Increasing tax burden for Brazilian companies

Nélio Weiss and Joseph Wolf of PricewaterhouseCoopers outline the significant changes planned for Brazilian corporate taxes.

The impact of the global economic crisis that spread from Asia to Russia during 1998 was also strongly felt in Brazil. Fears that Latin America's biggest economy – the eighth largest in the world with a 1997 GDP of around $820 billion – might suffer economic turmoil shook Wall Street and global markets.

Under the 'Real Plan' of 1994, President Fernando Henrique Cardoso liberalised the economy and subdued inflation by pegging the Brazil's real to the US dollar, making it very attractive for foreign investment. Thus, the government has refused to devalue the currency. Instead, when speculators attacked, the government spent some $38 billion of foreign exchange reserves and sharply increased interest rates (currently at about 32%). Failure to curtail government spending has pushed debt to 7% of GDP.

In an attempt to cut its huge government budget deficit – which stands at nearly 8% of its gross domestic product – Brazil's congress has approved almost 100% of a package of widely unpopular proposals to cut the budget and raise taxes. These measures are designed to give investors confidence that the local currency will be anchored in solid fiscal policy, rather than on the more shaky foundation of inflated interest rates.

The most relevant steps recently taken by the Brazilian government could be based on the idea that a dollar-pegged currency is no longer useful, particularly with the instability of the international markets. It is still too early to determine the impact of the recent depreciation of the Brazilian currency. However, there are some positive points:

- the fact that the fiscal package agreed with the IMF is almost entirely approved by congress and will probably be concluded the beginning of this month;
- the possibility that the Brazilian authorities will cut interest rates, allowing, the economy to recover; and
- the fact that the new floating exchange rate appears relatively stable, thus encouraging exports and minimising the inflation impact, – which is a different experience rom other emerging markets that faced similar situations.

Changes in tax law

Brazil recently enacted new tax rules which will significantly increase the effective corporate tax rate and limit the benefits of tax planning. On 27 November 1998, the Brazilian congress enacted Law 9.718 which increased the rate of the COFINS tax from 2% to 3% beginning 1 February 1999.

This is one of the measures aimed at increasing revenue in order to combat the current budget crisis.

The COFINS tax is imposed on a Brazilian company's monthly billings. A second revenue tax known as PIS is also imposed at the rate of 0.65% of a company's monthly billings. Together, the combined PIS/COFINS tax rate is 2.65% which will now be increased to 3.65%.

Under current law, the amount of PIS/COFINS taxes paid during the year cannot be credited against other taxes but is deductible for corporate income and social contribution tax purposes. It is common practice in Brazil for companies to avoid the cost associated with the PIS/COFINS taxes by passing them on to customers through a gross-up to sales price of products and services.

Social contribution

Brazilian companies are also subject to regular corporate income tax at the maximum rate of 25% as well as the social contribution tax on income at the rate of 8%. Since dividends attributable to corporate earnings derived after 1995 are not subject to withholding, the combined corporate income and social contribution tax rate, on a fully repatriated basis, is 33%.

Law 9.718 did not increase these tax rates. However, it did add an important change which allows a credit of one third of total COFINS paid against the social contribution tax liability arising in the tax year. Any allowable portion of the COFINS tax which is not credited in a given tax year may not be carried forward to be used in subsequent years.

The new law also modified the treatment of the COFINS tax for corporate income tax purposes. While the COFINS tax is deductible in determining

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corporate income tax, any portion of the COFINS credited against the social contribution tax becomes non-deductible for income tax purposes. Finally, financial institutions, which have been exempt from COFINS, will now be subject to COFINS on their revenue beginning 1 February 1999.

Brazilian companies which have a net margin of less than approximately 12.5% will incur a higher tax cost as a result of these changes. The 12.5% net margin represents the breakeven point where the full amount of the one-third increase in the COFINS is fully offset by the social contribution tax and is derived by dividing the portion of the COFINS which can be credited or 1% by the social contribution tax or 8% of net income.

In other words, a company will be required to generate net income of 12.5% in order to fully offset the 1% increase in COFINS, and not suffer an incremental tax cost in Brazil. For these companies, the effective corporate income tax rate will also increase due to the fact that the portion of the COFINS which offsets the social contribution tax will not be deductible.

