

DOING BUSINESS IN BRAZIL



I.A General Overview of Brazil

Following three centuries under the rule of Portugal, Brazil became an independent nation in 1822. Brazil overcame more than half a century of military intervention in the governance of the country when in 1985 the military regime peacefully ceded power to civilian rulers. Brazil continues to pursue industrial and agricultural growth and development of its interior. Exploiting vast natural resources and a large labor pool, it is today South America's leading economic power and a regional leader. Highly unequal income distribution remains a pressing problem¹

With a population of around 182 million, Brazil is the fifth largest country in the world after China, Canada, Russia, and the United States. With an area of approximately 8.5 million square kilometers, Brazil occupies almost half of South America. Brazil is usually divided into five large regions: (i) North, including the States of Amazonas, Para, Acre, Roraima, Rondonia, Amapa, and Tocantins; (ii) Northeast, including the States of Maranhao, Piaui, Ceara, Rio Grande do Norte, Paraiba, Pernambuco, Alagoas, Sergipe, and Bahia; (iii) Southeast, including the States of Minas Gerais, Espirito Santo, Rio de Janeiro and Sao Paulo; (iv) South, including the States of Parana, Santa Catarina, and Rio Grande do Sul; and (v) Midwest, including the Federal District and the States of Mato Grosso, Mato Grosso do Sul, and Goias. Each state has its own government with a structure that mirrors the federal level. Possessing large and well-developed agricultural, mining, manufacturing, and service sectors, Brazil's economy outweighs all other South American countries and is expanding its presence in world markets. Prior to the institution of a stabilization plan—the *Plano Real* (Real Plan)—in mid-1994, stratospheric inflation rates had disrupted economic activity and discouraged foreign investment. The evolution of the tax systems in Brazil in the past decade has reflected the

¹ BNA TAX LIBRARY, *Business Operations in Brazil*, by Syllas Tzzini et al., Portfolio No 954-3rd

transformation of the region's economies toward more reliance on markets and international commerce.²

Brazil's ongoing economic transformation was sparked by changes in public policy and initiatives in the public sector. These included:

- Privatization of state-owned enterprises.
- Reductions in the barriers to foreign direct investment.
- Unilateral and multilateral tariff reductions.
- Market reforms in the regulated sectors of the national economies, such as telecommunications, banking and finance, transportation, energy, and agriculture.

A. The Registration of Foreign Capital

A company making a foreign investment must first register with the Data Processing Department of the Central Bank of Brazil, in order to receive a password which will enable it to electronically declare the direct foreign investments. Since September 4, 2000, the Central Bank of Brazil has been accepting only those declarations made through the Internet, at www.bcb.gov.br.

To receive the password, it is necessary to submit the Registration Request form duly filled in, with the notarized signatures of the company's legal representatives, together with the documents which attest to the powers of those signing them (articles of incorporation, by laws, minutes of the general shareholders meeting or meeting of quota holders conferring the signing powers and, as the case may be, the power of attorney).

Having completed the procedures above, the person must access the *Banco Central do Brasil*, site, under the option "*Sisbacen-Data Processing*", item "*Access to Sisbacen via Internet*" and download, then run, the program "*PASCW10 – Sisbacen via VPN*". Using it, the registration of the foreign capital can be processed. After this operation, the person will receive a registration identification number, equipped with which he may go to the Central Bank to complete the foreign exchange operation.

There are no restrictions on the distribution of profits and their subsequent remittance abroad. As of January 1, 1996 profits generated are exempt from Federal withholding taxes. Profits remitted must be declared using the same program *PASCW10*, via Internet. The person will then receive a number which is to be taken to the Central Bank.

If the investor opts to reinvest profits rather than sending them abroad, these may be registered as foreign capital (as in the case of the initial investment, via Internet), thus increasing the basis for calculation for future divisions of capital for taxation purposes.

² LEVEY: US TAX CONSIDERATIONS FOR U.S. BUSINESSES, *Brazilian tax considerations for U.S. Investments*, Simone Dias Musa et al. 2006.

Foreign capital registered at the Central Bank may at any time be sent back to the country of origin, no previous authorization being necessary. Capital repatriated in an amount greater than the amount registered will be considered to be a capital gain on the part of the foreign investor and will be subject to withholding tax at the rate of 15%.

In the specific case of repatriation of capital, it is important to observe that the Central Bank of Brazil usually examines the net worth of the company involved, based on its balance sheet. If the net worth is negative, the Central Bank of Brazil may consider that there was a dilution of the investment, thus denying permission for repatriations in an amount proportional to the negative results verified.

Remittances of currency abroad may be restricted when there is no corresponding registration at the Central Bank of Brazil, since the remittance of profits, the repatriation of capital and the registration of reinvestments are all based on the amounts registered as foreign investment.

B.Exemption From Withholding On Investment Government Bonds

Article 1 of Mp 2281/2006 reduces to zero the withholding income tax (IRF) levied on the income from investments made by persons resident or domiciled abroad in Brazilian Federal Government Bonds. This benefit (i) applies to income from federal government bonds acquired as from February 16, 2006 (ii) applies to foreign investors not resident or domiciled in tax havens, (iii) applies to foreign investments made under the rules of National Monetary Council Resolution No. 2689 of January 26 2000; and (iv) does not apply to bonds acquired by foreign investors under repurchase agreements.

The IRF zero rate will also apply to income from investments in the shares of investment funds exclusively held by non-residents, provided that their portfolio is composed of at least 98% of federal government bonds.

II. An Overview of the Brazilian Tax System

Historically, Brazilian tax regulations have been complex. Although the government is engaged in reducing and simplifying the Brazilian tax system, at this time an extensive body of tax regulations still applies. Taxes may be imposed in Brazil at three different levels: federal, state, and municipal.

A.The Corporate Income Tax

Most business entities are required to pay corporate income taxes (IRPJ). The IRPJ is computed at a 15 percent rate on adjusted net income. Annual net income in excess of R \$240,000 is also subject to a surtax of 10 percent.

