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# Brazil Tax Alert

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## RTT repealed, changes made to CFC and share premium allocation rules

The Brazilian government enacted Provisional Measure No. 627/13 (PM No. 627) on 12 November 2013, which introduces far-reaching changes to the country's tax rules. The most significant of the 100 articles included in PM No. 627 are those that repeal the transition tax regime (RTT) and revise the controlled foreign company (CFC) and allocation of share premium rules.

Due to the complexity and number of topics covered in PM No. 627, clarifying regulations will be issued by the federal revenue service.

### Transition tax regime

PM No. 627 revokes the RTT as from 1 January 2015, but provides for an early adoption election, under which taxpayers can adopt the changes made by PM No. 627 starting on 1 January 2014.

In this context, the continued applicability of PM No. 627 will depend on whether a taxpayer has elected to adopt the changes made by the PM as from calendar year 2014. If the taxpayer makes the election, the RTT regime is automatically revoked and the new provisions are effective on 1 January 2014.
If the election is made, the taxpayer will be relieved from the taxation of dividends effectively paid until the date of enactment of PM No. 627 and generated from 1 January 2008 through 31 December 2013 in excess of the balance sheet amount determined based on the accounting criteria in effect on 31 December 2007 (as provided under the controversial Normative Instruction (NI) 1,397/13 (issued on 17 September 2013), and which has not been revoked (for our alert on NI 1,397/13, click here).

PM No. 627 also allows taxpayers to adopt the criteria under IFRS (accounting GAAP) for the computation of the Interest on Net Equity (INE) from calendar year 2008-2013 if the taxpayer elects the early adoption of the new rules in the PM.

These measures clarify that the federal revenue service will not apply the provisions relating to dividends and the INE retroactively, which had been a concern after the issuance of NI 1,397/13. Nevertheless, taxpayers should analyze carefully whether to elect to apply the new rules in 2014, and assess the

impact of dividends distributed and the new provisions in PM No. 627.

## CFC rules

Under Brazil's CFC rules, profits earned by CFCs of Brazilian entities are subject to corporate income tax (IRPJ) and social contribution tax on profits (CSL) at the level of the Brazilian controlling or parent company. Profits earned by CFCs of Brazilian companies are considered available to the controlling/parent company in Brazil and are subject to taxation at the end of each fiscal year.

PM No. 627, which contains 20 articles on the CFC regime, introduces measures that make the application of these rules more flexible:

- The main change is that Brazilian taxpayers will have the option to make an irrevocable election (on a calendar year basis) to consolidate the profits and losses of CFCs until 2017; the tax authorities will issue guidance on how such an election is to be made. This election will not be available, however, if the CFC is resident in a tax haven jurisdiction (a jurisdiction on Brazil's black list), a privileged tax regime jurisdiction (a jurisdiction on the grey list) or a jurisdiction that has not concluded an exchange of information agreement with Brazil; or the income of the CFC is subject to a nominal income tax rate lower than 20%.
- Profits of a CFC that already have been included in the taxable base of its Brazilian parent company as a result of transfer pricing adjustments made in relation to transactions between the CFC and the Brazilian parent will be excluded from further inclusion in the corporate income tax base of the Brazilian taxpayer under the CFC rules.
- Losses incurred by CFCs may be carried forward by the Brazilian parent for five years if certain requirements are met.
- The payment of corporate income tax related to the CFC's profits may be deferred for up to five years (with a minimum of 25% paid in the year following the relevant computation year), with the balance being paid within the following four years, subject to certain interest rate adjustments. However, this option will not be available to taxpayers that currently are litigating the application of the CFC rules and that may qualify for the recent tax amnesty program (for which an application must be made by 29 November 2013; for our alert on the tax amnesty, click here).
- The taxation of the profits of non-controlled entities generally should take place at the time the profits are distributed to the Brazilian entity if the requirements in PM No. 627 are met. Otherwise, the profits of such entities will be taxed when computed on 31 December of each year.
- Similar rules also will apply to Brazilian resident individuals.

## Share premium allocations and goodwill

PM No. 627 provides that the allocation of the premium in an acquisition of shares is to be broken down into two categories, in the following order: (1) identifiable assets acquired and liabilities assumed at fair value; and (2) future profitability (goodwill) or negative goodwill. Both amounts must be recognized in a separate account and be supported by an independent appraisal registered with the federal revenue service or the registry of deeds and documents.

