



MERGERS AND ACQUISITIONS

Brazil

Taxation of Cross-Border Mergers & Acquisitions
2008 Edition

TAX

Brazil

Introduction

Despite a modest economic downturn in recent years, Brazil remains an attractive market for foreign investors due to a variety of economic factors, including relative economic and political stability, control over inflation and a large and growing consumer market. Specifically with respect to taxation, Brazil, like other Latin American countries, has made significant strides in introducing changes in the tax legislation to attract direct foreign investments. Legislative changes have reduced taxes on dividends and finalized double taxation treaties with countries that are major exporters of technology.

The Brazilian merger and acquisition environment is dynamic, in the sense that tax laws are subject to frequent changes, creating not only pitfalls that can frustrate merger and acquisition tax advisers, but also tax planning opportunities. Furthermore, while Brazilian tax law often seems inflexible, it can also provide significant flexibility for Brazilian tax planning.

Good acquisition due diligence is important everywhere, but particularly so in Brazil. The complexity of the tax system, the large amount of tax litigation necessary to resolve tax issues and the protective labor regulations, among other issues, complicate the evaluation of Brazilian targets, and sometimes the negotiations, significantly.

There are a number of potentially significant tax issues not yet identified or assessed by the tax authorities or tested in the courts, including:

- Informal practices: income not recorded/false invoices in the accounts;
- Outsourced or unregistered employees;
- Doubtful/aggressive tax planning;
- Low quality of financial information/controls;
- Inclusion of private/shareholders' interests with the company's interests;
- Frequent changes/increases in the tax burden;
- High number of tax lawsuits; and
- Succession risk.

Overall, there is a relatively high tax burden in Brazil, with complex and interrelated tax provisions. Good tax planning is, therefore, essential for the parties involved in any merger and acquisition project in Brazil.

Overview of Brazilian Taxation

Although simplification of the tax was discussed during 2003 and 2004, most of the significant proposed changes, such as the creation of a value-added tax to replace other existing taxes, have yet to be enacted. Discussions continue, but it is unclear when reforms will be affected. In the meantime, the Brazilian tax system remains complex and the tax burden remains relatively high. Brazil taxes activities at the federal, state, and municipal levels through the use of income tax, types of value-added taxes, transaction tax, excise taxes and property taxes, among others.

The main federal taxes are:

- Income tax and social contribution tax applied to net taxable income at rates of 25 percent and 9 percent, respectively, for most companies. They may be computed under the actual profit method (based on the net book profit) or under the deemed profit system (based on a percentage of the gross revenue). The deemed profit method is not available to, among others, companies with annual gross revenue higher than BRL 48 million.
- PIS (Programa de Integração Social) and COFINS (Contribuição para Financiamento da Seguridade Social) tax gross receipts. They can also be computed under a non-cumulative or a cumulative system. The choice of methodology will depend on the activities performed by the company and/or the system adopted by the company (actual profit or deemed profit) for paying the corporate income tax. Under the non-cumulative system, PIS and COFINS generally apply at rates of 1.65 percent and 7.6 percent, respectively. In most cases, PIS and COFINS credits are available to reduce these taxes, or at least their cumulative effect. Special PIS and COFINS provisions apply for financial institutions and companies in the automotive, telecommunication, beverage, oil and gas,

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pharmaceutical and cosmetic industries, among others. Under the cumulative system, PIS and COFINS are due at rates of 0.65 percent and 3 percent and no credits can be recorded.

