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Companies in Brazil Need to be Proactive to Comply with Pillar 2

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Companies operating in Brazil must be proactive in understanding and complying with Brazil's new Pillar 2 rules to avoid penalties and ensure smooth operations, say KPMG practitioners.

The adoption of Pillar 2 in Brazil was a rapid and smooth process. In less than three months, Brazil introduced, discussed, and approved its own Pillar 2 rules, and the main aspects of these new rules are detailed below.

In early October, Brazil's Federal Government enacted a Provisional Measure, which is a type of legal rule that takes immediate effect as a law but requires subsequent confirmation by Congress. Simultaneously, the government presented a Project of Law to Congress with the same contents. Along with the Provisional Measure, the Federal Tax Authorities (RFB) issued Normative Instruction #2,228/2024 to complement the regulation.

By mid-December, Congress approved the Project of Law, and in the last week of 2024, the President approved and issued Law #15,079/2024. This law included a few modifications when compared to the Provisional Measure, mainly to improve certain aspects of the rules. At the same time, the RFB released a new Normative Instruction (#2,245/2024) to adapt the previous one to the changes in law and to improve specific regulatory points.

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Law #15,079/2024 represents a significant change in Brazilian tax policy, aligning it with international standards and addressing issues related to base erosion and profit shifting. Companies operating in Brazil must be proactive in understanding and complying with the new rules to avoid penalties and ensure smooth operations. This is particularly important in Brazil due to the complexity of its tax system, which necessitates even more caution in preparing for the application of the new rules.

Overview and Landscape

Brazil has chosen to adopt a Qualified Domestic Minimum Top-up Tax (QDMTT) at this time, without provisions for an Income Inclusion Rule (IIR) or Undertaxed Profits Rule (UTPR). However, there is an article in the law that requires the Federal Government to present a Project of Law in the first semester of 2025 to adapt the current controlled foreign corporation (CFC) rules. This adaption aims to (i) adopt an IIR in accordance with the OECD GloBE Model Rules (Model Rules); and (ii) adjust the CFC rules to be more aligned with other CFC international regimes that are narrower in scope, focusing on anti-avoidance.

From a landscape perspective, Brazil has adopted the Model Rules with several direct importations from the GloBE Commentary and Administrative Guidances (AGs). Law #15,079/2024 primarily consists of rules drawn from the Model Rules. Normative Instruction #2,228/2024 includes parts of the Model Rules and many elements from the Commentary and AGs, due to extensive work by the RFB to interpret and systematize these rules into the Normative Instruction. Additionally, the Commentary, the AGs, and other documents published by the OECD were given the status of "Reference Documents", meaning they can be used as interpretation guidelines for future reference.

Effective Date

The law came into effect on January 1, 2025. There are provisions for future changes, such as the Project of Law to adopt an IIR and adapt the CFC rules. Additionally, certain income tax incentives that are currently considered non-qualified tax credits will be adapted to become Qualified Refundable Tax Credits starting in 2026.

General Aspects and Effects

The Brazilian QDMTT rules are closely aligned with the Model Rules in almost every aspect. While there are differences, all the relevant aspects of the Model Rules, Commentary, and AGs are present in the Brazilian rules. The Normative Instruction considers all the AGs until December 2023, and the AGs published in June 2024 and January 2025 are not yet integrated.

Multinational groups with global revenue over EURO 750 million are in scope, just as established by the Model Rules. All the definitions regarding the scope of the rules are also aligned.

Furthermore, the Brazilian QDMTT adopts the Transitional CbCR Safe Harbors and the permanent Safe Harbor based on materiality.

Brazil has chosen to use Brazilian GAAP in all cases, even when the Brazilian entities are part of an MNE Group that consolidates based on a different GAAP. The Brazilian QDMTT is not a QDMTT Safe Harbor, meaning the Ultimate Parent Entity (UPE) or a Partially Owned Parent Entity (POPE) will still need to calculate Pillar 2 for Brazil. This may cause an additional burden in terms of calculating the Brazilian jurisdiction with different GAAPs. However, Brazilian GAAP is very similar to IFRS, so the differences might not be significant.

US MNEs with operations in Brazil will need to account for how the rule will impact their Pillar 2 strategy and compliance. As with other jurisdictions that have implemented Pillar 2 rules, companies should evaluate their financial statements to determine whether one of the Transitional CbCR Safe Harbor tests will be satisfied for Brazil and consider opportunities to minimize the impact of any potential top-up tax. Given the dynamic environment and pending guidance, they will also need to monitor developments, especially in cases of incentives or the introduction of new Qualified Refundable Tax Credits (QRTCs).