A low margin

In addition to financial institutions, the companies which will be most affected by these changes will be those which operate on a low margin, as well as those experiencing losses.

Due to the fact that the PIS/COFINS taxes are based on revenue, the increase in the COFINS with the offsetting credit against the social contribution tax will reduce the benefit of tax planning opportunities aimed at reducing the corporate income tax rate. Thus, multinationals should carefully analyse their current tax position in Brazil since tax planning strategies already in place may actually increase the overall tax burden.

The PIS/COFINS taxes are difficult to avoid since they are based on revenues. Where possible, multinationals should try to export product or render services directly to Brazilian customers rather than conducting these transactions through their Brazilian affiliates since foreign companies are not subject to PIS/COFINS. Furthermore, intercompany transactions between Brazilian affiliates should be avoided since such transactions will result in an incremental cost of 3.65%.

> Unpopular proposals to cut the budget and raise taxes are designed to give investors confidence that the local currency will be anchored in solid fiscal policy, rather than on the more shaky foundation of inflated interest rates

The new rules enabling a company to credit up to one third of the COFINS paid against the social contribution tax may also increase the home country tax burden for those multinationals which are located in countries which allow for a tax credit for foreign income taxes paid on earnings repatriated by foreign subsidiaries through dividends.

Such countries may treat the amount of the social contribution tax, which is an income tax and therefore allowed as a foreign tax credit, which is offset by the COFINS, a non-creditable tax, to become non-creditable. As a consequence, the combined effective income tax rate in Brazil and the home country may increase.

However, as discussed below, there is a current proposal to eliminate the PIS/COFINS taxes as part of an overall reform of Brazil's system of indirect taxation. Therefore, the problems raised by the new COFINS rules may only be temporary.

Additional tax changes

Further to Law 9.718, the Brazilian government enacted provisional measure 1788 on 29 December 1998. This new measure is also a result of the economic package which aims to guarantee that the Brazilian government will meet its 1999 fiscal goals. However, the effects of this measure will probably be felt beyond 1999 and will generate a tax burden much greater than the one initially provided in the fiscal adjustment programme aimed at 2000.

Among the several changes provided by measure 1788 is the increase in the withholding tax rate applicable to payments for services rendered to non-resident companies or individuals from 15% to 25%. The applicable services include any remittance to 'tax haven' countries having corporate income tax rate not greater than 20%, according to the Brazilian tax legislation – except for certain payments of interest due on foreign loans or linked to the financing of exports and leasing instalments, as specified in the tax legislation.

However, certainly the most serious impact on Brazilian companies is the fact that interest on debt and financing and deemed interest paid on net equity are no longer deductible for purposes of social contribution on net income, which is an additional corporate tax imposed at the rate of 8% of book income before the provision for income taxes.

Such interest, however, remains deductible for income tax purposes, imposed at a maximum rate of 25%. Since this change to the social contribution tax can only become effective 90 days after being approved by congress, this change will only take effect after 1 April 1999. Therefore, the effects would probably only be noticed after July 1999, when companies file their income tax return for the previous quarter.

The crucial factor is that the inability to deduct interest on debt and financing will affect both companies that incurred debt to manage difficult times and those more profitable companies which planned capital structures with more debt.

As a consequence of this measure and Law 9.718, the Brazilian government has increased tax on debt and financing, as creditors will have to collect PIS and COFINS at a combined rate of 3.65% on the one hand, and debtors will be denied a deduction for the 8% corporate social contribution tax on net income on the other.

Indirect tax reform proposal

On 1 December 1998, the Brazilian federal government presented before congress a new tax reform bill to amend both indirect taxes and social contribution tax laws. The bill is intended to be voted on by congress during 1999, and if passed, to become effective in the year 2000.

The government's proposal

recommends a number of changes to the whole tax system as it is currently structured, and, most significant, it is aimed at either raising tax revenues through rate increases and reducing the cost of production by extinguishing indirect taxes and social contribution taxes imposed on income and billings of companies. In regard to the federal income taxes, the social contribution tax on income would be incorporated into the income tax resulting in a single corporate income tax rate of 33%.