- PIS and COFINS are also applied on the import of products and services, regardless of whether the importer is under the non-cumulative or cumulative regime. In practice, Brazilian taxpayers under the non-cumulative PIS and COFINS regimes are entitled to recognize PIS and COFINS tax credits related to the PIS and COFINS paid on the import of products or services, provided certain conditions are met. Such credits can be used to offset PIS and COFINS taxes payable on local transactions.
- IPI (Imposto sobre Produtos Industrializados) is a federal tax that operates like a value-added tax and in general applies to the import of goods, the first transaction with the imported product, and manufacturing. IPI is a type of excise tax, because rates vary depending on the nature of the product.
- CPMF (Contribuição Provisória sobre Movimentação Financeira) is a banking tax that applies to the movement of funds at a rate of 0.38 percent. This tax is generally applied to the gross amount of funds withdrawn from bank and similar accounts.
- IOF (Imposto sobre Operações de Crédito, Câmbio e Seguro e relativas a Títulos e Valores Mobiliários) is a tax on certain financial transactions, including certain loans, foreign exchange and insurance transactions. IOF rates vary depending on the type and terms of the transaction. However, the tax rate for foreign exchange transactions relating to acquisitions is currently zero.
- Withholding tax (Imposto de Renda na Fonte) normally applies on most types of payments made by Brazilian residents to non-residents. The rates generally depend on the type of payment made. However, under Brazilian domestic law, the most common withholding tax rate is 15 percent and the tax is payable when the payment is due, remitted or credited – whichever occurs first. Note: one significant exception to the general 15 percent withholding tax rate is the zero-rate applicable to dividends associated with post-1995 profits paid by a resident to a non-resident.

- CIDE (Contribuição de Intervenção no Domínio Econômico) is a special contribution charged, in addition to withholding tax, to Brazilian resident companies making payments to non-residents in the form of royalties for the use of certain intangibles, such as know-how, patents and trademarks, or fees for certain services, including technical services and technical assistance. The rate is 10 percent. CIDE is usually distinguishable from a withholding tax in that it is levied on the Brazilian payer and not on the recipient.
- There are exemptions of PIS, COFINS, and IPI for export revenues.

Main state taxes:

- ICMS (Imposto sobre Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação) is the most significant tax imposed at the state level in Brazil. ICMS is a value-added-type tax that applies to the import and movement of goods and certain services, such as communications and interstate and inter-municipal transport services. The rate depends on the state, the transaction, and the product, but the most common rates are 18 percent for transactions within the same state and 7 percent or 12 percent for interstate transactions. Note: ICMS is the subject of a reform proposal that may result in significant changes if it is approved. Both IPI (federal value-added-type tax) and ICMS (state value-added-type tax) are normally applied to the movement of goods between entities as well as from one branch (estabelecimento) to another branch of the same legal entity, especially when the branches are located in different states.
- ITCMD (Imposto sobre Transmissão Causa Mortis e Doação) is a tax imposed on donations and other types of transactions involving the transfer of property with no payment.
- Export transactions are exempt from ICMS.

Main taxes imposed by Brazilian municipalities:

- ISS (Imposto sobre Serviços de Qualquer Natureza) is a tax imposed on certain services at rates that typically vary between 2 percent and 5 percent depending upon the municipality where the services are provided or where the service provider is located. ISS also applies to imported services.

- IPTU (Imposto sobre Propriedade Territorial Urbana) is a type of property tax and ITBI (Imposto sobre Transmissão de Bens Imóveis) is a real estate transfer tax. The rates for property tax (IPTU) and real estate transfer tax (ITBI) vary widely depending on the municipality, the use of the property and other factors.

Structuring the Transaction

Types of Legal Entities

According to the civil code, legal entities may be classified as sociedades simples or sociedades empresárias. In general, those entities that perform business activities are considered sociedades empresárias, while those involved with intellectual, artistic, scientific and literary professions are considered sociedades simples.

In practice, sociedades empresárias, regardless of the type of legal entity adopted and their type of activities (services, sales, or manufacturing), must be registered with the Registry of Commerce (Registro do Comércio – Junta Comercial).

Both sociedades simples and sociedades empresárias can adopt different types of legal vehicle. Both can choose, for instance, the legal form of a sociedade limitada (limitada), which is normally preferred because of more flexible provisions with respect to limitations on liability and to some extent the simpler level of administrative formalities when compared with sociedades anônimas (SA). However, the appropriate type of entity for a structure or activity depends on various factors, including the nature of the business, the desired capital structure and shareholding relationships. For instance, only a sociedade anônima can issue public shares/debt.

Please note that limitadas and SA must have at least two shareholders. Sole ownership of limitadas and SA is not permitted, but the second shareholder can hold a minimal interest.

