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New accounting and tax rules and reporting requirement under Transition Tax Regime

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The Brazilian tax authorities issued guidance on 17 September 2013 (Normative Instruction No. 1,397/2013 or NI 1,397) on the Transition Tax Regime (RTT). The RTT was enacted in 2009 to ensure the tax neutrality of accounting changes relating to income recognition and the computation of costs and expenses in light of Brazil's conversion of its accounting rules to IFRS. Under the RTT, taxpayers are required to follow the accounting criteria and methods in effect on 31 December 2007, i.e. the rules in effect before the law introducing IFRS was enacted.

NI 1,397 introduces several new rules that could have a significant—and potentially negative—impact on the mechanisms for calculating the corporate income tax (IRPJ) and the social contribution on profits (CSL) (as well as the social contributions on revenue (PIS/COFINS)), and that could lead to a retroactive assessment of tax. The NI provides that, for tax purposes, the calculation of assets, liabilities and net equity should be based on the 31 December 2007 accounting provisions. In addition, the NI introduces a new reporting requirement for companies that likely will increase the administrative burden and compliance costs.

The following are the most salient points in NI 1,397:

Dividends and profit distributions: The NI provides that tax-exempt profits and dividends are to be calculated using the accounting criteria in effect on 31 December 2007 (and this is in accordance with the interpretation of the Tax Revenue Attorney General adopted in earlier guidance). Any excess dividends/profits (i.e. dividends/profits that are not calculated based on the accounting standards in effect on 31 December 2007) will receive the following treatment at the level of the recipient:

- *Resident corporate entity*: The excess will be subject to IRPJ and CSL as taxable income.
- *Resident individual*: The excess will have to be included in the individual's annual income tax calculation and withholding income tax will be levied at the applicable progressive rate (0%-27.5%). The Brazilian payer will be responsible for withholding.
- *Nonresident*: A 15% withholding income tax will be levied on the excess (a 25% rate will apply if the recipient is domiciled in a tax haven). The Brazilian payer will be responsible for collecting the withholding tax.

Interest on Net Equity (INE): Under existing rules, a corporation may calculate and pay INE to its shareholders and deduct expenses incurred in making such payments when calculating its income tax liability. According to the NI, the net equity to be considered in the INE calculation is the equity accrued in accordance with the accounting provisions in effect on 31 December 2007.

Fiscal Accounting Bookkeeping (ECF): As from calendar year 2014, taxpayers subject to the actual taxable income regime (*Lucro Real*, the regime under which costs and expenses are deducted from taxable income) will be required to maintain ECF and submit their books electronically via a specific application in the Brazilian Digital Bookkeeping System (SPED). The ECF will comprise all entries for the applicable year based on the accounting criteria applicable on 31 December 2007. This is a fundamental change to the existing system and will require taxpayers to prepare two set of books: one for statutory purposes and the other for tax purposes. For calendar year 2013, taxpayers still must file the Transition Fiscal Accounting Control (FCONT) with the Brazilian tax authorities.

Comments

NI 1,397 expands the scope of application of the RTT, so taxpayers may face tax consequences relating to the following areas:

- Dividends;
- INE;
- The measurement of tax goodwill;
- Capital gains or losses related to investments recognized based on the net equity method; and
- The application of the thin capitalization rules.

The most controversial provision of the NI is the one relating to dividends and profit distributions, which potentially will affect many listed companies and large limited liability companies. The new ECF requirement likely will increase compliance costs.

Although NI 1,397 is effective as from the date of issuance, since it is the Brazilian tax authorities' interpretation of the law, the authorities may attempt to apply the provisions retroactively. The legality of certain provisions in the NI (such as any retroactive application and the expansion of the scope of the RTT) is questionable and litigation is likely to ensue.

Taxpayers should assess and address the implications and risks arising from the issuance of NI 1,397 as soon as possible.