A Brief Analysis of its highlights and pitfalls under Brazilian Tax Law

The (new) Bilateral Income Tax Treaty between Brazil and Switzerland

was signed in 2004 and ratified by Brazil in 2017. The BITT with Paraguay was signed in 2000, and it is yet to be ratified.

So, fingers crossed.

In terms of the actual content of the new BITT with Switzerland, there is a lot to admire and a lot to criticize. Please find some of the most interesting provisions of the Treaty, together with specific comments, in the topics below.

II. Features in common with the majority of Brazilian Tax Treaties

The overall structure of the Brazil-Switzerland BITT is similar to the structure of other BITTs within the Brazilian network. In contrast to the recommendation of the Organisation for Economic Co-operation and Development (OECD) in Base Erosion and Profit Shifting (BEPS) Action 2, but in line with the majority of Brazilian Tax Treaties, this Treaty contains a tie-breaker clause that favors the Place of Effective Management (POEM) for the residence of legal entities in Article 4th, Paragraph 3. Also, there is no Paragraph 2 in its Article 9th, because Brazilian Tax Treaty practice has been not to include a corresponding adjustment clause for Associated Enterprises (Swiss Tax Treaty practice, on the other hand, is welcoming to this clause – see, for example, the Treaties with Belgium, Canada, Russia and South Africa, all of them members of the Brazilian Tax Treaty network). Finally, Article 24, Paragraph 5, establishes that the Non-Discrimination clause applies only to the taxes subject to the Treaty (in accordance with Article 2nd, the income taxes, including, in the case of Switzerland, federal, cantonal and communal taxes).

My comment here has nothing to do with the absence of a second Paragraph in Article 9th, because that (i) is commonplace in Brazilian BITTs and (ii) has been the subject of a “commitment” from Brazil in the Final Report of BEPS Actions 8, 9 and 10, which directs transfer pricing disputes involving BITT partners to a Mutual Agreement Procedures (MAP) “solution” (through a minefield of quotation marks, I admit – this...
“commitment”, however, seems reaffirmed by item 5 of the BITT Protocol). Also, it has nothing to do with the restricted scope of the Non-Discrimination clause, another general feature of Brazilian BITTs[2]. My comment has to do with the use of POEM as the tiebreaker for corporate residence in Article 4th, Paragraph 3, and this is one of the very few areas in which I concur with the position of the OECD. Let me spell it out: the nominal POEM standard (i.e., the simple reference to POEM in a Tax Treaty, without a Tax Treaty description of its scope) is an offense to legal certainty, and its mazelike interpretation across the globe has increased compliance costs for a number of multinationals, something that sound International Tax policy should be able to avoid[3]. Regardless of the political inclinations of Brazilian and Swiss negotiators, the better route in this case would have been (i) to fully define POEM in the BITT, or (ii) to adopt MAP as a tiebreaker for corporate residence, in line with the recommendations of the OECD in BEPS Action 2.

III. What is different in the Brazil-Switzerland Tax Treaty

For starters, Article 1st of the BITT with Switzerland is complemented by item 1, letter “a”, of the BITT Protocol, which describes the treatment of collective investment vehicles (CIVs) as individuals, provided the beneficial interests in those CIVs “are owned by residents of the Contracting State in which [the CIVs] are established”. Item 1, letter “b”, of the BITT Protocol goes on to define CIVs in both Switzerland and Brazil, and letter “c” defines that a Swiss limited partnership shall not be treated as a resident of Switzerland for Treaty purposes (though it may claim benefits on behalf of its owners that would have been available to them directly under the BITT, except if the owners themselves make that claim). The tax treatment of CIVs is a recurring debate topic in the OECD, but it is beyond the scope of this text[4].

In terms of permanent establishment (PE) provisions, the PE definition in Article 5th, Paragraph 2, letter g, of the BITT with Switzerland, refers to a building site or an assembly or installation project with activities lasting for more than nine months. This is unusual in Brazilian BITT practice: though it is the minimum period established in the BITTs with Israel and Portugal, it is higher than the one referred to by the equivalent provision in the UN Model Convention (six months) and lower than the one in the OECD Model Convention (twelve months). Also, the list of exceptions to a PE in Paragraph 4 is not complemented by a “preparatory or auxiliary character” catch-all clause, as present in the current version of the OECD Model Convention and recommended by the OECD in BEPS Action 7 (recent Swiss BITTs, such as the ones with Liechtenstein and Oman, have also not included the catch-all clause, even though they have been signed after the release of the preliminary reports of BEPS Action 7).

