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New provisions on taxation on M&A transactions

Over the past several years, M&A activities have played an important role in Brazil driven by an increase in the level of foreign direct investments in Brazil, as a result of a relative stabilization of the domestic economic and political environment, the opening of the Brazilian market to imported products and the privatization process of various public companies.

Medida Provisória n. 135 was enacted on October 30, 2003 and published on October 31, 2003. The new provisions make significant changes to Brazilian tax law. The new legislation may specifically impact M&A transactions in progress in light of the provisions related to taxation of capital gains and changes to taxation of gross revenues that will be applicable as of January 1, 2004 and February 2, 2004, respectively.

A *Medida Provisória* is a provision issued by the President and must be voted by the Brazilian Congress and converted in law within a maximum 120 day-period. If the Congress does not approve the *Medida Provisória* within this period, the provisions become ineffective. In this case, Brazilian Congress must issue a new provision regulating the transactions performed during the period in which the *Medida Provisória* has been in force.

There are many provisions in the *Medida Provisória*. However, two significant provisions related to the withholding tax on gains on the sale of certain assets by non-residents and changes to COFINS, a tax on gross receipts.

Withholding tax

Background

In general, withholding tax applies at 15 percent on certain capital gains earned by non-residents. The prevailing understanding among Brazilian tax practitioners was that no Brazilian taxation was imposed on the sale of shares or quotas in Brazilian entities when the transaction was performed by two non-residents. This was because of the "source of payment" principle adopted by the Brazilian tax law.

More recently, Brazilian revenue service (*Secretaria da Receita Federal*) issued *Instrução Normativa* n. 200/02, requiring non-resident legal entities holding, among others, assets or rights subject to public registration in Brazil, such as real state, vehicles, vessels, airplanes or interest in legal entities to obtain a federal taxpayer's number in Brazil (*CNPJ*). In addition, non-residents were required to indicate a Brazilian resident legal representative (*procurador*) with a power-of-attorney as an administrator of the asset.





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Changes

The significant changes to Brazilian tax law contained in *Medida Provisória* n. 135 seems to impose a burden on the Brazilian representative of the buyer of assets located in Brazil. According to the new provisions (art. 24), the representative of a non-resident buyer is responsible for withholding and paying the Brazilian tax on any capital gains of the non-resident seller.

Because, in theory, non-resident shareholders of Brazilian entities would have to register for Brazilian tax purposes to obtain the federal taxpayer's number (*CNPJ*) and would also have to indicated a Brazilian representative, it seems the federal tax authorities would now have additional tools to monitor compliance with the new tax law.

In general, international treaties on income and capital taxes that Brazil has entered into do not provide for special benefits associated with capital gains taxation, other than a foreign tax credit in the contracting state of the seller. Exception is made to the treaty with Japan that provides for a tax exemption. However, the treatment under the treaties should be always analyzed on a case-by-case basis.

Gross revenue taxes

Background

A Brazilian entity is normally subject to a gross revenue tax (PIS) at 1.65 percent on gross sales proceeds associated with the disposal of an investment. Cofins, another gross revenue tax that historically applied in a similar fashion, is currently not applicable due to a special tax exemption for the sale of permanent assets.

Changes

Medida Provisória n. 135 narrowed the scope of the Cofins tax exemption. Beginning on February 2, 2004, Cofins will apply to the gross revenue arising from the sale of shares or quotas at a 7.6 percent rate (arts. 1(§3)(II) and 2).