According to Law No. 9,430 (December 30, 1996), taxpayers may opt to calculate the IRPJ quarterly or annually. If the IRPJ is calculated quarterly, it is also payable quarterly. A 15 percent rate is applied over the quarter net income, plus a 10 percent surtax on net income exceeding R\$60,000 per quarter.

If the IRPJ is calculated annually taxpayers are required to anticipate monthly payments of IRPJ calculated over estimated income. For most companies the monthly estimated income corresponds to 8 percent of the total monthly gross revenues plus capital gains and other revenues and positive results incurred by the company. Such percentage ranges from 8 percent to 32 percent, depending on the taxpayer's activity. Again, the 15 percent rate applies over this tax basis, plus the 10 percent surtax on estimated income exceeding approximately R\$20,000 per month. Whenever the annual method of calculation is adopted and monthly estimations take place, the taxpayer is asked to proceed to a final adjustment at the end of the year in which it will either pay or request reimbursement for the difference between the amount paid monthly and the amount calculated on annual income. Another method of calculating income tax is the presumed method. Under this method, the income tax is calculated quarterly and for most activities the tax basis corresponds to 8 percent of gross revenues. There are other applicable rates to calculate presumed income related to certain specific activities (e.g., 32 percent for most service activities). Over the presumed income, the income tax rates are 15 percent and 10 percent surtax levied on presumed income exceeding R\$60,000 per quarter. If the presumed method of taxation is adopted, the taxpayer is *not* subject to any adjustment according to annual actual income.

Eligibility requirements for the presumed method are (1) revenues earned in the previous tax year must not exceed R\$48 million; and (2) profits, capital gains, or other earnings cannot be originated abroad (this rule does not apply to companies whose profits derive from export transactions).

The following companies are not eligible to adopt the presumed method of taxation:

1. Financial institutions or equivalent entities, as provided in Brazilian law.
2. Companies that have tax benefits under authorization of the Brazilian tax law (e.g., tax exemption or income tax reduction).
3. Companies that have paid the income tax calculated in a monthly and estimated manner.
4. Factoring companies.

Until 1998, companies directly owned by foreign entities were not eligible to adopt the presumed method, but in 1999 this restriction was revoked.

Net operating losses (NOLs) generated in a given period can be used to offset taxable income of the subsequent period, limited to 30 percent of taxable income and according to some specific rules (i.e., for each R\$1.00 of income, R\$0.70 must be subject to taxation, regardless of the existing amount of NOL). Tax losses may be carried forward, without a statute of limitation.

Interest on loans is full deductible, provided that cross-border loans are duly registered with the Central Bank of Brazil. Loans contracted between related parties that are not registered with the Central Bank of Brazil are deductible expenses, provided that they are in accordance with the transfer pricing rules (Libor (London interbank offering rate, the rate at which London banks lend to each other) plus 3 percent).

B. Withholding Taxes

In general, payments made to nonresidents are subject to withholding income tax in Brazil. As a general rule, payments to nonresidents for services rendered to Brazilian residents and payments to nonresident individuals for work remuneration are subject to the general withholding income tax rate of 25 percent.

The 25 percent rate for payment of services does not apply to interest on loans and other types of payments that are not classified as services, and are subject to specific legal provisions. For these types of payments, the lower withholding rate of 15 percent is still in place.

As discussed below, due to the creation of the new Contribution for the Intervention in the Economic Domain (CIDE), the income tax rate applicable to licenses for the use of rights, the acquisition of technological knowledge, and the transfer of technology, as well as for technical services, administrative assistance, and other similar services that do not involve the transfer of technology, was reduced to 15 percent. In addition, the payments remitted abroad for these rights and services will be subject to the 10 percent CIDE.

Law No. 9,779, Article 8, increased the previous withholding tax of zero or 15 percent to 25 percent for all payments of income, with few exceptions, made to nonresidents established in a low-tax jurisdiction. The Brazilian Federal Revenue Department has listed locations considered to be low-tax jurisdictions for Brazilian tax purposes (Treasure Ruling No. 188/02) as discussed below. Thus, for example, interest payable on loans to a low-tax jurisdiction is currently subject to the greater 25 percent withholding rate, unless there is legal provision regulating the withholding tax on the specific type of loan contracted.

The location may be deemed a low-tax jurisdiction if it does not impose income tax or imposes an income tax at a maximum rate of 20 percent. It may also be deemed a low-tax jurisdiction if its legislation prevents the disclosure of investments in a company or title to these investments. The characterization of low-tax jurisdictions is extremely important to determine, among other issues, the applicability of transfer pricing rules and the increased withholding income tax rate of 25 percent.

Pursuant to Normative Ruling No. 188/02, the new list of low-tax jurisdictions is: American Samoa, American Virgin Islands, Andorra, Anguilla, Antigua, Aruba, Bahamas, Bahrain, Barbados, Barbuda, Belize, Bermuda Islands, British Virgin Islands, Campione D'Italia, Cayman Islands, Channel Islands (Alderney, Guernsey, Jersey, and Sark), Dominica, Cook Islands, Costa Rica, Cyprus, Djibouti, Saint Kitts & Nevis, Gibraltar,

Grenada, Hong Kong, Isle of Man, Labuan, Lebanon, Liberia, Liechtenstein, Luxembourg (with respect to holding companies existing under the Luxembourg Law of July 31, 1929), Macao, Madeira Islands, Maldives, Malta, Mauritius Islands, Marshall Islands, Monaco, Monserrat Islands, Nauru, Netherlands Antilles, Niue Islands, Occidental Samoa, Oman, Panama, Santa Lucia, Saint Vincent & Grenadines, San Marino, Seychelles, Singapore, Tonga, Turks & Caicos Islands, United Arab Emirates, and Vanuatu. The tax authorities update this list from time to time.

Nonresidents are subject to taxation according to the same rules applicable to Brazilian resident individuals, which means that capital gains paid to nonresidents will be subject to a 15 percent income tax. Recent changes in the tax legislation have increased this rate to 25 percent on capital gains remitted or paid to nonresident taxpayers located in low-tax jurisdictions, which previously had been the case only for payments of income to taxpayers in low-tax jurisdictions.

