Double Taxation Treaty Between Brazil and Germany.

Important new development!

This newsletter is a brief summary of the main consequences for companies doing business in Brazil and Germany under both Brazilian and German law, if the Double Taxation Treaty between Brazil and Germany ("DTT") should cease to exist.

The Brazilian Ministry of Foreign Affairs confirmed that last week it received a notice from the German authorities detailing the intended termination of the DTT. Therefore, the DTT will expire on 31 December 2005.

We understand that the main reasons for this termination as determined by the German authorities are as follows:

(i) **Differing Interpretations.** The interpretation of important provisions of the DTT (such as Article 7° – Business Profits – and Article 9° – Associated Enterprises) – as made by the Brazilian tax authorities diverge from those interpretations as given by most countries and the Organization for Economic Cooperation and Development ("OECD"). Over recent years, the German and Brazilian tax authorities have frequently held differences of opinion as regards interpretation and often this has been to the detriment of taxpayers. As such, the purpose of the DTT has been defeated.

(ii) **Non-Inclusion of Ancillary Import Taxes.** The Brazilian government enacted additional taxes (other than income taxes) on the import of goods and services which are not likely to be covered by the current DTT.

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1 Source: DCI - Diário, Comércio e Indústria of 11 April 2005.
2 Such as the Contribution for the Intervention on the Economic Domain ("CIDE"); the Social Contributions on the Import of Goods and Services ("PIS-Importação" and "COFINS-Importação") and the Service tax on the Import of Services ("ISS-Importação").
(iii) **No Need for Matching Credits.** There is no longer a need for granting "matching credits" as neither the present economies of Brazil or Germany are comparable to the situation in 1975, when the DTT was enacted. In other words, Brazil is no longer a developing country.

**German Investments in Brazil**

In general, it would not seem to be the case that the termination of the DTT heralds a disaster for German companies with investments in Brazil. This is because Brazilian withholding tax rates levied on interest, dividends and royalties generally do not (though there are a few exceptions) exceed the maximum limits established under the DTT. There will be, however, some immediate effects that shall be outlined.

The most important areas of interest are as follows:

1. **Business Profits (Article 7 DTT)**

   The issue is - in a nutshell - the Brazilian position to withhold income tax on payments of non-technical services to German residents. This taxation is excluded under the DTT. However, the Brazilian tax authorities by interpreting Article 7 differently than the OECD and most countries of the European Union levies the tax.

   Provided the DTT exists, taxpayers have at least a legal basis from which to argue that Brazil has no right to impose withholding tax on payments for non-technical services rendered by and paid to German residents and thereby contest certain tax assessments. However, the termination of the DTT would remove this opportunity.

   **Tax Credits.** Without the DTT, the question as to whether or not a tax credit will be granted with respect to Brazilian taxes paid by German residents who render services in Brazil, will be governed by German law. The general rule is that Germany does not grant corresponding tax credits for Brazilian withholding taxes levied on non-technical services rendered by German tax residents. Tax credits are granted only if German tax residents conduct such services through a permanent establishment or a permanent agent in Brazil.

   **Deductible Expense.** However, any Brazilian tax can be deducted as an expense by the German service provider when determining the German taxable income. Should the DTT cease to exist, this treatment as

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3 Matching credits exist when one of the Contracting States of a DTT, usually the most developed (Germany in this case), grant a credit for the taxes paid in the other Contracting State (Brazil in this case) at a rate higher than the effective rate of taxation in the latter country. For instance, the maximum withholding income tax rate applicable under the DTT for interest paid by a Brazilian source to a German resident is 15%, but under the treaty Germany is required to grant a credit as if the tax had been withheld in Brazil applying the rate of 20%. The difference (20% less 15%) is a matching credit.
deductible expense could actually be a benefit for German tax residents, as it is currently disputed whether Brazilian taxes (as assessed by Brazilian tax authorities against the express wording of the DTT) can be deducted from the taxable income of German tax residents.

2 Transfer Pricing Rules (Article 9 DTT)

This is certainly one of the most relevant issues. Contrary to what it is set out in Art. 9 of the DTT, the current Brazilian transfer pricing rules establish rigid arithmetical methods with pre-fixed profit margins and very little consideration of economic, risk and functional issues.

Nevertheless, Brazilian tax authorities have in the past always argued that their transfer pricing rules are in strict compliance with the DTT. This has been an argument of taxpayers with the Brazilian courts because Art. 9 DTT establishes the so called “arm’s length principle”. This principle means that transactions between related parties are only subject to transfer pricing rules, if the commercial or financial conditions differ from those agreed between independent parties.

Unfortunately, should the DTT be terminated, the legal grounds for this interpretative argument shall be removed.

