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8 Bouverie Street
London EC4Y 8AX UK
Tel: +44 20 7779 8308
Fax: +44 20 7779 8500

MANAGING EDITOR Anjana Haines
anjana.haines@euromoneyplc.com

COMMERCIAL EDITOR Prin Shashiharan
prin.shashiharan@euromoneyplc.com

DEPUTY EDITOR Josh White
josh.white@euromoneyplc.com

SENIOR REPORTER Mattias Cruz Cano
mattias.cruz@euromoneyplc.com

REPORTER Danish Mehboob
danish.mehboob@euromoneyplc.com

PRODUCTION EDITOR João Fernandes
jfernandes@euromoneyplc.com

HEAD OF BUSINESS DEVELOPMENT Margaret Varela-Christie
margaret.varela-christie@euromoneyplc.com

HEAD OF BUSINESS DEVELOPMENT – EVENTS Jamil Ahad
jamil.ahad@euromoneyplc.com

BUSINESS DEVELOPMENT EXECUTIVES
Raquel Ipo raquel.ipo@euromoneyplc.com
Alexandra Strick alexandra.strick@euromoneyplc.com

SUBSCRIPTIONS MANAGER Jack Avent
jack.avent@euromoneyplc.com

HEAD OF EDITORIAL David Braid
david.braid@legalmediagroup.com

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CUSTOMER SERVICES: +44 20 7779 8610

UK SUBSCRIPTION HOTLINE: +44 20 7779 8999

US SUBSCRIPTION HOTLINE: +1 800 437 9997

Preparing for take-off

Tax lawyers are the unassuming superheroes of Brazil. According to the World Bank, a Brazilian company on average takes longer to prepare, file and pay taxes than anywhere else across the globe. Alongside national charges, there are regional taxes imposed by 27 states and more than 5,500 municipalities. Predictably, there is one word on every policymaker's mind: Reform.

ITR brings you practical insight, in English and Portuguese, into some of the most significant recent developments from the Brazilian tax world.

The guide takes on a journey across a range of topics on reform, considering the main objectives and challenges that lay ahead. In addition, the much-debated opinion regarding the offsetting of tax losses in the termination of companies is also discussed.

Brazil is simultaneously undergoing the most radical changes to its transfer pricing (TP) regime in decades. By taking a novel approach, policymakers have sought to adapt the country's historically formulaic TP framework to align with international standards.

This guide explains the importance of Brazil's convergence towards the OECD's model and evaluates its merits. Meanwhile, further trends, inspired by global



Prin Shashiharan
Commercial editor
ITR

adherence, including the tax implications of increased cost-sharing agreements and the utility of US-inspired tax transactions to resolve disputes, are analysed.

Digital technology continues to transform the order of business in Brazil. Manufacturers have stepped up their investment in research and development and the government has incentivised innovation through the form of tax-deductible financial credits.

The guide considers how Brazil has dealt with the growing digitalisation of its economy, while looking deeper at how beneficial tax laws are helping fintechs disrupt traditional banks. In contrast, the gap between legislation and reality is also discussed, especially when taxing transactions involving digital goods and services.

Brazil's tax world is set to blossom in the 2020s. We hope that you enjoy hearing from the tax experts leading the progression in our first Brazil Special Focus.

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Assessing Brazil's tax landscape in 2020

The first edition of ITR's Brazil Special Focus comes at a precarious time for the country's economy, with the long-awaited matter of reform unexpectedly being overshadowed by a sudden global pandemic. **Romero J S Tavares** of **PwC Brazil** introduces the key topics that will dominate the tax landscape in 2020.

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Globalising the transfer pricing landscape

As Brazil finally considers converging its transfer pricing framework to reflect OECD standards, **Francisco Lisboa Moreira** and **Felipe Thé Freire** of **Bocater, Camargo, Costa e Silva, Rodrigues Advogados** examine the similarities and divergences between the approaches.

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The taxation of cost-sharing agreements

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The long expected Brazilian tax reform – objectives, challenges and pitfalls

After years of contemplation, Brazil looks set to overhaul its complex tax system starting in 2020. **Guilherme Giglio** and **Marcelo Natale** of **Deloitte Brazil** discuss what the long journey to efficiency may entail.

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Redefining the banking landscape

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STJ to decide on controversial tax loss limit upon termination of companies

A single vote in 2020 looks set to end 25 years of confusion surrounding corporate income taxes and the offsetting of tax losses when companies terminate operations. **Ana Lúcia Marra** and **Stephanie Makin** of **Machado Associados** take a closer look at the much-debated 30% tax loss limit upon termination of companies and the pre-impact of the upcoming decision.

