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Brazil: The Qualification of Income Derived from Technical Services

Luis Eduardo Schoueri

I. Introduction

Tax treaties are not a frequent issue in Brazilian courts, especially if one considers the judicial decisions. As a matter of fact, many tax cases do not even reach judicial courts, since Brazilian law has an administrative review procedure, whereby taxpayers may bring their claims to the Administrative Council of Tax Appeals (CARF), which replaced the Taxpayers' Council that existed until 2009. The CARF is a very specialized group of experts, chosen among both the tax authorities and taxpayers, which is supposed to review tax assessment in a way similar to a judicial procedure.

Therefore, it may be interesting to analyse a decision regarding a tax treaty issue enacted by a Brazilian court in 2010, concerning to the qualification of income derived from the rendering of technical services in which there is no technology transfer.

Accordingly, Brazilian DTCs, unlike Article 21 of the OECD MC, entitle the source country to tax 'other income'. Since Brazilian taxation reaches payments deriving from Brazilian residents to non-residents (source-of-payment principle), if an item of income is included in Article 21, Brazil may tax such item with no limitation.

It is not surprising, therefore, that the Brazilian tax authorities have adopted a position whereby the remuneration for services which are not included in Article 12 would fall under the provisions of Article 21, rather than under Article 7. In such circumstances, Brazil would claim to be entitled to tax the amounts paid to non-residents as remuneration for the rendering of such services. This would not be the case if one would understand that services (not included in Article 12) would be within the scope of Article 7 since, under its provisions, the country would only be entitled to tax the profits of the provider if the latter has a PE in its territory. Therefore, since Article 21 establishes the right of the source state to tax 'other income', the practical effect of the position adopted by the tax authorities is that the Brazilian tax authorities claim the right to tax all income deriving from services paid by Brazilian residents, except for those included in Article 12.

In the decision here, the taxpayer appealed to the Court pleading the application of Article 7 of the Brazil-Finland DTC to the amounts paid to Finnish companies as remuneration for the technical services rendered – since the Finnish companies did not have a permanent establishment in the country, their profit would not be taxed in Brazil. Notwithstanding the dissenting opinion, the Court correctly recognized the application of Article 7 in the case, thus classifying the income as business profit and denying Brazil's taxation right.

II. The Taxation of Other Income and Business Profits under Brazilian DTCs

Due to the peculiarities of the Brazilian tax treaty policy, one must first analyse the provisions regarding the taxation of so-called 'other income', as well as of business profits, under the provisions of the tax treaties that Brazil has signed.

As the reader may be aware, Article 21 of the OECD MC provides for a general rule concerning the income not specifically dealt within the other articles of the Convention.

To this effect, Paragraph 1 of Article 21 assigns the exclusive right of taxation of such income to the state of residence. The rule is applied irrespectively of whether the taxation right is effectively exercised by the state of residence or not – thus, whenever the income to which Article 21 is applicable arises, the source state is not entitled to tax it, even if the income is not taxed by the residence state.[1]

On the provisions of the OECD MC, the only exception to this rule is set by Article 21(2), which is applicable when the income is associated with the activity performed by a permanent establishment constituted by the non-resident company in the source country. In such a case, Article 7 is applicable, and the country where the PE is located may tax the income.

Nevertheless, a relevant issue which appears in Brazilian tax policy is that Brazilian treaties deviate from the OECD MC on Article 21. Accordingly, Brazil claims that the state of source should also be entitled to subject such 'other income' to unlimited taxation, provided that it derives from that state, while the OECD's understanding is that 'other income' should be taxed only in the state of residence, as mentioned. Hence, Brazil has reserved its position on Article 21 of the OECD MC in the sense of maintaining the right to tax income arising from sources in its own country.

The rule whereby the source country is entitled to tax the 'other income' is adopted in all tax treaties that Brazil has signed, except for the treaty with France, which does not even include an Article 21.

When it comes to the taxation of business profits, Brazilian tax treaties, unlike the case of 'other income', adopt the provisions of the OECD MC. Accordingly, considering the OECD MC Article 7 as a whole, Brazilian tax treaties usually adopt its wording with the exclusion of paragraphs 4 and 6, as they read on the OECD MC version of July 2008.

