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Brazilian Superior Court of Justice addresses whether technical service fees are subject to withholding tax under treaty with Spain

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The second chamber of the Brazilian Superior Court of Justice (STJ) recently addressed whether technical service fees paid by a Brazilian entity to a Spanish tax resident are subject to taxation in Spain (where the service provider is resident) or to withholding tax (WHT) in Brazil under the Double Taxation Treaty (DTT) between Brazil and Spain.

Historically, Brazilian tax authorities have imposed WHT on payments related to the provision of technical services by foreign entities, even when there is a DTT between the countries that contains Article 7 of the Organisation for Economic Co-Operation and Development (OECD) model treaty. Article 7 states that business profits must be taxed only in the jurisdiction where the service provider is located. The understanding of the Brazilian tax authorities is that cross-border payments for technical services made by Brazilian parties should be considered royalties that are subject to WHT. The STJ's position on Article 7 may represent a change in the STJ's precedent on this subject.

Facts

A Brazilian entity hired a Spanish tax resident to provide engineering services and administrative assistance. Upon payment of the service fee, the Brazilian company did not withhold tax, asserting that Article 7 applied. The Brazilian tax authorities challenged the Brazilian taxpayer's position on the WHT, arguing that the taxpayer did not take into consideration Article 12 of Brazil-Spain DTT, which establishes how royalty income is taxed.

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Decision

The STJ remanded the case to the lower court, finding that each case needs to be individually analyzed, and Article 7 of the DTT should not automatically apply to the income derived from the technical services. On remand, the STJ wants the lower court to analyze both Article 12 and Article 14, which establish how income from royalties and independent personal services are taxed. Article 7 of the DTT would only apply to income from technical services if the lower court determines that Articles 12 and 14 do not apply. If Article 7 applies, the income from the technical services would be not subject to WHT.

In addition, to establish the correct tax treatment of the transaction, the STJ requires the lower court to analyze if the income classification is the same in the country where the service provider is located and in Brazil; otherwise, the taxpayer could be using the treaty in an abusive way to avoid taxation. The OECD understands that the abusive use of DTTs has an overall negative impact on competition, efficiency, transparency, fairness, and tax revenue.

Spanish tax perspective

While the wording of Article 12 of the Brazil-Spain DTT does not cover technical services, the letters exchanged between the Spanish and Brazilian tax authorities in 2003 may lead to the understanding that technical services – regardless of whether they are related to the transfer of technology – are covered by either Article 12 or Article 14 of the DTT.

The approach that payments for technical services provided by a Spanish taxpayer to Brazil would be considered royalties has been confirmed by the Spanish tax authorities in binding ruling V0798-17, dated 28 March 2017. The ruling also confirmed that, while the maximum WHT applicable in Brazil would be 10%, the tax sparing clause would be applicable, allowing a tax sparing credit in Spain equal to 25% of the gross amounts received.

Accordingly, if the lower court consults with the Spanish Government, and the Spanish Government follows the position of the Spanish tax authorities as per the above, the STJ would likely rule that Article 7 does not apply. As such, the technical service fees would be subject to WHT in Brazil and a tax sparing credit would be available in Spain.

Other considerations

Because of the potential change in the tax treatment of technical service fees, multinational companies with a presence in Brazil may want to evaluate their transactions and consider either using other conflict resolution instruments or other repatriation methods with a tax treatment that offers more certainty for taxpayers.

To avoid litigation, which can be lengthy and costly, multinational companies might want to consider the Mutual Agreement Procedure (MAP), which has recently been implemented in Brazil (see EY Global Tax Alert, *Brazilian National Attorney General regulates recently enacted conflict resolution system*, dated 13 December 2019). MAP is a mechanism intended to solve issues on the interpretation or application of treaty provisions, bilaterally (with the participation of the tax authorities of both jurisdictions).

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