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Compromising towards a futuristic tax model

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Romero J S Tavares and **Priscila Vergueiro** of **PwC Brazil** outline how Brazil can enhance its international tax and transfer pricing model through a bespoke, calculated approach.

51 Technology in Brazil**The challenge of taxing digital goods and services**

Brazil's technological revolution is developing at speed, generating a divergence between legislation and reality. **Ana Cláudia Akie Utumi** of **Utumi Advogados** explores why applying taxes to transactions involving digital goods and services remains a challenge.

Redefining the banking landscape

Brazil has taken its position as Latin America's pioneer in digital transformation. **Lavinia Junqueira** and **Cauê Rodrigues** of **Junqueira le Advogados** examine how beneficial regulations and tax laws are helping financial technology companies (fintechs) disrupt traditional banks.

A non-resident financial entity interested in setting up a banking or similar operation in Brazil should strongly consider all alternative routes before entering the market, instead of just simply opting for a traditional commercial bank model.

In this article, the development of Brazil's fintech boom is explored, taking account of how its remarkable operational, regulatory and tax benefits have transformed the financial landscape.

The fintech skyrocket in Brazil

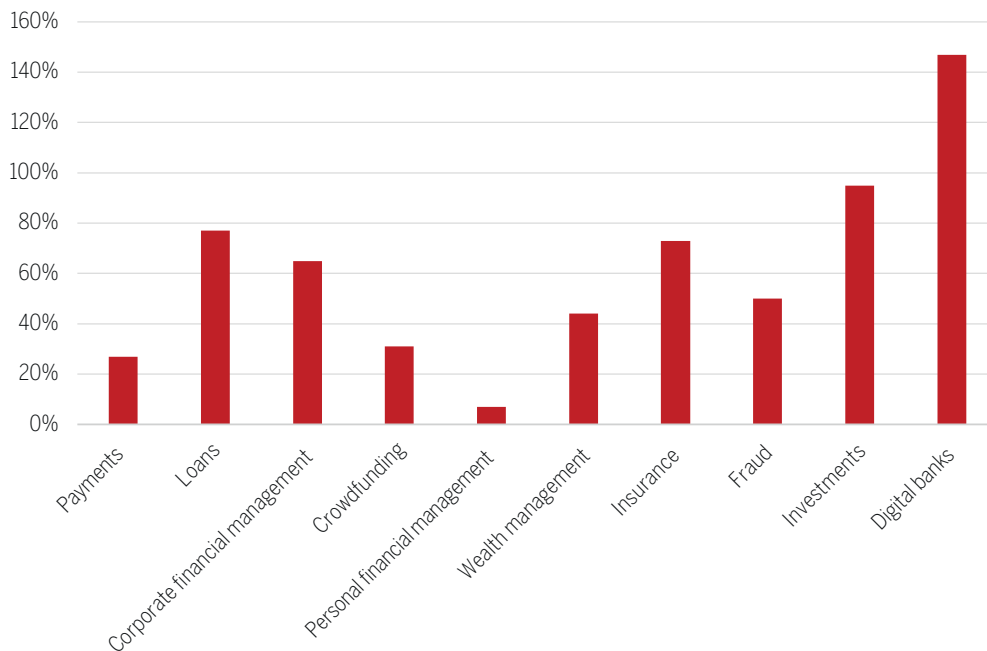
Brazil is the country with the largest number of fintechs in Latin America. According to a study released by Radar FintechLab, at the end of the first half of 2019, Brazil had a total of 604 financial start-ups in operation, which represented a growth of 33% in comparison to the first half of 2018. These numbers show that the Brazilian market remains intrigued about the potential of this area and explains the correlated growth in the fintech market.

Among the start-ups mapped by Radar FintechLab, emerging businesses were identified as active across several market segments such as insurance, cryptocurrencies and distributed ledger technology (DTL), investments, funding, digital banks and payments among other sectors.

Another survey run by Finnovation, in collaboration with Finnovista and the Inter-American Development Bank (IDB), considered other Latin American countries that stand out for their fintech infrastructure of conceiving data of great relevance to the market. The research revealed that Mexico was in second place, behind Brazil, with 334 active fintech start-ups, followed by Colombia with 180, Argentina with 116 and Chile with 84.

The absolute numbers by segment produced similar results to the study elaborated by Radar FintechLab. It revealed that the Brazilian fintechs

Figure 1: Annual growth/segment



Source: 2018 Fintech Radar Brazil study

operating in the loan sector represent the third biggest slice of this market, at a rate equivalent to 15% of the total analysed start-ups. An important figure for the purposes of the market study was the indicator of annual growth per segment of operation (see Figure 1).

To enhance the market performance data previously mentioned, the table shows that the loans and insurances segments have respectively the third and fourth highest rates of growth among all analysed segments.