Specific Topics Already Identified for Pillar 2 in Brazil

Although the Brazilian Pillar 2 rules are closely aligned with the Model Rules, Commentary, and AGs, the interactions between the new system and existing local tax rules are expected to create some friction. In Brazil, some of the main issues identified so far are as follows:

a) M&A Transactions: The Model Rules generally do not recognize any accounting adjustments from purchase accounting. This means that goodwill and fair value step-up of assets/liabilities recorded due to a business combination will not be allowed to generate any effect in the calculation of the minimum tax. In Brazil, however, there is long-standing legislation that grants the acquirer, in a business combination, the right to amortize and deduct, for income tax purposes, goodwill and fair value step-up if the acquired entity is merged into the buyer (or vice-versa) and certain requirements are met. This amortization will not be allowed to produce effects in the Model Rules, which can significantly impact ETR. Additionally, the normal Brazilian mechanism to take the goodwill and step-up deductibility – the two-step structure with the acquisition of a legal entity and then a merger conducted at book value – may create even more problems since the merger can, due to guidance contained in the June 2024 AG, generate Pillar 2-specific deferred tax assets that potentially cause a one-time impact to the ETR upfront. The issue arises when, in a “full Pillar 2” year following the transitional period, a group conducts the merger of an acquired entity into the acquirer or vice-versa to obtain tax amortization of goodwill and step-up. In such cases, the GloBE carrying value of the goodwill and step-up remains zero, as these amounts are excluded from any Pillar 2 calculations. Conversely, the local tax basis for these items is adjusted to their full accounting value, creating a discrepancy between the GloBE carrying value and the local tax basis. This discrepancy may result in a DTA (specifically for Pillar 2 purposes) based on the difference between the two bases. This DTA essentially encapsulates the entire effect of the goodwill and step-up amortization upfront for Pillar 2 purposes, significantly affecting the ETR. If the ETR becomes negative due to this DTA in the merger year, which frequently occurs given the magnitude of M&A transactions, the MNE group can utilize the Negative Tax Expense Carry-Forward mechanism to mitigate the impact. However, they will likely lose part of the tax benefit associated with the goodwill and step-up amortization. Taxpayers must be aware of this possible effect and carefully monitor how the June 2024 AG may be incorporated into Brazil QDMTT when structuring M&A transactions in Brazil.

b) Interest on Net Equity (INE): INE is a commonly used mechanism in Brazil to reduce the tax burden of local entities, especially when the shareholders are individuals or foreign entities. INE is deductible in Brazil at 34% and taxed at source at 15%, creating an opportunity for arbitrage. However, INE does not affect the accounting income or loss as it is considered a form of profit distribution. The RFB actually inserted a specific rule in the law to address the INE and make sure that the effect is as described, i.e., no reduction to the accounting profit or loss and a reduction to the covered taxes. Therefore, the payment of INE will result in a reduction to the ETR for Pillar 2 purposes and needs to be carefully evaluated to avoid payment of top-up-tax.

c) Regional Income Tax Incentives: Brazil has constitutionally established the ability to adopt income tax incentives to reduce the development inequality among regions. Because of that, there are certain income tax incentives that can reduce the nominal income tax rate from 34% to 15.25%, just above the Model Rules’ minimum threshold. However, the ETR in such cases may easily be lower than 15%, generating the need to pay top-up tax. These regional income tax incentives are not qualified refundable tax credits as per the current design, but Law #15,079/2024 mentions a programmed change to be implemented no earlier than 2026 to transform them into QRTCs. Until this change happens, these incentives may create friction with Pillar 2 and must be considered in all cases.

d) State Income Tax Incentives: There are numerous cases of State VAT tax incentives that taxpayers have been trying to exclude from the income tax calculation based on certain constitutional principles. This debate has been ongoing for the past decade or so and Courts have in many cases granted the taxpayers the right to exclude the amount of those incentives from the income tax basis. However, a simple exclusion would not qualify as a QRTC, and these incentives are a common issue in Pillar 2 analysis in Brazil as they might significantly reduce the ETR. Law #14,789/2023 tries to address this issue by granting taxpayers the right to take the effect through a mechanism of financial credit designed to be a QRTC. The trade-off is that the amount of credit is not as significant as the direct exclusion, and the procedure is more complicated than the simple exclusion done at the income taxable basis calculation. The impact of direct exclusions versus the QRTC may have extremely different Pillar 2 impacts. Therefore, it is advisable to consider the effect of the minimum tax when deciding on the strategy to approach these incentives and their effect on income taxes.

e) CFC Rules: Brazil has very broad and aggressive CFC rules that generally tax at 34% all accounting profits generated by entities abroad that are either controlled by or affiliated with a Brazilian entity. These CFC rules may be broader in scope than an IIR. The Federal Government is required to present a Project of Law to create an IIR and reduce the scope of the current CFC regime to be more anti-avoidance focused. Until this happens, Brazilian entities applying CFC rules may need to be careful with the possible inefficiencies generated by the two different systems in place with very different rules. Law #15,079/2024 established that minimum tax paid abroad will be creditable by the Brazilian owner within the CFC calculation, but with no further details. While the general mention of this possibility is welcome, the rules for calculating tax credits for Brazilian CFC may reduce the efficiency of this provision or render it entirely ineffective. This is not a problem created by the newly adopted Brazilian QDMTT, but rather an issue that exists even if Brazil had not adopted Pillar 2. Nevertheless, it needs to be considered by all Brazilian companies with subsidiaries subject to Pillar 2 in other jurisdictions.

Ancillary Obligations

Constituent entities are required to comply with additional obligations related to the information needed to calculate the Brazilian Top-Up Tax. These obligations include providing detailed information about their global income, taxes paid, and other relevant financial data. The RFB are still working on regulations to clarify these obligations.

Penalties for Non-Compliance

Law #15,079/24 imposes significant penalties for failing to comply with ancillary obligations. If taxpayers fail to meet these obligations, they may face fines of up to 10% of the company's annual revenue, capped at BRL 10 million. These penalties apply to delays, errors, and inaccuracies in submitting the required information, but may be reduced by 25% to 90% depending on the way the taxpayer handles the mistake or acts to correct it.

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