Therefore, under the provisions of Brazilian tax treaties, the business profits of an enterprise are only taxable in the residence state, unless the company has a PE in the source country. In such a case, the latter may tax the profits to the extent that these profits are attributable to the PE.

[1] See para. 2 of the July 2010 OECD Commentary on Art. 21 of the OECD MC.

As one may remember, Article 7 is applicable only when the profits are not subject to specific rules of other articles of the OECD MC. Thus, the items of income to which the provisions of Article 7 are applicable are the ones which do not fall under 'special categories of income'.[2]

III. The Qualification of Income Derived from the Rendering of Technical Services

A DTC may be considered to be a tool whereby two countries, for the purposes of avoiding the double taxation decide upon sharing their tax jurisdiction. To this effect, the tax treaty does not establish or raise any taxation, but only provides for the limits of the tax jurisdiction of each contracting state when it comes to international transactions and structures. Under the limits set by the treaty, the states may exercise – or not – their taxing power.

The avoidance of double taxation by means of a DTC depends, to a large extent, to the harmonized interpretation of its provisions by both the contracting states, especially with regard to what concerns the qualification of the income in one of the several distributive rules contained by a DTC. Thus, whenever certain income receives a different qualification under the provisions of a DTC by each of the contracting states, double taxation may rise.

Regarding the qualification matter, Vogel states that the avoidance of double taxation, as well as of double exemption, demands a harmonization of the decisions concerning the application of the DTC between the administrative courts and the regular courts of both contracting states.[3] According to Vogel, this harmonization should not go to the point where it would imply the submission of the court to the terms of a decision previously enacted by a court of the other contracting state, but would certainly require that the adoption of a different understanding should be followed by a discussion of the arguments of the previous decision and a presentation of the reasons which led to their denial.

As stated by the renowned German scholar, conflicts regarding the qualification of types of income in a DTC can hardly be entirely avoided, and the proposal adopted by the OECD in its Partnership Report (the 'new approach') does not completely exclude circumstances in which different qualifications by the contracting states may give rise to double taxation or double non-taxation.[4] To this effect, a solution would be an autonomous qualification, in which the reference to the domestic law of the contracting states would be dispensed with,

[2] See para. 1 of the July 2010 OECD Commentary on Art. 7 of the OECD MC.

[3] See K. Vogel, *Harmonia decisória e problemática da qualificação nos acordos de bitributação* (São Paulo: Dialética, 1998), 73.

[4] See K. Vogel, Conflicts of qualification: the discussion is not finished, in *Bulletin for International Fiscal Documentation*, v. 57, no. 2 (2003), 41.

but which would require the consolidation of a common international tax language.[5]

The qualification of income derived from technical services in which there is no technology transfer has been quite a controversial issue in Brazil. As one may be aware, according to the OECD itself, the income at stake must be qualified under the provisions of Article 7. Hence, the OECD Commentaries on the OECD MC, when distinguishing know-how contracts (to which Article 12 is applicable) from contracts in which the service is not followed by any technology transfer, state about the former: *This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7.*[6]

From such a provision, one may see that, in the OECD MC framework, Article 12 is applicable to payments for the supply of know-how (agreements in which one of the parties imparts to the other a special knowledge or experience which is unrevealed to the public in a way that the latter may use for its own account). On the other hand, whenever the party renders a service without transferring any technology to the other, there would be a simple provision of technical services, which should be taxed under Article 7.