What is a fintech?

Despite the growth of the area, the definition of the term remains a prime subject for debate – so, what is a fintech? The term is the combination of the words ‘financial’ and ‘technology’, and is often used to designate companies that rely on a business model, distinguished from the traditional banks in regard of their offering of products and financial services, and which instead operate through digital platforms.

Following the global financial crisis in 2008, there was a significant increase in regulations for the financial sector, and this development also prompted the rise of fintechs. Taking advantage of the gap in investments, fintechs started

to offer technology at a lower cost and through more flexible transactions. It is also worth noting that many of the people that began to promote the fintech expansion had come from the major financial institutions that were affected by the 2008 crisis.

The accelerated development of this niche area embraces the most varied types of financial services such as: digital banking, crowdfunding, invoices automation, online accounting, insurances, and credit democratisation to small- and medium-sized companies.

Financial competition and the fintech challenge

The challenge launched by fintechs is to provide high quality services through technology, while becoming more agile, convenient and competitively priced than traditional offerings. This rising competition facing the traditional banks can, in the medium term, reduce the huge share held by key players in the banking sector. The Banking Economy Report published annually by the Brazilian Central Bank stated that the banking concentration had reached 80.4% in 2018. In other words, more than three-quarters of all assets and resources from commercial financial institutions in Brazil were held by the five largest banks in the country: Caixa

Econômica Federal, Banco do Brasil, Itaú Unibanco, Bradesco and Santander.

However, following the expansion of the fintech sector in Brazil, it is expected that this number will decrease. For instance, Nubank, a neobank that was considered as one of the country's biggest fintech enterprises in 2019, has gathered more than six million consumers across Brazil. In an interview with *Consumidor Moderno*, the co-founder of Nubank, Cristina Junqueira, explained that the key factor for this growth is mainly due to their provision of more affordable financial products and services.

On the other hand, fintechs have also faced limitations that are often difficult to overcome for small businesses. One of them was simply the difficulty of raising money, the most important starting point for businesses within the financial system. In Brazil, before improvements were made to the regulations, fintechs could not make loans if they were not associated with a financial institution.

Regulations have improved competition in the credit market

In 2018, the National Monetary Council (*Conselho Monetário Nacional*) approved Resolution No. 4,656/18 and Rule No. 3,898/18, which confirmed the existence of two more types of financial institutions with exclusive formats for granting bank loans through digital platforms. Based on these new regulations, fintechs then started to offer digital credit and to act as direct credit companies (DCC) (*Sociedades de Crédito Direto*, or SCD) or peer-to-peer (P2P) lending companies (*Sociedade de Empréstimo entre Pessoas*, or SEP).

The Brazilian Central Bank showed itself to be favourable to technological advances and predicted that these new fintechs would encourage healthy competition with traditional banks. The Brazilian Central Bank predicted that the developments would provide consumers with a differentiated and low-cost experience, in addition to the emergence of new solutions to operate in the financial market.

The DCC is a financial entity with the main purpose of carrying out credit rights loans, financing, and acquisition transactions, which are made exclusively through a digital platform and through financial resources from its own capital. The DCC can also perform other services such as third parties' credit analysis, insurances linked to credit transactions, and even the issuance of electronic currency. A P2P is characterised as a financial institution whose purpose is to carry out financing and loans transactions between individuals or entities exclusively through a digital platform. Therefore, it intermediates the relationship between the creditor and debtor and may charge fees for those services.

Unlike the DCCs, the P2P can raise funds from third parties provided that they are linked to the loan transaction. The conditions for raising funding with unqualified

investors are very restrictive so that the P2P is often expected to raise funding mainly with qualified and professional investors. In addition, P2Ps can also provide other services, such as the issuance of electronic currency, credit charge on behalf of its customers, *inter alia*.

Similar to commercial banks, P2Ps and DCC companies are authorised by the Brazilian Central Bank and can offer credit to legal entities and individuals in multiple ways. They can acquire credit cards and other receivables, can provide working capital, real estate financing, trade financing, and they can also provide financing for capital expenditures. For individuals, in addition to real estate financing and mortgages, they can offer payroll collateralised loans, direct credit to the consumer, and general personal loans.

However, there are some clear downsides to the P2P model when compared to a commercial bank or credit and finance company. P2Ps regularly cannot raise funding through deposits of any type – neither bills nor notes – and can only do so with professional or qualified investors through a direct credit approach, by which the investor fully runs the credit risk. Moreover, commercial banks may also be allowed to have other financial businesses such as foreign exchange trading, whereas the business of P2Ps are more restrictive.

