined by TRF3 in this case, following TRF3's usual practice of not contemplating it in its decisions.

The TRF3's decision in this case was challenged by the Brazilian tax authorities. Upon analysing the specific circumstances, the STJ decided that the matter should be analysed once again by the lower judicial level, taking into consideration the Interpretative Declaratory Act 5/14.

The STJ stated that, differently from the lower court's understanding, the Brazilian law and STJ case law's definition of royalties for tax purposes does not require any transfer of technology.

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In STJ's view, particular focus should be given by the lower court to the fact that engineering services would fall under the definition of independent personal services provided for in Article 14 of the Brazil–Spain DTT. Further, considering that the protocol to the Brazil–Spain DTT expressly establishes that Article 14 would also apply to services rendered by legal entities, STJ gave an inclination that Article 14 should apply (instead of Article 7) and, thus, WHT would be levied in Brazil.

Further developments are expected not only once the TRF3 reanalyses the matter, but also when other courts start applying STJ's understanding to other cases based on their own interpretation of this decision.

Besides bringing Article 14 to the DTTs to the spotlight, STJ also called the attention of the TRF3 to the fact that the analysis should take into consideration the treatment attributed by Spain to these remittances so as not to create a hybrid mismatch arrangement, in terms of Action 2 of the OECD/G20 BEPS project, expressing some concern that taxpayers could be benefitting from a lower taxation.

Although attention to mismatches is indeed important, from a practical perspective, the broad definition of technical services attributed by Brazilian tax authorities and their views on the application of DTTs may actually lead to double taxation.

Timing of payment of WHT

In August 2020, the First Panel of the STJ decided, unanimously, when analysing REsp 1.864.227, that the WHT should be paid on the due date of the payable instead of on the date of its accounting credit.

The case originated in a tax assessment issued by federal tax authorities against the taxpayer demanding the payment of the WHT on remittances made to a US-based company related to the license to commercialise software when the payable was recorded for accounting purposes by the Brazilian company.

According to Brazilian legislation, the WHT must be paid upon the payment, credit, delivery, use or remittance of the amounts to a beneficiary abroad. Historically, federal tax authorities have interpreted that the expression credit corresponded to the accounting credit by the payer in Brazil, which was not convincing.

However, in March 2014, the Superior Court of Tax Appeals (CSRF), the highest administrative federal level, had already clarified that the WHT should not be considered due upon the accounting credit, but rather only upon the moment that the funds are economically or legally available (tax triggering event of the income tax). In the Administrative Court's opinion, based on civil law, the account payable would be legally available on its maturity date.

From a practical perspective, this rationale would prevent that the decision of the Brazilian company not to pay or settle the liability with the service provider abroad postpones or even avoids the payment of WHT.

Until this confirmation by the STJ, there was still some discussion whether the WHT should only be paid upon the actual remittance of the funds abroad or if it should be paid on the date the payable becomes due.

It is necessary to bear in mind that, although this rationale should not, in theory, be applied to the other federal taxes levied upon the import of services – such as the social contributions on imports (PIS/COFINS-import) and the Contribution for the Intervention in the Economical Domain (CIDE) – tax authorities could try to extend this reasoning to these taxes and question the collection of these taxes only upon the actual payment of the funds abroad.

The Administrative Court of Tax Appeals (CARF) has concluded in at least one case that WHT and CIDE have the same triggering event and CIDE should also be levied when WHT is considered due.

This line of thinking is debatable. While the income tax in general in Brazil is levied upon the economic or legal availability of income, the same concept does not apply to CIDE. CIDE is not, in any circumstances, levied on income.

Importance of keeping updated

Although the legislative background surrounding the taxation on the import of services has not changed significantly in previous years, new interpretation and approaches are a common fixture in Brazil which requires that the parties doing business in Brazil and rendering services in Brazil be vigilant and keep up-to-date to confirm their procedures are in line with current practices to eliminate possible contingencies and visualise possible opportunities.

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