3 Brazilian Withholding Tax on Dividends, Interest and Royalties

3.1 Dividends (Art. 10 DTT)

The payment of dividends out of profits generated after 1995 are exempt from withholding income tax in Brazil and, in practice, subject to minimal taxation in Germany (i.e. the corporate income tax to be paid is calculated on 5% of the amount of the dividend received).

The termination of the DTT would per se not change this. However, it should be noted that in the absence of the protection provided by the DTT both countries are free to change this tax treatment in the future.

3.2 Interest (Art. 11 DTT)

Reduced Tax Rates and Tax Exemption. The termination of the DTT would have a very important negative effect on certain interest payments made by Brazilian residents to German residents as currently the DTT establishes (as mentioned in the two cases below) that interest payments are taxed at a lower rate or even that they are tax exempt. For example:

- A tax rate of only 10% (and not 15%) applies under the DTT, if loans of a German bank are granted for a
period of at least 7 years with the specific purpose to finance (A) purchase of industrial equipment, (B) research, (C) purchase and installation of industrial or scientific sites, or (D) public works; and

- A complete exemption from tax applies if the recipient of the interest payment is the German Government, a political subdivision or any agency (including a financial institution) wholly owned by the German Government.

If the DTT is terminated, all existing loans which currently benefit from this reduced tax rate, or are even exempt from taxation in Brazil, would be affected. Furthermore, it is possible that the termination will have a significant negative impact on future financings coming out of Germany for the purchase of industrial equipment, industrial sites and public works by Brazilian companies.

**Matching Credits.** As long as the DTT still exists, German tax residents may register a “matching credit” of 20% with the German tax authorities, even if the effective tax rate in Brazil upon interest is only 15% or even if it is less. This benefit granted by Germany to subsidize investments in Brazil by German tax residents, will no longer exist if the DTT is terminated.

3.3 **Royalties (Article 12)**

As regards royalties, there would be no immediate consequences, as the domestic withholding tax rate on royalties (15%) is equal or even lower than the maximum rate established under the DTT. As is the case regarding dividend and interest income, the main effect of the termination of the DTT upon royalties is that both Brazil and Germany are free to change this tax treatment in the future.

**Matching Credits.** For the same reasons as noted regarding interest income, matching credit will no longer be allowed in Germany in relation to royalty income.

**Brazilian Investment in Germany**

1 **Tax Credits for Brazilian Resident Individuals**

Brazilian resident individuals are only allowed to offset taxes paid abroad on their worldwide income subject to tax in Brazil (i) if there is a DTT signed between Brazil and the country where the taxes were paid or (ii) if
the Brazilian beneficiary of the income proves that there is a reciprocity of tax treatment between both countries. The latter option is one that is rather complex to demonstrate.

The termination of the DTT would thus require that Brazilian resident individuals earning income subject to tax in Germany, demonstrate that Germany would give a tax credit for the tax paid in Brazil in relation to the income earned by a German individual investing in Brazil. In short, it must be shown that the withholding tax can be offset.

According to German tax law there is no claim for a Brazilian tax resident to obtain such confirmation from the German tax authorities. As a result, it is up to the Brazilian tax authorities to accept the legal opinions of German based tax professionals as proof that such reciprocal German tax treatment exists.

2 German Withholding Tax on Dividends, Interest and Royalties

The withholding tax rates in Germany on dividends, interest and royalties will increase as follows in comparison with the limits currently established by the DTT (15% in most cases):

2.1 Dividend payments. According to the German Income Tax Act, a 20% withholding tax rate is levied on dividend payments from a German tax resident corporation to a Brazilian investor.

2.2 Interest payments. Depending on the source of the interest payments (e.g., public listed bonds) and its underlying securities (e.g., private loan secured by German real estate) a withholding tax rate of between 25% and 35% can apply.

2.3 Royalty payments. A withholding tax rate of 20% is levied, provided that the intellectual properties of the royalties in question are held in Germany.

If the beneficiary of the income is a Brazilian legal entity, the effect may be only upon cash flow, as Brazil grants tax credits for the tax paid abroad up to the limit of the Brazilian corporate income taxes that apply on the same income at a combined rate of 34%. If the beneficiary is an individual, the practical effect will depend on whether or not a tax credit will be granted, based on the reciprocity test as referred to above.

Final Comments

The Ministries of Finance of both countries are under enormous pressure to increase revenues. It is a pity that the negotiations between Germany and Brazil could not be settled so as to cater for the best interests of the industry.
of both countries. The termination of the DTT evidences the conclusion that despite ostensible agreement, Brazil and Germany did not concur as to vital points such as transfer pricing. We hope that the currently existing tensions between the two Ministries of Finance will ease over time, particularly in view of the growing integration of Brazil as an important player in international business and trade.

The termination of the DTT will not be a disaster for the German-Brazilian industry. However, there are a number of issues (in particular cross border financing and transfer pricing) that will require careful study as regards any modification.

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