Both limitadas and SA are taxed at the entity level (that is, these are not flow through entities) and are subject to entity-level income tax, social contribution tax and other Brazilian taxes. Dividends paid to shareholders or quota-holders are generally received tax free.

Unlike other countries, there is only a single level of income tax, in most cases, on corporate profits.

In general, there are no restrictions on foreign ownership of limitadas or SA and, like resident shareholders and quota-holders, non-residents are not

subject to Brazilian tax on dividend distributions. As mentioned earlier, under current Brazilian tax law dividends associated with post-1995 profits paid by a resident entity to a non-resident are subject to a zero rate of withholding tax.

A consórcio is an association of local companies without a joint corporate identity. The consórcio operates through an agreement between the member companies and is most commonly used to structure large infrastructure projects, because it can only be adopted for a single enterprise.

Other types of legal entities are available, but are uncommon. Operating in branch form is rare in Brazil mainly because establishing a branch is cumbersome and time-consuming, and involves obtaining presidential authorization. Brazilian tax law taxes branches in substantially the same way as other legal entities in Brazil.

Taxation of an Asset Deal

- The seller of assets would be subject to income tax and social contribution tax (totaling approximately 34 percent) on the increase in value of the assets, if any. For Brazilian tax purposes, there are no preferential rates that apply to capital gains; both operational and non-operational gains are taxed at the same rate, although there is a difference in tax treatment between capital and ordinary losses.
- PIS and COFINS may apply, depending on the type of asset sold. They are applied on the sale of most assets other than of property, plant, and equipment (such as fixed assets).
- ICMS would apply to the transfer of inventory, but the tax paid may become a credit to the purchaser insofar as these same products are subsequently sold or used as raw materials in the manufacturing of products are sold by the purchaser. The ICMS credits generated on the purchase of the assets can generally be used to offset the ICMS debts arising from subsequent taxable transactions (such as sales). There are restrictions on a taxpayer's ability to use credits on the purchase of fixed assets. The sale of fixed assets is in general not subject to ICMS, but ICMS credits generated on the purchase of fixed assets may have to be written-off.
- IPI also applies to the transfer of the inventory, provided the inventory was directly imported or manufactured by the seller. IPI tax paid may also be creditable by the purchaser if the product is to

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be used in the manufacture of other products. IPI may also apply on the sale of fixed assets, provided the asset was directly imported or manufactured by the seller and the subsequent sale occurred within five years of the date the asset was recorded as a permanent asset by the seller.

- Municipal real estate transfer tax (ITBI) may also apply to the transfer of real estate, as well as CPMF on the sales proceeds paid for assets.

Taxation of a Share Deal

- The sale or purchase of shares in a Brazilian entity is more common than an asset deal, because of the lower levels of documentation requirements and indirect taxation.
- The taxation of a share sale depends, to some extent, on the residence of the seller and purchaser.
- A Brazilian corporate seller (*peessoa jurídica*) is subject to income tax and social contribution tax on the net gain from the sale of shares. In most cases, where a seller owns a significant interest (usually more than 10 percent), the gain is calculated as the difference between the gross proceeds and the proportional book value of the target entity's equity.
- The sale of shares is not subject to PIS and COFINS, ICMS, or IPI. A Brazilian purchaser would be subject to CPMF (banking tax) on gross sales proceeds. There are no transfer taxes or stamp duties on the sale of shares in Brazil.
- Irrespective of whether the seller is a Brazilian individual or a non-resident, the gain is subject to a final 15 percent withholding tax, but the amount of the gain is calculated differently. For a Brazilian individual, the gain is calculated based on the difference between the gross proceeds and the capital contributed or paid in a previous acquisition. For a non-resident, because of the lack of clarity of the relevant tax provisions, there is some debate about how the capital gain is determined. A possible interpretation is that the gain is normally calculated as the difference between the amount of foreign capital registered with the Brazilian Central Bank and the gross sales proceeds in foreign currency. Another possible interpretation is that the gain should be calculated as the difference in Brazilian currency between the sales proceeds and the capital invested, thereby including exchange fluctuations

in the tax base. The different positions arise because of differences between the wording of the law and the regulations. It is important to state in the sales contract whether the sale price is gross or net of withholding tax.