C. Social Contribution Taxes

Most entities are required to pay Social Contribution on Net Income (CSLL). This is a true corporate income tax surcharge, at the rate of 9 percent. The reason it is levied separately from the corporate income tax is because it is paid to the social security system, and not to the federal administration.

Tax basis for the CSLL is net income specifically adjusted for CSLL purposes. As with the IRPJ, taxpayers may opt to calculate CSLL quarterly or annually. In the latter case, monthly payments must be estimated. Law No. 9,316, (November 22, 1996) provides that the CSLL is no longer deductible from net income for purposes of calculating IRPJ.

Negative basis of CSLL (tax loss for CSLL purposes) can be used to offset taxable income from subsequent periods, although limited to 30 percent of taxable income. Similar to tax losses for IRPJ purposes, negative basis of CSLL may be used to offset future taxable income without a statute of limitation, provided that some conditions of the tax legislation were satisfied.

The overall income tax rate, considering the maximum rate for the income tax (15 percent + 10 percent) plus CSLL, is currently 34 percent.

CIDE is a new social contribution that is due from companies that (1) own licenses for the use of rights, (2) acquire technological knowledge, or (3) are parties in agreements that imply a transfer of technology executed with foreign residents. As of January 1, 2002, CIDE is also due from companies that render technical services, administrative assistance, and other similar services that do not involve transfer of technology.

The CIDE is levied on the total amount paid, credited, delivered, used, or remitted in each month to nonresident beneficiaries as royalties of any kind and remuneration under agreements to (1) supply technology; (2) provide technical assistance (technical assistance services and specialized technical services); (3) license and assign trademarks;

(4) license and assign patents; and (5) render technical services, administrative assistance, and other similar services that do not involve the transfer of technology.

The rate is 10 percent of the amount paid, credited, delivered, used, or remitted monthly to nonresident beneficiaries of the items listed in the preceding paragraph. The contribution is due by the last business day of the fortnight following the month that the royalty or fee was paid, credited, delivered, used, or remitted abroad.

This contribution is levied on the import and commercialization of certain types of fuel (oil, diesel, aviation kerosene and other types of kerosene, fuel-oil, liquefied petroleum gas, including the one derived from natural gas and naphthenate, and alcohol fuel) at fixed amounts in Reais.

The CIDE is paid by the producer, blender, or importer of fuels. The taxpayer is allowed to deduct the CIDE from the (Program for Social Integration) PIS and (Contribution for the Financing of Social Security) COFINS contributions (discussed below) levied on the sale of fuels, subject to limits provided for in the applicable legislation. This contribution will not be levied on the income derived from the exportation of the products mentioned above.

D.Federal Welfare Taxes

There are two types of federal welfare taxes, PIS and COFINS, which are due on monthly gross revenues of any kind, with a few exceptions established by the tax legislation.

Law Nos. 10,637/02 and 10,833/03 introduced a new system for calculating the PIS and COFINS, which applies to most companies in Brazil. The main purpose of the legislation is to avoid the cumulative effect of those contributions through the grant of tax credits. Therefore, the PIS and COFINS levy on a company's gross revenues is non-cumulative, with a combined rate of 9.25 percent (PIS: 1.65 percent; COFINS: 7.6 percent).

According to the new system, a taxpayer is entitled to credits related to these contributions from, among others, the following operations:

1. Acquisition of goods for resale.
2. Acquisition of goods and services to be used as raw materials for manufacturing products for sale or used in the rendering of services.
3. Acquisition of machinery and equipment to be used in the manufacturing process of products for sale, as well as in the acquisition of other goods incorporated to the fixed assets.

These credits can be used by the company to reduce the PIS and COFINS levied on revenues derived from subsequent transactions. This new system does not apply to certain taxpayers, such as (1) companies that calculate income tax based on the presumed or arbitrated profit; or (2) financial institutions, health plans operators, private pension entities, and security companies. In these instances, the PIS and COFINS will continue to apply on the company's total revenues, in general at the combined rate of 3.65 percent.

Financial institutions are subject to COFINS at a 4 percent rate and PIS at a 0.65 percent rate.

On April 30, 2004, the Brazilian Official Gazette published Law No. 10,865, which provides for the levy of PIS and COFINS on the importation of goods and services (PIS/COFINS-*Importação*).

PIS and COFINS-Import is levied on the importation of goods and services, as a general rule, at a total rate of 9.25 percent over a broad tax basis that includes the total value of the imported goods, the state value added tax (ICMS), and the contributions themselves (PIS and COFINS). For the importation of services, the contributions are levied on the amount paid, credited, delivered, used, or remitted abroad, calculated before the withholding income tax, plus the Municipal Services Tax (ISS), and will also include the contributions themselves—PIS and COFINS.

Legal entities subject to the rules of non-cumulative PIS and COFINS, pursuant to Law Nos. 10,637/02 and 10,833/03, are allowed to take credits derived from the PIS and COFINS levied on the importation of goods or services, according to specific conditions established by the legislation, as noted in the discussion related to the federal welfare taxes.

E. Financial Transactions Taxes

The financial transactions tax (IOF) is imposed on foreign currency exchange transactions effected to remit payments abroad for services, including technical assistance fees and royalties for the use of trademarks and patents. The local party who remits the funds abroad bears the responsibility for the payment of IOF. The tax is collected by the commercial bank in Brazil at the time of the transaction. Currently, however, a zero rate applies in most instances.

The IOF is also due on currency exchange transactions intended to extend loans to Brazilian residents and/or to make certain investments in Brazil. Currently, the IOF rate is 5 percent on loans extended to Brazilian entities with a maturity term of less than ninety days. The law limits increases of the tax to 25 percent.

For exchange transactions made by credit card administrators to cover expenses made by their clients abroad the rate is 2 percent.

In addition to currency exchange transactions, an IOF is applied to financial transactions involving credit, insurance, and securities.