The same understanding was the one adopted by the Brazilian tax authorities until 1999. To this effect, one may see a decision given in 1997 by the tax authorities concerning the application of the Brazil-France DTC: *The withholding income tax is not levied on payments made to a French company which does not have a permanent establishment in Brazil deriving from the rendering of technical services which do not fall under the concept of know-how.*[7]

The understanding adopted by the tax authorities until 1999 may be also seen in another decision regarding the application of the Brazil-Spain tax treaty: *To the income derived from the contract of provision of services of a technical nature, signed between Brazilian company and company domiciled in Spain (the provider), without any permanent establishment in our country, and which does not correspond to payment of royalties, transfer of know-how or similar ... shall be given the treatment of transfer of business profits, being the right to tax of the country where the provider company is established.*[8]

As previously mentioned, one may see from both decisions that the understanding of the tax authorities when it came to the qualification of the income derived from the rendering of technical services was in line with the position of the OECD. Accordingly, the income at stake would fall under the

[5] See K. Vogel, *On double taxation conventions* (London: Kluwer Law International, 1997), 58.

[6] See para. 11.2 of the July 2010 OECD Commentary on Art. 7 of the OECD MC.

[7] See Decision No. 007 of the 9th Tax Region, of 30 Dec. 1997.

[8] See Decision No. 369 of the 7th Tax Region, of 29 Dec. 1998.

provisions of Article 7, thus being taxed exclusively by the residence state, unless the company were to maintain a permanent establishment in the country, when the source state would also be entitled to tax the remittance.

Nevertheless, in spite of the understanding adopted until then, the tax authorities changed their position on the matter in 1999. To this effect, one may read Opinion No. 58 issued in the year in question by the General Coordinator of the Tax System: The payments made to residents or domiciled abroad from the rendering of professional technical services without technology transfer are subject to the levy of the withholding income tax at the rate of 25%.[9]

In order to provide for a general statute on the matter in the ambit of the tax administration, the tax authorities issued, in 2000, Normative Declaratory Act No. 01/2000, which states as follows:

I. The remittances deriving from contracts of rendering of technical assistance and technical services without technology transfer are subject to taxation according to Article 685, II, "a" of the Decree no. 3000, of 1999.

II. In the Conventions to Avoid the Double Taxation of Income which Brazil has signed, such income is classified in the article Income Not Expressly Mentioned and consequently is taxed in the form of Item I, which shall also happen where the convention does not provide for such article.

III. For the purposes of item I of this act, it shall be deemed to be contracts for the rendering of technical assistance and technical service without technology transfer those who are not subject to register in the National Institute of Industrial Property and Brazilian Central Bank.[10]

As stated by the provisions of Normative Declaratory Act No. 01/2000, the Brazilian tax authorities came to understand that income from services which would not be included in Article 12 would automatically fall under Article 21, not under Article 7. Since the Brazilian tax treaties deviate from the OECD MC on Article 21, the source country would be entitled to subject the 'other income' to unlimited taxation, provided it derives from the state of source. However, in the case of Brazilian DTCs, very few services would not be included in Article 12 due to the broad interpretation of royalties and technical services.

Accordingly, Brazilian DTCs adopt an extended concept of royalties, maintaining its traditional definition provided for by the 1977 OECD MC, which includes *inter alia* leasing, as well as covering payments from films and tapes for television broadcasting, as provided for by the UN MC.

Since the royalties' provision has always been a focus of Brazilian treaty negotiators, in several agreements Brazilian negotiators have obtained, in the protocol, a statement with a view to including technical assistance and technical services within the scope of Article 12. This happened for the first time in the

[9] See Opinion of the General Coordinator of the Tax System No. 58, of 10 Jan. 1999.

[10] Translation by the author.

treaties with Denmark and Spain (both signed in 1974). This provision did not appear in the treaties with Sweden and Austria (both signed in 1975), but from then on, this was constant in all subsequent treaties in force in Brazil, except for the treaty with Finland, which contains no such provision.

Evidence that Brazil wishes this to be a basic characteristic of its treaties is the provision of the treaty with Israel which contains something similar to a most-favoured-nation clause. To this effect, the protocol to said treaty provides for the extension of Article 12 to technical services, but it states that if in the future Brazil agrees to sign a tax treaty with a non-Latin American country which does not provide for the extension of Article 12 to technical services, then the same regime must also be applied to Israel.