This requirement means that the tax treatment of the premium should be consistent with the accounting purchase price allocation (PPA). The deduction for the premium should be taken based on the depreciation and/or amortization of

the assets acquired and liabilities assumed at fair value and/or amortized within a minimum five-year period (for the portion allocated to goodwill). This position should end the debate that arose when IFRS was introduced as to whether the tax rules granting the goodwill deduction would be grandfathered using the RTT regime (tax GAAP), or if the PPA criteria under IFRS (accounting GAAP) would prevail for the determination of tax goodwill.

Restrictions apply to the deduction of goodwill if the appraisal report is not filed in a timely matter or if it contains inconsistencies or errors.

## Other measures

As previously mentioned, in addition to the CFC and premium allocation rules, PM No. 627 introduces other changes that are summarized in the following table:

| Articles of PM No 627 | Subject |
|---|---|
| Article 1 | - Enactment of PM No. 627 |
| Article 2 (Changes to Decree-Law No. 1,598/1977) | - Filing of the e-Lalur (Taxable Income Calculation Book) in the Public Digital Bookkeeping System (SPED)<br>- Definition of gross revenue (including the treatment of present value adjustments)<br>- Deductibility of interest<br>- Treatment of subventions for investments and fair value evaluations<br>- Equity pick-up method and corresponding tax treatment Real estate (swap/determination of cost and gross profit determination)<br>- Capital gains determination on the sale of assets (investments, PPE and intangibles) |
| Articles 3-4 | - Present value adjustments |
| Article 5 (Changes to Law No. 9,430/1996) | - Determination of anticipation of income tax |
| Articles 6-8 | - Deemed and arbitrated profit determination and percentages<br>- INE calculation<br>- Mergers and spinoffs |
| Article 9 | - Capital gains calculation |
| Article 10 | - Pre-operating and pre-industrial expenses |
| Article 11 | - Foreign exchange effects |
| Articles 12-18 | - Fair value adjustments |
| Articles 19-27 | - Mergers and acquisitions – premium, goodwill, etc. |
| Article 28 | - Long-term contracts |
| Article 29 | - Subvention for investments |
| Article 30 | - Premium on issuance of debentures |
| Article 31 | - Impairment test |

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| Articles 32-33 | - | Payments based on shares |
| Article 34 | - | Concession contracts |
| Articles 35-37 | - | Acquisition of share participation in installments |
| Article 38 | - | Depreciation – Exclusion in e-Lalur |
| Articles 39-40 | - | Amortization of intangibles |
| Article 41 | - | Non-operating losses |
| Article 42 | - | Concession contracts (deemed profit) |
| Article 43 | - | Estimated dismantling costs |
| Articles 44-47 | - | Leasing |
| Article 48 | - | Application for Social Contribution on Profits (CSL) |
| Articles 49-53 | - | Application for Social Contributions on Revenue (PIS/COFINS) |
| Articles 54-59 | - | Future new accounting regulations and tax neutrality |
| Articles 60-66 | - | Provisions on initial adoption and implications for tax determination |
| Article 67-70 | - | RTT and dividend distributions |
| Article 71 | - | Option for effects of PM No. 627 for 2014 |
| Articles 72-91 | - | CFC rules |
| Article 92 | - | Recently enacted tax amnesty program |
| Articles 93-100 | - | Final provisions, option for regulations on PM No. 627 and effects |

## Comments

The issuance of PM No. 627, which provides long-awaited guidance on how taxpayers are to deal with the tax effects associated with the Brazilian accounting framework (IFRS), is an important step towards reducing uncertainty associated with issues such as tax neutrality, the transition period, the effects of mergers and acquisitions and outbound investment, among others.

Although PMs are effective as soon as they are issued, the Brazilian House of Representatives and Senate still must vote on the PM, and this must take place within four months from the date the PM is published. A PM will remain in force for two months and will expire automatically if it is not extended for an additional two-month period or if the House and Senate do not vote on the PM within the four-month period.

PM No. 627 is expected to be converted into law in 2014, which is why the measures include an option for taxpayers to adopt the changes in 2014. If this option was not made available, the new law would not have effect for corporate income tax purposes until 2015.

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