Law No. 9,311 (October 24, 1996) created the Provisional Tax on Banking Transfer (*Contribuição Provisória sobre Movimentação ou Transmissão de Valores e de Créditos de Natureza Financeira* (CPMF)), which was intended to be temporary. In 2003, the effects of this tax were extended until December 2007. The CPMF applies at a 0.38 percent rate to all banking transfers and withdrawals of currency, such as the cashing of checks.

F. VAT

The State Value Added Tax on Sales and Services (ICMS) is the most important state tax. Similar to the IPI, it is a value added tax on sales and services, payable on the importation of a product into Brazil and a sale or transfer within Brazil, or as to certain communication and intrastate and interstate transportation services, at the time that the service is rendered. According to Constitutional Amendment No. 33/01, the ICMS will be levied on importation carried out by legal entities, as well as by individuals, even if they are not considered as taxpayers for ICMS purposes.

ICMS rates and tax benefits vary from state to state and according to the type of transaction (e.g., intrastate or interstate sale of goods, communication, or transportation services). Currently, ordinary rates in the state of São Paulo are 12 percent on transportation services, 18 percent on products imported, sold, or transferred, and 25 percent on communication services. Other rates may also apply, according to the specific product or service. Rates may also vary with respect to interstate transactions (normally 7 percent or 12 percent depending on the state of destination of the goods and services).

Because it is a value added tax, taxpayers are allowed to offset the ICMS paid in acquired goods and services against the ICMS due on subsequent taxable transactions (e.g., sale of goods and services subject to ICMS tax). The balance between credits and debts will be the amount owed to the state government.

Taxpayers are also allowed to register ICMS credits on imports and local purchases of fixed assets. However, pursuant to the Complementary Law No. 102/00, such credit registration must be made at a monthly rate of 1/48. As of January 1, 2007, the taxpayer will be allowed to take a credit for the ICMS paid on acquiring goods (other than raw material, intermediate products, and packaging material) self-consumed in the taxpayer's activities.

For taxpayers with excess of ICMS credits, some state regulations provide for alternatives that allow them to transfer the credits. In the state of São Paulo, for example, state regulations provide some alternatives through which the taxpayer with excess of ICMS credits can use the tax already paid (besides offsetting ICMS debts). They can (1) transfer ICMS credits to any of its branches or offices located within the state of São Paulo; (2) transfer the credits to an interdependent company, as defined in the regulations; or (3) use the credits to pay for purchases to a supplier of raw material or certain fixed assets. Other state regulations may provide for other alternatives to use excess ICMS credits.

G. Municipal Services Tax

The Municipal Services Tax (ISS) is assessed on specific services that are listed in federal regulations. Rates vary from 2 percent to 5 percent, depending on the type of service and the local legislation of the particular municipality in which the party rendering the services is located.

On July 31, 2003, the Brazilian government enacted Complementary Law No. 116, introducing relevant changes in ISS. Pursuant to the new legislation, ISS will be levied

not only on services rendered in Brazil, but also on the “importation of services” (i.e., services originating from abroad or the rendering of which were initiated abroad). In such instances, each municipality may set forth in the relevant municipal law that the recipients or agents of the services in Brazil are liable for collecting the tax due. Complementary Law No. 116 also provides that the export of services abroad will not be subject to ISS, except for services developed in Brazil and the results occur in Brazil, even if the payer is a foreign resident.

Additionally, Complementary Law No. 116 lists the services that will be subject to ISS tax. The list includes several services that were not encompassed by the prior legislation, apart from certain services that were maintained. As an example, the following activities were included as services for ISS tax purposes: assignment of trademark use and propaganda signals; assignment or license of use of computer programs—software; franchising; improvement of objects; maritime agency; and installation and assembly of products, parts, and equipment related to civil construction.

H. Tax Treaties

Brazil has executed numerous tax treaties with other countries to avoid double taxation on international transactions. The tax treaties provide for tax reductions on income such as royalties, interest, remuneration, dividends, and profits. To date, Brazil has executed treaties with Argentina, Austria, Belgium, Canada, China, Czech Republic and Slovakia Republic, Denmark, Ecuador, Finland, France, Germany, Hungary, India, Italy, Japan, Korea, Luxembourg, the Netherlands, Norway, the Philippines, Portugal, Spain, Sweden, Chile, Paraguay*, Mexico** and Ukraine** (* pending publication of an executive decree; ** pending publication of a legislative decree with approval of the Brazilian Congress, and the enactment of an executive decree).

I. Controlled Foreign Corporations

Brazilian legislation determines that profits earned by controlled foreign corporations (CFCs) and by certain foreign affiliates (non-controlled subsidiaries) of Brazilian entities will be included in the basis for calculating the income tax and CSLL of the Brazilian controlling or parent company (Article 25 of Law 9.249/95 and Article 21 of Provisional Measure 2.158-34).

The tax legislation states that the profits earned by CFCs and by non-controlled subsidiaries of Brazilian companies will be considered available to the controlling or the parent company in Brazil (and subject to taxation) at the end of each fiscal year. The income tax paid abroad can be used as a credit to offset the income tax due in Brazil.

Prior to this rule, the income earned by CFCs or by non-controlled subsidiaries was subject to income tax in Brazil when the income was either distributed to the Brazilian controlling or parent company in the form of dividends or a distribution of profits, or if the corresponding cash was credited or applied in favor of the Brazilian entity. Other situations that triggered taxation in Brazil under the old laws were related to the lending

of proceeds by the foreign entity to any party to the extent that profits or reserves of profits had not yet been taxed in Brazil.

J. Personal Income Taxes

Brazil has in comparison low taxes on personal income. Only seven percent of the total tax revenue comes from personal income taxes, mainly because incomes under the equivalent of ten thousand U.S. Dollar are exempt. The median income for a native of Brazil is only slightly above five thousand U.S. dollars so income taxes are generally seen in Brazil as a tax on the wealthy since only around 16% of the population was subject to them in 1999. The maximum rate of tax on personal income is 27.5% which when compared with the rates of other nations puts it near the bottom of tax rates on personal income. You have already noticed that Brazil has many other taxes to make up for its generosity in the personal income tax area.