In order to justify the position adopted by means of Normative Declaratory Act No. 01/2000, the tax authorities argue that the scope of Article 7 is restricted to the taxation of profits: this means that Article 7 would only be applicable in the circumstances where taxation would affect companies' profits. They claim that profits of non-residents are not taxable in Brazil; only some items of income are taxable. Since Article 7 would protect non-residents from a taxation of their profits, Article 7 would not be a protection against taxation of mere items of income.

This is of course much criticized by treaty partners and also by the majority of Brazilian scholars. As stated by the Brazilian scholar Alberto Xavier, since it provides the exclusive taxation right to the residence state in the absence of a PE, Article 7 is precisely applicable to the circumstance when the company of a contracting state does not have a PE in the other contracting state, which generally is the case with regard to services.[11]

The wording of Article 7 itself, in its paragraph 7, assumes that it is applicable to items of income, not only to profits as a whole, since it recognizes that the profit is compounded by several items of income, which may or not be provided for in a specific article of the OECD MC. Thus, the profit taxable under Article 7 is not just the one which matches the definition of profit given by Brazilian internal law (the result of the receipts and expenditures accounting), as intended by the tax authorities.

As mentioned by Gerd W. Rothmann, Article 7 covers all the income derived from business activities which are not covered by a specific article of the OECD MC (such as interest, dividends and royalties): the general concept of business profit covers a plurality of income attributable to an enterprise.[12] Moreover, according to Alberto Xavier, the 'other income' provided for by Article 21 is income that is unusual, atypical or of little importance, which would not justify a proper

[11] See A. Xavier, *Direito Tributário Internacional do Brasil* (Rio de Janeiro: Forense, 2004), 695.

[12] See G.W. Rothmann, Problemas de qualificação na aplicação das convenções contra a bitributação internacional, in *Revista Dialética de Direito Tributário*, no. 76 (2002).

provision in the MC, and, therefore, services could not be taxed under such an article.[13]

Nevertheless, as a matter of practice, services rendered to Brazilian parties are subject at least to the risk of such taxation. What makes this a dramatic situation is that usually Brazilian treaty partners will not recognize the Brazilian right to tax services rendered in Brazil without a PE, due to Article 7. Consequently, there is the risk that tax paid in Brazil would not be offset against the tax due in the state of residence.

Recently, this issue has been successfully solved between Brazil and Spain, whereby the latter recognized a broad interpretation to Article 12 but, on the other hand, Brazil promised not to apply Article 21 to the remaining services. To this effect, the Revenue Service Interpretative Declaratory Act No. 27/04 states, concerning the Brazil-Spain DTC:

I. *Included in the concept of royalties, for the purposes of application of this Convention, shall be all technical services or technical assistance, regardless of whether they imply or not in the transfer of technology ...;*

III. *Article 22 of the Convention ("Income not expressly mentioned) shall not be applied, in any form, to the technical services rendered by a company of a Contracting State in the other Contracting State'.*[14]

Unfortunately, the same understanding was not reached with Germany and this seems to be one of the reasons why Germany revoked its treaty with Brazil. Thus, one may see how serious this issue may be to the relation of the country with its treaty partners.

IV. Reasoning of the Court

In March 2010 the Brazilian Federal Court of the 2nd Region enacted a decision in an Appeal on a Writ of Mandamus in which the judges dealt with the qualification of income derived from the rendering of technical services for the purpose of the application of the Brazil-Finland DTC.[15]

In the case, the taxpayer hired technical services from Finnish companies due to the construction of a plant in the Brazilian State of Bahia. As previously mentioned, the DTC with Finland is an exception to the Brazilian policy on the matter and does not include technical services in Article 12. To this effect, the payment for the services rendered by the non-resident companies was qualified as 'other income' by the tax authorities and consequently taxed by the withholding (income) tax in Brazil.

[13] See A. Xavier, *Direito Tributário Internacional do Brasil* (Rio de Janeiro: Forense, 2004), 698.

[14] See the Brazilian Revenue Service's Interpretative Declaratory Act No. 27, of 21 Dec. 2004.

[15] See 2nd Region Federal Court, 16 Mar. 2010, judgment No. 2004.50.01.001354-5.