The purpose of the proposed amendments is to provide measures which are designed to perfect Brazil's system of taxation, improve the collection of tax revenues and promote compliance on behalf of taxpayers.

In light of the tax proposal, a list of indirect taxes and social contribution taxes, – the ICMS (VAT), the IPI (Federal excise tax on products) and PIS/COFINS – would be eliminated and a new federal VAT would be created.

ICMS, a state value-added-tax, is levied on sales or physical movement of goods. It is also levied on freight, transportation and communication services, and electric energy. The rate depends on the state in which the sale or movement of products occurs. ICMS is also payable on almost all imports. The rates vary depending on the state and type of product or service, with the states of Sao Paulo and Rio de Janeiro imposing the general rate of 18%.

IPI, a federal excise tax, is levied at varying rates, depending on the product's tax code according to the harmonised system, on nearly all sales and transfers of goods manufactured in or imported into Brazil. The rate tends to be in the range of 10% to 15%, although there are many exceptions subject to higher or lower rates.

Non-cumulative

The new VAT would be a non-cumulative tax imposed on the circulation and movement of goods and the rendition of certain types of services It has been speculated that the rate could range between 19% to 25%.

The tax rate will be the same throughout the country. However, the collection of the new VAT would be the responsibility of the states. The revenue would be shared by the federal, state and local governments, through a so-called participation fund.

As a consequence of this structure, a new public agency would be created to facilitate the structuring of the system and the relationship between federal and state levels.

The proposal also provides for a 12-year transition period from the current system to the new one in order to permit adjustments where necessary.

This is to avoid the overnight conversion to the new VAT, which would be due in the state of destination, while the current ICMS tax is based on a mixture of concepts that take into account either the origin or the destination of goods, and is also due to possible losses of revenues by the federal or state administrations.

The provisional measure has the immediate force of law and is valid for 30 days. It can be converted into permanent law after being ratified by congress. ■

In brief, major changes as from January 1999 are:

- the withholding rate applicable to payments for services rendered to non-resident companies or individuals has increased from 15% to 25% (many treaty rates, however, are 15%). This tax increase also refers to remittances to tax havens (corporate income tax up to 20%);
- foreign individuals entering the country who are authorized to work in Brazil will be subject to taxation on a worldwide basis in the same manner as residents as from the date of arrival, even if entering under temporary visas. Previously, for the first 12 months within the country, foreign individuals with temporary visas were subject to taxation on only local income at a flat 15% income tax rate (withheld at source);
- interest on debt and financing and deemed interest paid on net equity is no longer deductible for purposes of social contribution on net income, which is imposed at a rate of 8%. Such interest, however, remains deductible for income tax purposes, imposed at 25%;
- the rate for COFINS, a social contribution calculated on net sales, has increased from 2% to 3%, however, one third of this tax can be used as a credit against social contribution on net income due each year. The one third not compensated each year, however, can not be carried over to future years. As a consequence, companies with low levels of profitability will have an effective tax cost increase;
- the tax base of both COFINS and PIS, which are social contributions on net sales, now includes any other income, including financial income;
- the minimum average maturity for foreign loans was reduced to 12 months;
- several changes have been passed reducing effective cost of labor charges;
- loans between companies (excluding financial entities), including related companies, and between companies and individuals are now subject to IOF (Tax on Financial and Exchange Transactions). The applicable daily rate depends on the type of loan;
- for transactions occurring during the period beginning 24 January, 1999, until the date in which the CPMF tax once again becomes effective (probably May or June), IOF (tax on financial transactions) will apply to several remittances to Brazil and from Brazil; and
- on 6 January, 1999, in a first stage of voting, the Senate approved the extension of CPMF, a tax on bank account debits, for another three years. The CPMF tax was originally established on a temporary basis, expiring on 22 January, 1999. The rate, subject to further voting stages in the Senate and also the House of Representatives, will be increased from 0.20% to 0.38% during the first year, and then reduced to 0.30% for the remaining two years. Since the new CPMF will not be effective until 90 days after the final approval, there will be no CPMF charges during the period beginning 23 January, 1999 and the date the new CPMF becomes effective, expected to be in June 1999.

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