II. Business Entities

The main forms of business organization available in Brazil are:

- (i) A partnership not organized as a business enterprise (*sociedade simples*);
- (ii) (i) A partnership not organized as a business enterprise (*sociedade simples*);
- (iii) A limited partnership (*sociedade em comandita simples, sociedade em comandita por ações*);
- (iv) A silent partnership (*sociedade em conta de participação*);
- (v) A limited liability company (*sociedade limitada*);
- (vi) A corporation (*sociedade anônima*).

The most common forms of doing business used by foreigners are limited liability companies and corporations.

A. Opening a Branch in Brazil

A foreign company may open a branch in Brazil with the authorization of the federal government. An application to open a branch must be accompanied by the following documents: (i) evidence that the foreign company is duly organized and in existence in its country of origin; (ii) the complete text of its bylaws; (iii) a list of all managers of the foreign company with their respective identification and the number of shares held by each of them, except shares issued in bearer form; (iv) a copy of the minutes of the shareholders' meeting which authorizes the opening of the branch in Brazil and sets forth its capital; (v) evidence of the appointment of a legal representative in Brazil; and (vi) the latest balance sheet.

The legal representative appointed to Brazil must have the power to decide any and all issues that may arise in Brazil, including the power to accept the conditions that may be imposed by the Brazilian government for the establishment of the branch, as well as the power to receive service of process.

To be effective in Brazil, any changes in the by-laws of a foreign company having a local branch must be approved by the federal government. The financial statements concerning operations of the branch must be prepared in accordance with Brazilian law and published in the Government's Official Gazette (*Diário Oficial da União*). Moreover, if the foreign company is required under the law of its country of origin to publish its own financial statements, they also must be published in Brazil.

Although used frequently in the past, branches of foreign companies have become very rare because of bureaucratic difficulties encountered in establishing them and the elimination of previously available legal advantages in comparison to limited liability companies and corporations.

B. The Limited Liability Company

A limited liability company is formed with the execution of an agreement (equivalent to articles of association), known as a *Contrato Social*, by at least two partners, whether individuals or legal entities. The articles of association may be drafted to accommodate the needs of the relevant company, but certain requirements must be observed. First of all, the articles of association must be written in Portuguese. In addition, certain provisions must be necessarily included, including: (i) the name of the partners and respective personal data; (ii) the name of the company, which must include its purpose and the expression "Limitada " (or its abbreviated form "LTDA") and may not be identical or similar to the name of a pre-existing company; (iii) the address of the head offices; (iv) the company purposes, which must be clearly described; (v) the company duration, which may be determined or undetermined; (vi) the company capital and whether or not it is fully paid and the payment term; and (vii) each partner's participation in the capital and that the responsibility of each partner is limited to the company's subscribed capital. Other provisions may be included in the articles of association if the partners so desire; for instance, regulations on the transfer of quotas.

The capital of a *limitada* is represented by units called "quotas," with no issuance of certificates of ownership. The capital is denominated in Brazilian currency and recorded in the articles of association, as amended from time to time to reflect any assignment and transfer of quotas and capital increases and reductions. In general, no minimum capital requirement exists.

Management of the *limitada* is vested in one or more resident individuals, appointed in the articles of association or in a separate document. Managers may or may not be partners, but in the latter case the articles of association must expressly authorize the appointment of non-partner managers.

Any act performed by the managers exceeding their powers, or in violation of Brazilian Law or the articles of association, subjects them to unlimited personal liability *vis-à-vis* third parties and before the tax authorities for debts arising there from.

C. Corporation

Incorporation is subject to compliance with the following requirements: (i) subscription of all of the issued shares by at least two individuals or legal entities, or any combination thereof, whether or not Brazilian residents; (ii) where all or part of the issuance price of the capital is to be paid in cash, payment of at least 10% of such amount must be made (except in the case of those types of companies for which the law requires payment of higher amounts, such as financial institutions); and (iii) deposit, on behalf of the company, of the initial payment proceeds, if the capital is paid in cash, with the *Banco do Brasil S/A* or with another banking institution approved by the CVM, within five days of receipt of such funds. A corporation may be formed with a public or private subscription of its shares. Incorporation with a public subscription (i.e., the offering of a corporation's securities to the public at large by means of a prospectus and with the intermediation of brokers or brokerage firms) must be registered with and approved by the CVM, and thereafter formalized at a meeting of the subscribers

Corporate capital is divided into shares which may only be issued in registered form. Depending on the nature of the rights and advantages they carry, the shares are classified as common (*ordinárias*), preferred (*preferenciais*), or shares of participation (*de fruição*), which result from the amortization of shares. Corporate capital is divided into shares which may only be issued in registered form. Depending on the nature of the rights and advantages they carry, the shares are classified as common (*ordinárias*), preferred (*preferenciais*), or shares of participation (*de fruição*), which result from the amortization of shares.

Corporations may also issue: (i) debentures; (ii) debenture-backed securities; (iii) subscription bonuses; (iv) stock options; (v) founders' shares (*partes beneficiárias*); and (vi) commercial paper. A debenture confers on its holder a credit right against the corporation. There are several forms of debentures, which vary depending on whether there are security interests or other preferences over third party creditors indicated in the indenture, including: (i) mortgages on real property; (ii) floating liens on all properties of the company; (iii) guarantees subordinated to the general creditors of the company; or (iv) no guarantees whatsoever. In practice, debentures have also been issued with a guarantee from the parent company or from a banking institution. A *parte beneficiária* is a negotiable security with no par value, issued separately from the corporate capital and conferring a contingent right to receive from the corporation a participation in the annual profits. The participation may not exceed one-tenth of the profits. A subscription bonus¹¹⁶ is a negotiable security granting the right to subscribe and pay for shares of the corporation subject to the conditions set forth therein. Subscription bonuses may only be issued up to the limit of the "authorized capital." Subscription bonuses may be an alternative to the issuance of shares, when the corporation is uncertain as to the total

placement of the shares. Under the rules issued by the CVM, an issuance of shares is not valid if the total subscription is not verified.