Taking into account the provisions of Article 7 of the DTC Brazil has signed with Finland, the taxpayer appealed to the Federal Court, pleading that the withholding income tax should not be levied on the amounts remitted abroad as remuneration for the technical services rendered by the Finnish companies.

According to the taxpayer's understanding, the income derived from technical services corresponds to the profit of the company, which is specifically governed by Article 7 of the respective DTC. To this effect, Article 21 could not be applied in the case, since it is assigned to income which was not dealt within the other provisions of the DTC.

As addressed by the taxpayer, under the rule provided by Article 7 of the Brazil-Finland DTC, the amount remitted abroad would only be subject to taxation in Brazil if the non-resident company maintained a PE in the country to which the profit could be attributed. Since the Finnish companies which rendered the services did not have a PE in Brazil, the taxation right belonged exclusively to the residence state.

Moreover, the taxpayer argued that the treaties signed by the country prevail over Brazilian internal law, and thus their provisions could not be changed by a mere rule issued by the tax authorities, such as Normative Declaratory Act No. 01/2000.

In the judgment of the case, Judge Luiz Antonio Soares, whose view led the minority dissenting opinion, held that one must not consider any hierarchy between international treaties and the internal law. To this effect, both the treaty and the internal law coexist harmoniously, and an occasional conflict between them should be resolved by means of the 'lex specialis' criteria.

As addressed by Judge Soares, Article 3, Paragraph 2 of the OECD MC, notwithstanding that it does not provide for an immediate reference to internal law, certainly would allow the domestic law to define expressions the exact meaning of which was not established by the provisions of the DTC. This would be the case for the word 'profits', whose meaning, since it was not provided by the treaty, should be established by the internal law of the contracting state.

To this effect, as one does not find any definition of 'profit' in the Brazil-Finland DTC, the question of whether the amounts remitted abroad by the taxpayer as payment for the rendering of services correspond to profits or to income not expressly dealt within the provisions of the tax treaty should be resolved by Brazilian internal law.

According to the dissenting view, the DTC, when referring to 'profits' in its Article 7, does not intend to cover every kind of operating 'income' which would make up the global 'profit' of the company. Under the Brazilian Income Tax Ruling, 'profits' would include all 'income' derived from the activities of the company, but are not equivalent to it: the 'actual profit' (tax base for the income tax) deriving from adjustments in the book profit. To this effect, the expression 'profit' would substantially differ from the concept of 'income', and thus the

income derived from technical services could not be characterized as 'profit', which would be a much wider concept.

As stated by Judge Moraes, Normative Declaratory Act No. 01/2000, which classifies the amounts paid as remuneration for technical services in which there is no technology transfer as 'other income' under Brazilian DTCs, would be in line with Brazilian internal law and with the DTCs that the country has signed. Therefore, the remittances at stake would be subject to the withholding income tax provided for by Article 685, II of the Brazilian Income Tax Ruling.

Nevertheless, the referred understanding did not prevail at the end of the day. The majority of judges, following the view of Judge Alberto Nogueira, denied the Brazilian right to tax the amounts paid by the taxpayer as remuneration for the services rendered by the Finnish companies.

Accordingly, Judge Nogueira agreed with the dissenting opinion on the absence of a hierarchy between international treaties and the internal law (which is not – one should note – the traditional position of Brazilian courts). However, the judge held that, in the OECD MC framework, a contracting state may only give a specific legal meaning to a provision of the treaty if it does not do so in an arbitrary and discriminatory way.

As addressed in the position adopted by the majority of the judges, Brazilian internal law does not provide for a definition of profits. On the other hand, it only establishes types of profits – the actual profit, the deemed profit and the arbitrated profit[16] – which are methods to determine the tax base of a company in Brazil.

Thus, since one may not find in Brazilian internal law an exact definition of profits, the discussion on whether the amount remitted abroad by the taxpayer corresponds to income or to profit of the Finnish companies under the Brazilian internal law was deemed insufficient for the purpose of determining the application of Article 7 or Article 21 to the case. Instead of limiting their judgment to the analysis of the internal law, the judges considered that the most reasonable interpretation should be made by taking into account the provisions of the DTC.