As far as dividends are concerned, the BITT restricts taxation at source to (i) 10%, if the beneficial owner of the dividends is a company (other than a partnership) “which holds directly at least 10% of the capital of the company paying the dividends throughout a 365-day period that includes the day of the payment of the dividend” (a provision that is partly in compliance with Article 8th, Paragraph 1, of the BEPS Multilateral Instrument, or MLI), or to (ii) 15%, in all other cases[5]. Taxation at source is not imposed if the recipient is a pension fund (compliant with “general” Limitation on Benefits [LOB] provisions) or the Central Bank of the other Contracting State.

In terms of the taxation of interest, a similar 10%/15% divide is established by the BITT with Switzerland, with the exception that the 10% maximum rate applies for interest “if the beneficial owner is a bank and the loan has been granted for at least five years for the financing of the purchase of equipment or of investment projects”. In contrast to Article 10, the equivalent provision in Article 11 establishes non imposition of taxation at source if the recipient is a pension fund (compliant with “general” LOB provisions) or “the Government of [the other Contracting State], a political subdivision or local authority thereof; any agency (including a financial institution) wholly owned by that Government, or [the Central Bank of [the other Contracting State]]”.

For royalties, the maximum rates established by the BITT are (i) 15%, for royalties arising from the use or the right to use trademarks, or (ii) 10%, in all other cases. Typically, this would be followed by a round of drinks for Brazilian tax practitioners, because (a) the expression “in all other cases” is usually associated with “technical services and technical assistance”, the remuneration of which is regarded as royalties by the majority of Brazilian BITTs in effect (the popular exceptions are Austria, Finland, France, Japan and Sweden), and (b) the domestic Withholding Income Tax (IRRF) rate for royalties in Brazil is currently set at 15%. One of the interesting features of the BITT with Switzerland, however, is that it does not equate the remuneration for “technical services” to royalties (but, in a near-Kaufmaniesque twist, item 10 of the BITT Protocol does equate “technical assistance” to royalties), as we will explain in the paragraph below. This means that, if the Brazil-Switzerland BITT is ratified, all the judicial arguments about the concept of “royalties” as applied to “technical services” (based on Article 110 of the Brazilian Tax Code, or CTN, claiming that tax legislation cannot alter the concept of “royalties” to encompass a remuneration that is not intrinsically qualifiable as “royalties”) would not apply for Brazil-Switzerland operations.

Article 13 of the BITT with Switzerland deals with fees for technical services, a title that, right from the start, seems very misleading. The definition given for “technical services” in

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[4] For further insight into this topic, please read the Commentary to Article 1th of the OECD Model Convention (items 22 to 48).

[5] An important point: the 365-day minimum holding period can be complied with post-payment, a case in which the beneficial owner will be subject to a refund from (ii) to (i) – cf. item 6 of the BITT Protocol.
Paragraph 3 is "any service of a managerial, technical or consultancy nature". If managerial and consultancy services were prima facie qualifiable as technical services, why would the BITT drafters need to add those terms to Paragraph 3? The answer is negative on both counts, which seems straightforward, but this has unfortunately become the boilerplate language of other BITTs around the world, such as the India-Belgium BITT, the Chile-Malaysia BITT, and the Pakistan-Singapore BITT (this text has also been favored by the UN Committee of Experts on International Cooperation in Tax Matters, back in 2012). Also, Article 13 does not apply to (a) fees paid to "an employee of the person making the payment" (which, presumably, are dealt with by Article 16), to (b) fees for "teaching in an educational institution or for teaching by an educational institution" (presumably within the scope of Articles 16 and 22), or to (c) fees paid "by an individual for services for the personal use of the individual" (which, presumably, are outside of the scope of the BITT). Finally, though this type of payment is placed in a separate Article, it is also subject to a maximum taxation at source at a rate of 10% (so, I suppose drinks are still on the house).