Shareholders have the following rights that cannot be taken away by means of a modification to the by-laws or by a decision of the Shareholders' General Meeting: (i) participation in the profits; (ii) participation in the net assets of the corporation on liquidation; (iii) supervision of the corporate management; (iv) a preemptive right to subscribe for shares and other securities convertible into shares issued by the corporation; and (v) withdrawal from the corporation

Shareholders dissenting from certain types of resolutions adopted at a Shareholders' General Meeting (e.g., a change in the corporate purpose, an issuance of preferred stock or an increase in an existing class of preferred stock where the proportions of all classes of preferred stock are not preserved, or a reduction of the compulsory dividend) may withdraw from the corporation by means of the reimbursement of the value of their shares if they so request within 30 days from the date on which the minutes of the Shareholders' General Meeting are published.

Corporations must, in principle, distribute a certain portion of their annual profits as a compulsory dividend. The compulsory dividend must be established in the by laws based on a percentage of profits or on the registered capital, or on any other criterion that is regulated by the bylaws in detail and does not subject minority shareholders to the will of management or of the controlling shareholder. The absence of any mention of a compulsory dividend in the bylaws renders the corporation liable to make a mandatory dividend payment equivalent to 50% of the annual net profits.

The Shareholders' General Meeting of a closely held corporation not controlled by a publicly held corporation, as well as of a publicly held corporation that raises funds with the public only by issuing unconvertible debentures, may agree on the distribution of profits at a rate lower than the compulsory dividend or even on no distribution at all, provided there is no opposition to such a resolution among all the shareholders attending the meeting.

III. Transfer Pricing.

Transfer pricing rules have applied in Brazil since January 1, 1997, when Law No. 9,430 came into force. The system adopted is one of determining the maximum amount of deductible expenses and the minimum amount of taxable income for Brazilian entities engaged in transactions with related parties established outside of Brazil, or cross-border transactions that are deemed “controlled” under Brazilian law.

The transfer pricing rules provide for three methods to determine maximum deductible expenses, costs, and charges related to goods, services, or rights imported from a related party. The three methods are:

1. The comparable uncontrolled price method.
2. The resale price less profits method.
3. The production cost-plus profits method.

For exports, taxpayers will be subject to adjustments whenever the average sales price in such transactions is lower than 90 percent of the average sales price in the Brazilian market during the same period and according to similar payment conditions. If the average price with related parties is lower than 90 percent of that used with unrelated parties, the export income will be adjusted according to one of the following methods:

1. The average price of export sales method.
2. The wholesale price in the destination country less profits method.
3. The retail price in the destination country less profits method.
4. The acquisition or production cost-plus taxes and profits method.

On April 30, 1997, transfer pricing regulations were issued through Treasury Ruling No. 38/97. In 2000, new provisions and regulations were issued dealing particularly with the resale price less profit method for imports of products subject to manufacturing processes in Brazil (Provisional Measure No. 1924—converted into Law No. 9959/2000 and Treasury Ruling No. 113/2000).

Brazil's official gazette of March 30, 2001, published Treasury Ruling No. 32, which consolidated provisions of Law Nos. 9430/96 and 9959/00 and Treasury Ruling Nos. 38/97 and 113/2000. On November 13, 2002, new transfer pricing regulations were issued through Treasury Ruling No. 243/02. This new ruling clarified some aspects that had been unclear.

In Brazil, the taxpayer has the burden of proof to demonstrate compliance with transfer pricing rules; otherwise, the tax administration may start a case. The costs and average prices to which Law No. 9430 refers must be based on either official information and reports from the importing or exporting country or research conducted by companies or institutions with well-known technical expertise.

For goods, services, and rights imported from a related party, the taxpayer must prove that the corresponding costs, expenses and charges do not exceed at least one of the three methods set forth by Law No. 9430. Otherwise, the tax authorities may challenge the deduction. The excess amount will be added back as taxable income and will thus be subject to the corporate income tax at the rate of 15 percent plus a surtax of 10 percent. The 9 percent CSLL also applies on the excess amount.

The exchange rate applicable to amounts in foreign currency on imports of goods, services, and rights will be determined according to the “sale exchange rate” of the currency, corresponding to the second business day prior to (1) the day of customs clearance, for goods, or (2) the day of accrual of costs or expenses, for provisions of services and acquisitions of rights. For exports, the exchange rate will be determined according to the “purchase exchange rate” published by the Central Bank (1) for the day

of shipment, for goods or (2) for the day the service is actually provided or the rights are actually transferred.

Although Law No. 9430 does not provide for adjustments to compare the taxpayer's prices with prices adopted by other Brazilian companies that import or sell identical or similar goods, services, or rights in the Brazilian market, Treasury Ruling Nos. 38 and 32 and now Treasury Ruling No. 243 establish some guidelines for comparison purposes.

The regulations define “similar goods” as those that, simultaneously:

1. Have the same nature and function.
2. Can mutually replace each other in the function for which they are made.
3. Have equivalent specifications.

The following parties are deemed to be a related party of the taxpayer for transfer pricing purposes:

1. Its parent company, domiciled abroad.
2. Its branch or agency, domiciled abroad.
3. The person or legal entity, resident or domiciled abroad, whose interest in the capital of the Brazilian taxpayer characterizes it as a controlling shareholder or affiliate party, as defined in the Corporate Law.
4. The legal entity domiciled abroad that is characterized as a controlled entity or affiliate party of the Brazilian taxpayer, as defined in the Corporate Law.
5. The legal entity domiciled abroad, when such an entity and the Brazilian taxpayer are under the common corporate or administrative control or when at least 10 percent of the capital of each entity is owned by the same person or legal entity.
6. The person or legal entity, resident or domiciled abroad, that together with the Brazilian taxpayer holds an interest in the capital of a third legal entity, which sum characterizes them as the latter's controlling shareholders or affiliate parties, as defined in the Corporate Law.
7. The person or legal entity, resident and domiciled abroad, that is associated, in the form of a consortium or condominium, as defined by the Brazilian law, in any enterprise.
8. The person resident in Brazil who is a relative up to the third family degree, (as defined in the Brazilian Civil Code), the spouse, or companion of the Brazilian company's manager or direct or indirect controlling shareholder.
9. The person or legal entity, resident or domiciled abroad, which has exclusive rights, as agent or distributor, to purchase and sell goods, services and rights of the Brazilian entity.
10. The person or legal entity, resident or domiciled abroad, which has the Brazilian entity as the exclusive agent or distributor to purchase or sell goods, services, or rights.

