Kluwer International Tax Blog

Avoiding the PE Status – Recent Ruling from Brazilian Revenue Service enforces Services Taxation where no Presence is found

Luis Schoueri (University of Sao Paulo; Lacaz Martins, Pereira Neto, Gurevich & Schoueri Advogados) · Thursday, February 12th, 2015

An issue of topical interest for tax administrations in the heat of the BEPS Plan, examining the existence of a PE does not seem to be on the agenda of Brazilian authorities. In a ruling from June, 2014, the Revenue Service confirmed the long-standing Brazilian treaty practice of taxing income from services at source irrespective of whether a PE is to be found.

Internal legislation explains authorities' sensibility at treaty level. While elsewhere the PE definition remains less than clear as the digital economy rushes in, Brazilian law stays away from the debate. It does not provide for the concept, but rather makes it sure the country always has its share in services paid out of the pocket of its residents. The rationale behind current legislation, burdening services paid abroad with a 25% WHT "regardless of the form of payment and of the place and date in which the transaction has been hired", sounds irresistable: where the Brazilian payer is allowed a deduction, the payment is to be taxed, be there a PE of the foreign supplier or not.

Although the approach is not consistently applied across all circumstances (royalties have restricted deductibility, whilst the full amount is subject to WHT) and persons (individuals are not granted deduction, but the supplier's remuneration is taxed anyway), this rough source-of-payment criterion for services is a pragmatic solution to an unresting argument. It curtails base erosion with no deference to the difficulties related to the PE, relieving tax authorities from tricky auditing. The side effect, however, is obviously unwelcomed by business: non-resident suppliers see their gross remuneration taxed in Brazil regardless of any meaningful presence in the country.

Being drafted after the OECD Model, Brazilian tax treaties would be expected to prevent such taxation. Perhaps aware of how unfavorable the PE language in the treaty was in view of internal law, negotiators managed to include "technical services" within the scope of Article 12, whereas maintaining source taxing rights for royalties. Source taxation was therefore preserved. Absent any definition of these "technical services" in either treaty or domestic law, it did not take long before a controversy was in place as to which activities would be covered therein.

Scholars and Revenue Service initially construed that qualification under Article 12 – and consequent taxation at source – would require services to be followed by technology transfer. The surprise came in 2000, when authorities claimed that all other services would be under the

Brazilian UN Model-oriented Article 21, thus unlimitedly taxable at source, instead of being governed by Article 7, where source rights depend on the PE. Their dreadful argument was that the latter provision would only apply to “profits” as the global matching of revenues and expenses, and not to mere “revenues”. Besides bypassing all literature produced worldwide about tax treaty practice, this position ignored the wording of the conventions themselves: Article 7 (4) (Article 7 (7) before AOA was embraced in 2010) is clear enough in that profit is composed of several “items of income”, dealt with or not in a particular distributive rule of the treaty.

Lower courts saw litigation grow rapidly, and the dispute eventually reached the Superior Court of Justice, last resort within the federal circuit. In the findings of the leading “Copesul Case”, the Court considered Treasury’s argument “absurd” since rendering Article 7 superfluous and “absolutely inapplicable”. It held that the provision is relevant whenever the services concerned are not covered by Article 12. The Court missed the opportunity, though, to determine the conditions under which a service is included in the royalties’ clause and thus taxable in Brazil irrespective of a PE (i.e. whether a related technology transfer is required at all to trigger taxation).

In any case, Article 21 was deemed unsuitable for governing services. Following a consultation from the Finnish government, the Treasury’s Attorney General issued a formal opinion suggesting the Revenue Service to cede. The Service immediately took heed of it, replacing its previous understanding with recent Declaratory Act 05/14.

The good news is that, under the current Act, authorities no longer resort to the “other income” provision as a way of preserving taxing rights for services supplied in the lack of any PE in Brazil. If it is certainly true that an utterly misled understanding was finally overcome, the Revenue Service’s will to release services from taxation is by no means evident.

Indeed, the Act declares that technical services – now whether implying technology transfer or not – are within the scope of Article 12 if included therein by the relevant treaty. Should the services concerned relate to “the technical qualification of an individual or a partnership”, the Act declares their inclusion in Article 14 “in case the convention allows taxation in Brazil”. Only if these two treaty provisions are rendered inapplicable may Article 7 step in.

It happens that almost every single Brazilian treaty maintain source taxing rights for royalties, being services included in the definition via Protocol. Likewise, most treaties concluded by the country deviate from the international practice to allow source taxation of personal independent services if borne by a Brazilian resident, being irrelevant the maintenance of a fixed base by the supplier.

In a context where technical services are understood by Revenue Service as covering any activity depending on specific knowledge, one wonders when (and if) the application of Article 7 will ever have a chance to put the PE threshold between a non-resident supplier and Brazilian income tax. Perhaps the main opportunity comes from Article 12 itself: should the payments be effectively connected with a PE maintained by the supplier in the country, Article 12 (3) – adopted by all Brazilian treaties – ensures Article 7 is the one to apply.

Where taxation at source seems inevitable, shifting to Article 7 at least enables the non-resident supplier to deduct expenses attributable to the PE, alleviating the burden otherwise associated with gross taxation. Surprisingly, to avoid the PE status in Brazil is thus not as interesting as it may sound in the first place.

In the current Act, nonetheless, the provision was simply ignored by the Revenue Service. Confirming the policy Brazil enforces since the enactment of current legislation back in the 1970s, recent ruling from authorities indicates that the country is not likely to forego (preferably gross) taxation on services paid out of its tax base, wherever and however supplied.

To make sure you do not miss out on regular updates from the Kluwer International Tax Blog, please subscribe here.

This entry was posted on Thursday, February 12th, 2015 at 12:00 pm and is filed under Permanent Establishments, Residence, Tax Treaties
You can follow any responses to this entry through the Comments (RSS) feed. You can skip to the end and leave a response. Pinging is currently not allowed.