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Brazil-Spain DTT: Derivatives

3rd Region Federal Court of Appeals confirms application of "Business Profits" Article from Brazil-Spain DTT: specific and unprecedented case involving gains/income derived from Derivatives, paid to financial institution abroad – non-levy of the WHT in Brazil

On March 06, 2012, the 3rd Chamber of the 3rd Region Federal Court of Appeals ("**TRF3**") granted an Appeal lodged in a Declaratory Relief filed by a Brazilian financial institution (legal representative and tax liable agent of a foreign, in fact Spanish, financial institution investing in the Brazilian financial market under the rules of CMN Resolution No. 2,689/2000).

The Brazilian financial institution requested for a declaration of non-levy of the withholding tax ("**WHT**") applicable to the remittance of income or gains arisen from derivatives and obtained in the Brazilian OTC market to a financial institution residing in Spain, under the terms of Article 7 (Business Profits) of the Brazil-Spain double taxation treaty ("**Brazil-Spain DTT**"), published by Decree No. 76,975/1976.

The TRF3 has decided to grant the appeal lodged by the tax liable agent, granting their claim and declaring the non-levy of the WHT applicable to the remittance of income or gains arisen from derivatives, obtained in the Brazilian OTC market, under the terms of Article 7 (Business Profits) of the Brazil-Spain DTT, due to the fact that: the beneficiary of such "income" arisen from derivatives is a financial institution residing in Spain, whose core activity/corporate object includes financial transactions such as the execution of derivatives in the OTC market; and that the gain/income arisen from the derivatives is not considered as "interest" or any specific kind of income under the other distributive rules of the Brazil-Spain DTT.

According to the understanding expressed by the TRF3 3rd Chamber, Article 7 of the aforementioned treaty restricts the right of the State of Source (in this case, Brazil) to collect the WHT levied on the

remittance of the income derived from operational/core-business activities (such as, for financial institutions, the investment in derivatives) performed in such State of Source (in this case, in Brazil) to the relevant beneficiary (Spanish financial institution) residing in the Residence State (Spain), due to the fact that only this latter country (Residence State), in which the beneficiary resides, is able to tax such income.

The Court argued that the Brazilian bank acts as a mere manager of the investments of the foreign bank in Brazil, and does not, therefore, qualify under the concept of *autonomous establishment* (or permanent establishment, as designated by the relevant treaty) in connection with this sort of transaction.

Also, the Court has highlighted that the gross income obtained from derivative transactions carried out in the Brazilian OTC market shall be comprised within the core activity of the Spain-resident beneficiary, since it is widely accepted that the corporate object of financial institutions includes the intermediation and execution of financial investments in the financial sector (among which, derivative instruments). Consequently, in accordance with the most accurate interpretation of the Brazil-Spain DTT, and in line with the understanding expressed by the Organization for Economic Cooperation and Development ("**OECD**") and a great part of international scholars, such business profit income (the derivatives' income) shall be taken into consideration for purposes of ascertainment of the operational profit of the Spanish bank (beneficiary), and be subject to income tax exclusively in Spain, in such way that Brazil (State of Source) would be unable to double-tax the relevant income. Thus, the Court has denied the application of Article 22 ("Non-Specified Income", or "Other Income", as designated in other tax treaties), used by the National Treasury in an attempt to support the charge of the WHT in Brazil.

This has been a very important victory for the solidification of International Tax Law in Brazil, which makes all of us from Velloza&Girotto very proud of our participation in this accomplishment, which started with a Request for Tax Ruling presented before the Brazilian Federal Revenue and continued until the issuance of the aforementioned decision. Aside from ratifying the non-levy of the WHT on the remittance of business-profit income (i.e., income comprised in the profits of the foreign companies beneficiated with such income) to countries that are parties to double taxation treaties and in which the relevant beneficiary resides (in case the relevant situation is covered by a double taxation treaty), this decision also extends such potential debate towards the financial sector, so as to discuss what activities shall be considered to be operational for financial institutions.

In our opinion, a similar law suit may be lodged by any foreign financial institution residing in a country that has signed a double taxation treaty and invests in the Brazilian financial market under the terms of the applicable rules (all of the tax treaties entered into by Brazil contain the "Business Profit" article and all of those articles restrict the right to tax of the State of Source, under the condition that there is no permanent establishment of the beneficiary located in the State of Source).

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