The transfer pricing rules also apply to transactions carried out by an entity domiciled in Brazil through a interposed party (third party) who is not considered a related party to

the extent that such interposed party deals with another party abroad who is considered a related party of the referred Brazilian entity.

Taxpayers must report on their annual tax return (DIPJ) the existence of any relationship with related individuals or legal entities domiciled abroad.

A. Comparable Uncontrolled Price Method.

This method is defined as the arithmetical average of sales prices of goods, services, or rights, either identical or similar, prevailing in the Brazilian or foreign markets, on transactions of purchases and sales, under similar payment conditions. In other words, the taxpayer compares its costs, expenses, and charges of goods, services, or rights acquired from a related party, during a given period of time, with the arithmetical average. If the costs, expenses, and charges incurred by the taxpayer exceed the arithmetical average, the excess amount will be added back as taxable income.

Although Law No. 9430 is silent, Treasury Ruling No. 243 provides for some adjustments between controlled and uncontrolled prices. For identical goods, services, and rights, Treasury Ruling No. 243 permits adjustments related to:

1. Payment conditions.
2. Quantities negotiated.
3. Obligations related to warranty for the goods, service, or right.
4. Obligations related to promotion of the goods, service, or right by means of marketing and advertising.
5. Obligations for quality control, standards of services, and health conditions.
6. Agency costs in purchase and sale transactions carried out by unrelated parties.
7. Packaging.
8. Freight and insurance.

For similar goods, services or rights, in addition to these adjustments, the regulations permit the taxpayer to make adjustments relating to physical differences between the goods, services, or rights taken into consideration for comparison purposes.

Still with respect to the arithmetical average, only transactions carried out between unrelated purchasers and sellers will be taken into consideration for purposes of calculating the average. In addition, neither Law No. 9430 nor Treasury Ruling No. 243/02 elects a preferred jurisdiction, whether local, state, or foreign, in which “uncontrolled prices” are adopted in transactions between unrelated parties. Thus, a taxpayer may take into account, for purposes of calculating the arithmetical average price of goods, services, or rights, “uncontrolled prices” adopted in either local, state, or nationwide markets, or in import/export transactions, as well as in transactions carried on outside the Brazilian territory.

B. Resale Price Less Profits Method

Under the original rules and regulations enacted in late 1996 and in mid-1997, importers could not use the resale price method when imported goods or rights were subject to another manufacturing process that would result in a new product. In these situations, the

importer had to use one of the two remaining methods—that is, the comparable uncontrolled price or the cost-plus method.

On October 7, 1999, Provisional Measure No. 1924/99 (Law No. 9959/2000) was issued introducing some changes to Brazil's transfer pricing rules. The most relevant change was the adoption of a new resale price method for imports of goods or rights that will be subject to another manufacturing process in the country. Under the new rules, there is a bifurcation of the resale price less profit method, depending on whether the importer will submit the imported products to a manufacturing process in Brazil.

For imported goods or rights to be subject to a further manufacturing process by the importer or a related entity, the resale price less profit method is defined as the arithmetical average of resale prices of goods or rights (in Brazil) less:

1. Unconditional discounts granted.
2. Taxes and contributions imposed on sales.
3. Commissions and brokerage fees paid.
4. A profit margin of 60 percent, calculated over the resale price after deducting the above three items and the proportional value added in the country.

Normative Ruling No. 243/02 established the procedure to calculate the import cost of goods, services or rights used in the manufacturing process, pursuant to the resale price less profit method. This Normative Ruling not only defines “parameter price” (*preço parâmetro*), but also determines that this price should be calculated considering the percentage of the imported goods, services, or rights in relation to the total cost of the manufactured product.

For goods or rights imported into the country and not subject to a manufacturing process locally, the original rules continue to apply. In this situation, the resale price less profits method is defined as the arithmetical average of resale prices of goods or rights (in Brazil) less:

1. Unconditional discounts granted.
2. Taxes and contributions imposed on sales.
3. Commissions and brokerage fees paid.
4. A profit margin of 20 percent, calculated over the resale price (after deducting unconditional discounts).

However, when the 20 percent profit margin applies, the rules are silent as to any deduction from the resale price over which the profit margin is calculated. One could conclude that no deduction from the resale price would be allowed to calculate the 20 percent margin—that is, that the margin would be calculated over the total resale price with no deduction whatsoever. However, the existing regulations, although based on the old rules, provide that the 20 percent margin should apply over the total resale price, less the unconditional discounts only. If the regulations are not changed in the future, unconditional discounts could be subtracted from the resale price to calculate the 20 percent margin.

The resale price to be considered for purposes of this method is the price adopted by the taxpayer in the wholesale or the retail markets with unrelated purchases, either individuals or legal entities. Differences in payment conditions can be adjusted according to the interest rate adopted by the taxpayer in its regular sales. If the taxpayer does not adopt a determined interest rate consistently, the adjustments in payment conditions should be made according to interest rates provided in the regulations.

The costs of freight and insurance borne by the Brazilian importer and also the unrecoverable taxes paid on imports (e.g., import duties) must be included to determine the cost of the goods under the resale price less profit method. The wording of the old regulations seemed to consider the inclusion of these costs optional. The new regulations make clear that the inclusion is mandatory.

Finally, as regards the profit margins, the regulations accept profit margins other than those in the specific methods, provided that the taxpayer proves that they are based on publications, surveys, or reports prepared by foreign governments, foreign tax authorities, or companies or institutions with well-known technical knowledge.

C. Production Cost-Plus Profits Method

The third method used to determine arm's-length prices for imports of goods, services or, rights is the production cost-plus profit method. It is defined as the average production cost of goods, services, or rights, either identical or similar, in the country where they were produced, plus the taxes levied on exports in that country and a markup of 20 percent, calculated over the production cost.