- If both the buyer and the seller are non-residents, it is likely that the tax authorities will tax an eventual capital gain. The common view among Brazilian tax practitioners was that no Brazilian taxation was imposed on the sale of shares or quotas in Brazilian entities if the transaction was performed between two non-residents (this was because Brazilian tax law would in principle require a Brazilian source of payment), but as from 2004, Law 10.833/03 introduced a change to the Brazilian tax law that is being interpreted as an introduction of the taxation of non-residents' capital gains with respect to the assets located in Brazil even when neither of the parties to the agreement are Brazilian residents. The capital gain on the sale of publicly traded shares is subject to a rate of 20 percent for resident individuals and is exempt for non-residents, provided that some formalities are met and the seller is not a resident of a tax haven.
- FIP – Equity Investment Fund: According to the Brazilian legislation, funds are not legal entities, but condominiums with shares held by their investors. In general, FIPs are exempt from corporate taxes (income and social contribution taxes on profits) and gross revenue taxes (PIS, COFINS), since some requirements are met. Non-resident investors are not subject to Brazilian taxation upon the redemption of FIPs' quotas, even if the redemption follows liquidation. The exemption only applies if certain requirements are met, such as the non-resident holds less than 40 percent of the FIP's quotas, it's not entitled to more than 40 percent of the income paid by the FIP, it's not resident in a low-tax jurisdiction, and it doesn't hold the investment in the FIP through an account incorporated in accordance with Brazilian Central Bank rules.

Purchase Premium

One significant advantage of a share sale over an asset sale would be that, if a share sale is structured properly, the amount paid in excess of the net equity of the target may result in the generation of an amortizable premium or a step-up in the tax bases of otherwise depreciable or amortizable assets. This opportunity is not available if shares in a Brazilian company are purchased directly by a non-resident and

is not available to the same extent if assets are purchased.

To take advantage of this opportunity, the acquisition of shares would need to be made through a Brazilian acquisition vehicle.

According to legislation in force as of 1997, the liquidation or merger of the acquisition vehicle and the target would allow the premium paid on the shares to become recoverable in certain situations. To the extent that the premium relates to the value of recoverable fixed assets or relates to the value associated with the future profitability of the company, the premium could be amortized or otherwise recovered through depreciation.

Tax-Free Reorganizations

Forms of reorganizations provided for in the corporate law include:

- **Incorporação (merger).** A transaction by which one or more entities are absorbed by another where the second succeeds to all the rights or obligations of the first. One of the pre-existing entities survives the incorporação and continues as a legal entity, while the others are extinguished.
- **Fusão.** A transaction whereby two or more entities are combined to form a new legal entity that succeeds to all of the rights and obligations of the others, which cease to exist. Note: this type of reorganization is rarely used, because it may lead to the loss of certain tax attributes.
- **Cisão.** A transaction whereby one entity transfers the totality or a part of its assets, rights, or obligations to one or more entities that are created to receive such items or that already exist. The cisão may be a total or partial cisão, resulting in the extinction of the transferee entity or in a division of the net equity of the transferee entity, respectively.

Generally, corporate reorganizations (such as incorporações, fusões, and cisões as described above) as well as liquidations and capital contributions – including capital contributions of shares – can be accomplished tax free in Brazil, as long as assets are transferred at tax book value and other formalities are met.

However, there may be reasons to structure a reorganization transaction as a taxable transaction (such as a transfer of assets at fair market value). For example, transferring assets as part of a

reorganization may allow use of current-year losses that would otherwise become subject to loss limitations, may allow for international tax planning, or may allow for a step-up in the tax bases of assets.