As stated by Judge Nogueira, when it comes to the interpretation of an international treaty, whether at a domestic or international level, the wording of its provisions may assume a different understanding in each of the contracting states, as they may adopt different languages or give different meanings to the same word. This difference could only be avoided in the case of clauses assigned to provide for very specific technical definitions where there would be very little room left to the interpreter.

[16] Actual profit derives from companies' books, considering all items of revenues and expenses; deemed profit derives from the application of a fixed margin on companies' revenues; arbitrated profit shall be calculated by tax authorities when the two former profits cannot be accurately calculated (for instance, due to the fact that books are not reliable).

Therefore, according to the opinion adopted by the majority of judges in the case, the tax treaty must be interpreted according to common sense regarding the wording of its provisions. Hence, it would not be reasonable to think that the word 'profits' in Article 7 of the DTC that Brazil signed with Finland would correspond to the technical definition of 'profit' under Brazilian internal law, as an 'actual', 'deemed' or 'arbitrated' profit.

On the other hand, the word 'profits' used in the DTC would have the meaning of income, i.e., something derived from the business activity that represents a gain to the company. Thus, one may consider the remuneration for the rendering of technical services to be a business profit subject to the rule of Article 7, as well as the applicability of the same article to single items of income, provided that they are not specifically dealt within the other articles of the DTC.

Moreover, the majority understanding was that, since the Brazilian internal law does not provide for a concept of profit, the non-application of Article 7 would only be justified by the provisions of Normative Declaratory Act No. 01/2000. In such circumstances, since the application of Article 21 would lead to the taxation of the income in Brazil, one could argue that the Declaratory Act issued by the tax authorities would establish taxation, which is a role exclusively assigned to formal statutes enacted by the Congress under the Brazilian constitutional arrangement.

The Declaratory Act, being an act of the executive branch, may not go beyond the provisions of the law, but must rather limit itself to consolidating the legal provisions. Taxation may not be levied based solely in the provisions of an act of the tax authorities such as Normative Declaratory Act. No. 01/2000.

Based on the above arguments, the Federal Court of the 2nd Region held that the income derived from technical services would correspond to the profits of the non-resident company in Brazil, whose taxation must be governed by the provisions of Article 7 of the Brazil-Finland DTC. In contrast to the view adopted by the tax authorities, the judges recognized the application of Article 7 to items of income, and not just to the global result from the receipts and expenditures accounting.

V. Observations by the Author

Notwithstanding the dissenting opinion and the understanding adopted by Brazilian tax authorities, the Court decided at the end of the day for the most reasonable qualification of the income derived from the rendering of technical services.

The qualification of said income on Article 7 is line with the view of the majority of Brazilian scholars which, as previously addressed, point out that Article 7 is applicable to items of income (and not just to profits as a whole), while Article 21 is assigned to income of little importance.

Moreover, the decision of the Court is in line with the wording of Article 7 itself which, in its paragraph 7, recognizes that the profit is compounded by several items of income, what denies the position of Brazilian tax authorities.

VI. Conclusion

Notwithstanding the efforts of scholars and of the OECD itself, the conflict concerning the qualification of types of income in a DTC by the contracting states remains a difficult issue when it comes to international tax, which may give rise both to double taxation and double non-taxation.

In Brazil one may see an example of such a discussion in the case of the qualification of income derived from technical services in which there is no technology transfer, which has been a controversial issue in the country due to the understanding adopted by the tax authorities in Normative Declaratory Act No. 01/2000. According to this Act, income from services which would not be included in Article 12 (in the case of Brazilian treaties, very few services would not be included therein due to the broad interpretation of royalties and technical services) would automatically fall under Article 21, not Article 7.

Nevertheless, in a case decided recently, a Brazilian Federal Court, by adopting the argument that a DTC must be interpreted according to its own circumstances and context, always regarding the differences between the languages and the understandings and not according to the technical meaning of domestic law, concluded that the income was clearly a profit and, therefore, should be taxed under Article 7 of the DTC.