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Brazilian Government announces *IOF* increase on the inflow of foreign capital in the financial market

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International Corporate Tax Brazil

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On October 19, 2009, the Brazilian Government announced the increase of the *IOF* (Financial Operations Tax) on foreign capital inflows into the Brazilian financial and capital market. Under this new rule, transactions that previously qualified for a 0% tax rate will now be taxed at 2%, regardless of whether they are related to short or long term investments.

The remittances related to dividends and interest on equity received by such foreign investors will still qualify for the 0% rate, as well as any transaction derived from the sale of the investment.

Direct investment rules were not amended and are still subject to a 0.38% *IOF* tax, both on the inflow and outflow of funds.

The Finance Minister declared that such measures are created for the purpose of reducing the inflow of financial resources into the Brazilian capital markets, so as to try to stop the appreciation of the Brazilian currency.

The new *IOF* measures were introduced by **Decree 6,983/09**, published on October 20, 2009 and are in force as of the same date.

Court Decision on the application of article 7 of the tax treaties signed by Brazil to the remuneration of services

The application of the various provisions of Double Taxation Treaties (DTT's), based on the OECD Model, is a controversial issue in Brazil, especially in view of the lack of internal understanding combined with the historical position of the tax authorities.

In the past years, Brazilian practitioners have been discussing whether or not service fees would fall under article 7 of the DTTs, which restricts taxation to the residency country, unless there is permanent establishment in the other contracting state. Generally speaking, Brazilian tax authorities do not agree with the article 7 approach. Rather, the authorities have stated that service fees should fall under the "Other Income" article of the treaties, giving rise to withholding taxation (ADN Cosit 1/00).

Despite the above mentioned, on June 26th, 2009, a decision issued by the Federal Court (TRF 4th Region) established otherwise.

This decision stated that Brazilian tax authorities are not entitled to charge withholding income tax on service fees remitted abroad, provided that (i) such services are not related to the provision of technical services and (ii) the receiving country has a DTT signed with Brazil (Brazil has currently 28 DTTs in force). The decision analyzed article 7 of the OECD Model and whether or not its application could be extended to service fees (“treaty override”).

Such decision emphasized that although the service revenues could not be directly classified as profit, they are nonetheless a component of the final profit to be computed by the entities that receive the payments. The DTT with France, for example, provides even better arguments for the application of article 7, because it does not contain an “Other Income” article and does not consider technical services under the broader concept of “royalties”.

The specific case examined by the Federal Court accepted the taxpayer’s argument that the withholding income tax on service fees would be contrary to article 7 of the DTTs with Canada and Germany. However, it is important to mention that the DTT with Germany has not been in force since 2005.

Therefore, this is another important precedent issued by the Brazilian Courts regarding DTT’s interpretation based on the OECD Model Convention. Even though this is not a final decision from the Brazilian Supreme Courts (STF or STJ), the decision mentioned is significant considering the confirmation obtained at a court of second instance.

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