The following should be considered in a reorganization transaction:

- Preservation of tax losses and the succession of tax attributes and liabilities are the most significant issues when considering a corporate reorganization.
- In general terms, tax legislation and prevailing jurisprudence stress that corporate entities resulting from transformations, upstream or downstream mergers and spin-offs shall be liable for taxes payable by the original corporate entity up to the date of the act. This liability is also applicable in the case of the winding up of a company the business of which continues to be operated by any remaining partner, under the same or another corporate name or ownership.
- Successor liability depends upon one of two factors: the acquisition of the business (also referred to in the case law as the acquisition of goodwill, meaning business intangibles), or the acquisition of the commercial, industrial, or professional establishment (meaning the elements which are essential, inherent and irreplaceable for the conduct of the business).
- This rule treats an acquisition of assets, which constitutes a business unit, in a similar way to the acquisition of shares of a company, when the seller goes out of business. If the seller stays in business with other activity, then the buyer's responsibility is secondary and the tax authorities must first target the existing seller's assets to satisfy the existing tax contingency.
- The extent of such liability will largely depend, however, on the extent of business and operations acquired and continued by the buyer. Please note, however, that in Brazil, what constitutes a successor in terms of assuming the liability of a predecessor is defined more widely in other jurisdictions, and the law does not determine specific criteria for splitting the tax liability (there is no proportional liability).
- In other words, when the business line to be acquired is the same legal entity as the other business lines (which will not be part of the negotiation) the tax authorities may attribute the

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responsibility for all the business lines to the successor company.

- Other considerations in a corporate reorganization include indirect taxes that may be triggered on the movement of assets, triggering CPMF tax on the movement of funds, foreign capital registration, and issues related to the transfer of licenses and registrations (such as antitrust legislation, tax benefits granted and financial incentives).

Use of Tax Losses

The 1999 income tax regulations provide that tax losses generated in one year can be carried forward indefinitely. However, the use of tax loss carry-forwards is limited to 30 percent of taxable income generated in a carry-forward year.

Furthermore, capital loss carry-forwards may only be used against capital gains. The 30 percent limitation applies here as well.

Gain or loss from the sale of inventory is generally treated as ordinary or operational loss, while gain or loss from the sale of the machinery and equipment, buildings, land and general intangibles should be treated as non-operational (capital) gain or loss.

As mentioned above, particular attention should be paid to the effect of an acquisition or a reorganization on loss carry-forwards. For example, upon a merger (incorporação), the tax losses of the absorbed company cannot be used by the surviving entity and thus are essentially lost. In a cisão, the tax losses of the target entity are lost in the proportion of the net equity transferred.

In addition to the 30 percent limitation, loss carry-forwards may become limited and unusable insofar as there has to have been both a change in control and a change in business activity before the losses can be used.

Funding

There are no thin-capitalization rules in Brazil. Companies and acquisitions may be financed with almost 100 percent debt (at least a nominal share capital is required).

From a Brazilian tax perspective, the capitalization of an entity with debt or equity is influenced by the expected profitability of the company. At least for a non-resident shareholder, financing through debt is generally more tax advantageous insofar as the interest paid on the debt is fully deductible for

Brazilian corporate tax purposes; the potential benefits of an interest deduction of 34 percent may outweigh the withholding tax burden of 15 percent (or 25 percent if paid to a resident of a tax haven) associated with the interest paid. The interest deduction is used to offset the expected profits generated in the start-up years, usually reducing the corporate taxes in Brazil. Foreign exchange effects must also be considered.

Unlike interest, dividends associated with post-1995 profit are not subject to withholding tax when paid to a non-resident.

Hybrid instruments (that is, instruments that may have either debt and equity characteristics, or that may be treated differently in different jurisdictions) are a relatively new phenomenon in Brazil. They are being used with limited success. Brazil has very flexible tax rules with respect to debt, which makes the creation of hybrid financing instruments possible, but strict exchange control regulations generally limit the taxpayer's options.

Important Note: Foreign capital must be registered with the Brazilian Central Bank (Law 4131/62). Obtaining the foreign capital registration is of paramount importance, because this is the foundation for the payment of dividends and repatriation of capital in foreign currency, and, in some cases, it is required to record a tax base in a target company's shares or assets.

Interest on Equity

Brazilian tax law (Law 9.249/95) allows a company to make an election to pay interest to shareholders as return on equity capital at the official long-term interest rate. Interest on equity paid or accrued to resident or non-resident shareholders is generally deductible for income tax and social contribution tax. The payment is subject to withholding tax of 15 percent. However, there is a discussion about whether an increased rate should apply when the recipient is the resident of a tax haven. Brazilian tax authorities believe that a withholding tax of 25 percent should apply in such cases.