According to the regulations, the following items are (production) cost for purposes of this method:

1. Acquisition costs of raw materials, intermediary products, and packaging material used in the production of the goods, services, or rights.
2. The costs of other goods, services, or rights used or consumed in the production of the relevant goods, services, or rights.
3. The cost of the personnel used in the production of the goods, services, or rights, including those for production supervision, maintenance and security of production facilities, and corresponding social charges.
4. Costs of rents, leases, maintenance and repair, and depreciation and amortization charges of the goods, services, or rights used in the production of the relevant goods, services, or rights.
5. Reasonable losses in the production process that are allowed by tax legislation in the foreign country.

Therefore, to determine the maximum deductible costs, expenses, and charges according to this method, the taxpayer is required to prove they do not exceed the production cost, plus taxes and a 20 percent profit margin in the country that the goods, services, and rights were produced. The profit margin of 20 percent applies over the production costs before the taxes levied on exports.

D. Average Price of Export Sales Method

The taxpayer must first show that the export price in a transaction with a related party is higher than 90 percent of the average sales price adopted in the Brazilian market with unrelated parties. Therefore, this is the first condition for the taxpayer to avoid allocation of income based on the methods set forth by the transfer pricing rules.

For this purpose, the sales price in the Brazilian market will be considered net of unconditional discounts, ICMS, ISS, and the social contributions of gross receipts (i.e., PIS and COFINS). The export price will be considered net of insurance and freight expenses borne by the exporter.

If the export price does not exceed 90 percent of the average sales price in the Brazilian market, the taxpayer is required to compute a taxable income equal to one of the four methods provided by the transfer pricing rules.

The average price of export sales method is defined as the arithmetical average of export prices adopted by the taxpayer or another exporter for identical or similar goods, services, or rights with unrelated parties during the same corporate income tax period and under similar payment conditions.

If the taxpayer does not export goods, services, or rights to unrelated parties, the tax authorities may compare the taxpayer's export prices with those adopted by third parties that export identical or similar goods, services, or rights. The concept of "similar goods" for exports is the same as the one described to imports.

If the taxpayer does not carry out sales in the Brazilian market, the regulations allow sales prices adopted by third parties to be taken into consideration. In an extreme situation, a taxpayer may face an allocation of income based on comparisons made with both export and sales prices adopted by third parties in the Brazilian market.

The second method for exports carried out with a related party is the wholesale price in the destination country less profit method. It is defined as the arithmetical average of sales of identical or similar goods adopted in the wholesale market in the country of destination under similar payment conditions after deducting (1) the taxes computed in the sales price, charged in the country, and (2) a profit margin of 15 percent over the wholesale price.

The retail price in the destination country less profits method is similar to the preceding one, except that it takes into consideration the retail price instead of the wholesale price. It is defined as the arithmetical average price of identical or similar goods adopted in the retail market in the country of destination under similar payment conditions after deducting (1) the taxes computed in the sales price, charged in the country, and (2) a profit margin of 30 percent over the wholesale price.

E. Production Cost-Plus Profits Method

This is an authentic cost-plus method, which requires the Brazilian seller to recognize, at least, a profit margin of 15 percent (plus the costs incurred) for income tax

purposes. It is defined as the arithmetical average acquisition or production costs of goods, services, or rights exported, including the taxes levied on exports in Brazil and a profit margin of 15 percent over the sum of the costs and taxes. Pursuant to the regulations, the amounts paid by the foreign entity as freight and insurance are included to determine the acquisition costs for purposes of this method.

One of the relevant questions yet to be answered is whether services rendered by a Brazilian service-provider within Brazilian territory to a foreign related party would in fact constitute exportation under the transfer pricing rules, or whether these concepts/principles should apply only, for instance, to services rendered outside Brazil's boundaries, representing, therefore, clear and actual exportation.

F. The Application for Lower Profit Margins

The Treasury Ruling No. 243 allows taxpayers to apply for a change of the profit margins in the transfer pricing regulations. The regulations provide that procedures will follow the general rules for requests for rulings in the current legislation.

To change profit margins, the taxpayer must file an application with the Treasury and provide certain documents. The Treasury Ruling also requires the taxpayer to indicate the term within which the new profit margin will be adopted. The reason is yet unclear, particularly because the taxpayer has the opportunity to change the current transfer pricing method to a better one at the beginning of each fiscal year (in Brazil, January 1). After the application is filed, the Treasury analyzes the proposed profit margin, the term within which it will apply, and the documents that the taxpayer submitted. The Ruling authorizes the Treasury to request further information and documents, if necessary.

The request for change in profit margins can now be supported by official reports and publications of foreign countries, studies and reports prepared by independent third parties with well-known technical expertise, and research prepared by the World Trade Organization and the OECD. The former regulations allowed the use of such reports, studies, and research as an element of evidence, but not specifically as support when applying for lower profit margins.

If the Treasury does not accept the profit margin proposed, it notifies the taxpayer. No appeal is available. If the Treasury accepts the profit margin and the term, the application is sent to the Ministry of Finance, who notifies the taxpayer by Ordinance. If the Treasury accepts the profit margin but does not accept the term, it proposes a new term that the taxpayer must follow. Again, no appeal is available.

G. International Intercompany Loans and Financial Transactions

Also in connection with transfer pricing, Law No. 9,430 sets forth the minimum (taxable) and maximum (deductible) interest rates that can be charged in intercompany loans that are not subject to registration with the Central Bank of Brazil: LIBOR for six months plus 3 percent. Brazilian borrowers can only deduct a maximum interest rate of LIBOR plus 3 percent paid to a nonresident related party, while Brazilian lenders must

recognize as taxable income, at least, LIBOR plus 3 percent spread on loans extended to foreign related parties.

Normative Ruling No. 243/02 establishes that the provisions applicable to interest paid or credited to related parties resident abroad apply not only to loans, but also with respect to financial transactions in general. Pursuant to the Ruling, the interest deductible from the corporate income tax and the social contribution basis may be calculated according to comparable agreements or pursuant to comparable financial transactions that have the same date, interest rates, and terms.