Fintechs have optimised tax and operational costs

As DCC uses its own capital to finance debtors, and P2P usually obtains funding with the assistance of qualified or professional investors, meaning their level of systemic risk is low. Therefore, the compliance with applicable Brazilian Central Bank regulations can be achieved with a well-structured, controlled approach in a less expensive and burdensome manner, in comparison to other business models.

The tax burden of a DCC or P2P is also lower than the burden of a commercial bank or financing company. The chart below summarises the comparative tax burdens of a fintech and other financial businesses.

	Bank	CFC	DCC and P2P
Income tax	25.00%	25.00%	25.00%
Social contribution tax	20.00%	15.00%	9.00%
PIS/COFINS tax	4.65%	4.65%	4.65%
Deduction of PIS/COFINS tax	-2.09%	-1.86%	-1.58%
Total tax burden	47.56%	42.79%	37.07%

The taxes are mostly owed on a monthly basis. It should be assumed that the municipal services tax only applies to financial fees and levies at the same level in all business models.



Lavinia Junqueira

Partner
Junqueira le Advogados
Tel: +55 11 4550 2784
lavinia@jlegalteam.com

Lavinia Junqueira is a founding partner at Junqueira le Advogados. She has more than 20 years of experience as a lawyer, advising financial institutions and companies, while structuring and implementing financial transactions in Brazil and abroad.

She acts as senior counsel to Brazilian multinational companies, and has extensive experience with legal, regulatory and tax issues related to the Brazilian financial market. This includes work for the Brazilian Central Bank on foreign exchange regulations, tax and regulatory advice for financial institutions, and assistance to international banks on structuring and setting up their Brazilian operations.



Cauê Rodrigues

Associate
Junqueira le Advogados
Tel: +55 11 4550 3118
caue@jlegalteam.com

Cauê Rodrigues is an associate at Junqueira le Advogados. He has previously worked in renowned law firms in São Paulo, international banks and multinational companies as a tax consultant. He advises financial institutions and companies, while structuring and implementing financial transactions in Brazil and abroad, including on regulatory, accounting and tax issues.

He has solid ground expertise on tax matters related to the Brazilian and international capital markets, such as financial institutions, asset managers and placement agents.

A commercial bank, for instance, must pay federal corporate income taxes of 45% over their profits, including 25% of income tax and 20% of social contribution tax. The bank also has to pay 4.65% of federal turnover taxes on its financial margin (PIS/COFINS tax) which are deductible from the corporate income taxes. In total, the bank pays taxes overall on an effective rate of 47.56% over its financial margin.

The credit and finance company has to pay around 25% income tax, 15% social contribution tax and 4.65% PIS/COFINS tax ending up with an effective tax burden of around 42.79%, whereas a DCC and P2P pay 34% corporate income taxes plus 4.65% PIS/COFINS with a total tax burden of 37.07%.

On this basis, the fintechs spare 10% of their total profit margin in taxes, when compared with banks, and almost 6% when compared with other financial businesses. However, there are further tax advantages.

A non-resident, for instance, willing to extend credit to Brazilian entities and individuals can open a local financial account under Resolution No. 4,373/14 and through this account may invest in a local private credit fund

(*Fundo Investimento em Direito Creditório*, or FIDC). This, in turn, may act as a professional investor and purchase credit originated by financial entities or may provide direct funding for credit offered by P2P. The investor may have a commercial partnership with the P2P to extend credit and may even have a credit consulting company of its own, effectively verifying and approving the credit model and the debtors. The FIDC, for its turn, is not subject to taxation in its portfolio on a monthly basis but is rather subject to 15% taxation on the redemption of quotas for non-residents not located in low tax jurisdictions.

A Brazilian resident, who is a qualified or professional investor, may also use a closed ended FIDC to extend funding in the credit sector with a similar taxation ranging from 15% to 22.5% on the amortisation of the quotas.

In the FIDC, all expenses and costs are tax deductible in the tax computation. Meanwhile, in the financial business itself, the deduction of several significant expenses is limited in time and subject to several conditions. One important example is the provision for credit recovery, which is not deductible for corporate income taxes until such time when the legislation believes that the loss is effectively realised

and the tax authorities challenge the deduction of such provision also in the PIS/COFINS tax basis.

Conclusion

Even when considering that fintechs may have a restricted scope of operation when compared to the traditionally wide-ranging services of a bank or credit and finance company, the benefits are slowly beginning to shine bright.

Fintechs can gain funding from a couple of professional or qualified investors, partner up with the FIDCs, and end up operating a modern and high-tech business model. It also turns out to be the best alternative considering the operational costs and taxation. Therefore, the numbers of fintech companies continue to grow, and are consolidating themselves as an alternative investment option for investors who seek to enter the Brazilian credit market.



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