To wrap up this topic, here is a quick-fire sequence of highlights from the BITT with Switzerland. There are exclusive residence taxation rules in Articles 14 (capital gains) and 22 (other income), but their scope is so limited, that I could not come up with a single hypothetical to which they would clearly apply. Pursuant to Article 23, the elimination of double taxation is via a credit system in Brazil and via an exemption method in Switzerland, except if the relevant income is dividends, interest, royalties or fees for technical services (a case in which a credit, a lump sum reduction of the Swiss tax, or a partial exemption may be allowed by Swiss authorities). In terms of the MAP provisions, as one would expect from Brazilian negotiators, there is no commitment to solving these disputes via arbitration (nevermind "mandatory arbitration" or "binding arbitration" – there is not even a passing reference to word "arbitration" in the entire text of Article 24). As far as the BITT Protocol is concerned, item 8 contains a Most-Favored Nation (MFN) clause for interest, royalties, and fees for technical services, item 9 equates the Brazilian Interest on Net Equity (JCP) to interest, and item 17 seems to be a catch-all provision allowing the imposition of the Brazilian Controlled Foreign Company (CFC) rules and of the Brazilian "General Anti-Avoidance Rule" in Article 116, sole paragraph, of CTN (GAAR, but please note those all-important quotation marks). Finally, Article 27 of the BITT contains both a Principle Purpose Test (PPT, in its Paragraph 1), and a blended ownership, stock exchange and substantive business activity LOB test (in its Paragraph 3), coupled with what I call "stateside" LOB provisions (i.e., provisions that limit access to treaty benefits depending on actions carried out by the Contracting States themselves, as opposed to the parties resident in either of those States, such as the ones in Paragraphs 2 and 4). Is that in compliance with BEPS Action 6? Yes, in light of the PPT in Paragraph 1. On the other hand, is that a set of anti-abuse provisions designed to provide legal certainty to multinationals operating in Brazil and Switzerland? Definitely not. Article 27 of the BITT between Brazil and Switzerland is nothing short of a MAP bonanza.

IV. What about the MLI?

Finally, if the current relationship between Brazil and Switzerland is maintained after the BITT enters into force, a question could arise as to the status of lex specialis of a provision in Brazilian Law called the "greylist". Pursuant to Article 24-A of Law 9, 430, of 1996, and in accordance with Article 2°, item X, of Normative Instruction RFB 1, 037, of 2010, (i) the "regime applicable to a legal entity incorporated as a holding company, a domiciliary company, an auxiliary company, a mixed company and an administrative company, the tax treatment of which results in the imposition of a combined Corporate Income Tax at a rate of under 20%, pursuant to federal, cantonal and communal law", is regarded as a "greylisted" regime. Also, (ii) the "regime applicable to other legal forms of incorporation of legal entities, via rulings issued by tax authorities, which results in the imposition of a combined Corporate Income Tax at a rate of under 20%, pursuant to federal, cantonal and communal law", is similarly regarded as a "greylisted" regime. Typically, payments to persons subject to a "greylisted" regime are deemed as non-deductible (except if the payor complies with specific rules in Article 26 of Law 12, 249, of 2010), but they are not subject to an increased IRRF rate – which would be of 25%, generally applicable for payments of interest, royalties, fees for services and the like to persons in tax havens ("blacklisted" regimes). There are exceptions to that, though (the payments of freight for air and maritime transport being one of them), and one could argue that the appropriate tax "solution" in those cases would be to consider the treaty as lex specialis, in light of Article 98 of CTN (which basically prevents treaty overrides in Brazilian Tax Law).

V. Conclusion

For people unfamiliar with recent developments in Brazilian International Tax policy, the signature of a BITT with Switzerland may seem like yet another cross-border agreement between like-minded government authorities. This, however, is the first BITT signed by Brazil wholly within the post-BEPS era (the most recently ratified BITT in the Brazilian network is the one with Russia, but this Treaty was signed back in 2004). It is also the first BITT in which Brazil dedicates a specific provision to deal with "fees for technical services"
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(albeit in a more “comprehensive” form than the one this author would ideally wish for), which indicates a different trend in the current debates about the qualification of fees for technical services as royalties under Brazilian Law.

We sincerely hope that this BITT is ratified on both sides of the Atlantic in the short term, but some of its provisions are bound to generate conflict for tax authorities and multinationals. As I commented above, Article 27 alone seems like a MAP bonanza, but the use of POEM is also bound to prompt parties to a MAP “solution”. Above all, the fact that this BITT did not include a mandatory binding arbitration clause in the MAP Article is a bad sign for future Brazilian International Tax policy. In the accelerated environment of crypto-transactions and virtual goods/services, the morose dispute resolution of this MAP might jeopardize the effectiveness of the BITT with Switzerland in the long run.