Interest on equity is calculated by applying the daily pro rata variation of the long-term interest rate (TJLP) to the value of the company's net equity accounts at the beginning of the year. Increases and decreases in the equity accounts must also be considered in the computation, and the deduction is subject to limitations.

Because of its unique nature, interest on equity payments may be considered as dividend payments in several recipients' home countries, carrying underlying foreign tax credits or being exempt, while being deductible for Brazilian income tax and social contribution tax purposes.

Transfer Pricing and Disguised Distribution of Profits

In structuring acquisitions and reorganizations, it is important to keep in mind the potential application of Brazil's tax rules related to transfer pricing and disguised distributions of profits (DDL). Generally, these provisions require that Brazilian resident companies that buy or sell assets, including shares, from or to a related party do so at market value determined according to specific rules. Variations from market value may result in additional tax or in a reduction of the tax base.

Labor Costs

Brazilian labor law has no provisions for transferring employees from one company to another unrelated company without terminating their employment. Termination of employment can trigger significant costs, including not only accrued salaries and benefits, but also penalty payments (such as a 50 percent penalty over the amount of the accrued severance pay fund, known as FGTS, Fundo de Garantia por Tempo de Serviço).

Competition Agency

Relatively new Brazilian antitrust regulations may require a review and approval of the transaction if the acquisition may reduce competition.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

- The purchase of assets usually enables the buyers to obtain a step-up in the bases of the assets.
- If the assets acquired constitute a going concern (acervo de negócios), the purchaser may obtain benefits of tax credits and certain other tax attributes, especially those associated with indirect taxes (such as IPI and ICMS).
- An asset deal, in many cases, helps to minimize the inheritance of tax, legal and labor liabilities.
- An asset deal may take less time to implement.

Disadvantages of Asset Purchases

- Tends to result in a more tax burdensome transaction when compared to a share deal (especially for IPI, ICMS, PIS, COFINS, and ITBI purposes).
- An asset deal may prevent the buyer from carrying over the target's tax losses and other tax attributes.
- From a seller's perspective, an asset sale may also provide much more limited opportunities than a share sale for tax planning to minimize gains on the assets sold.
- If the assets transferred constitute a going concern (acervo de negócio), some inheritance of liabilities cannot be avoided. The purchaser of a going concern will generally remain with either joint, several or secondary liability for pre-acquisition tax liabilities related to the business acquired, depending on whether the seller continues to operate in the same line of business.
- While this would depend on the assets or business acquired, acquiring assets may require new registrations for tax, labor, and other regulatory purposes, termination costs and re-hiring costs for employees and other administrative burdens. Note: Brazilian labor and tax law provide for significant termination costs for employers. In an asset sale, employment technically must be terminated, triggering certain severance costs that can be significant.
- The post-acquisition administrative burden associated with the transfer of the assets or a going concern can be much more significant in an asset sale.

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Advantages of Share Purchases

- Minimization of tax impacts, especially for IPI, ICMS, PIS, COFINS, and ITBI purposes.
- If the transaction is structured properly, the purchaser may be able to obtain a better tax result by structuring the acquisition as an acquisition of shares than if assets were acquired directly. The significant potential benefit from doing this would be recovery of the purchase premium (sales proceeds exceeding book value of the target company) through amortization. The nature of the premium is significant for Brazilian tax purposes, but in most cases, a premium can be recovered over a five-year period—significantly faster than the recovery period for most fixed assets, which are generally depreciable over 10 years.
- Tax losses and other tax attributes of the target company may be carried over (see discussions on loss limitations above).
- If employees are to be transferred with the target business, it may be possible to transfer them with the acquired business without terminating their employment.

Disadvantages of Share Purchases

- The pre-acquisition tax liabilities of the target will remain with the purchased legal entity.
- If the buyer wants to purchase only part of the target's business, pre-acquisition structuring steps may take some time to implement.

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