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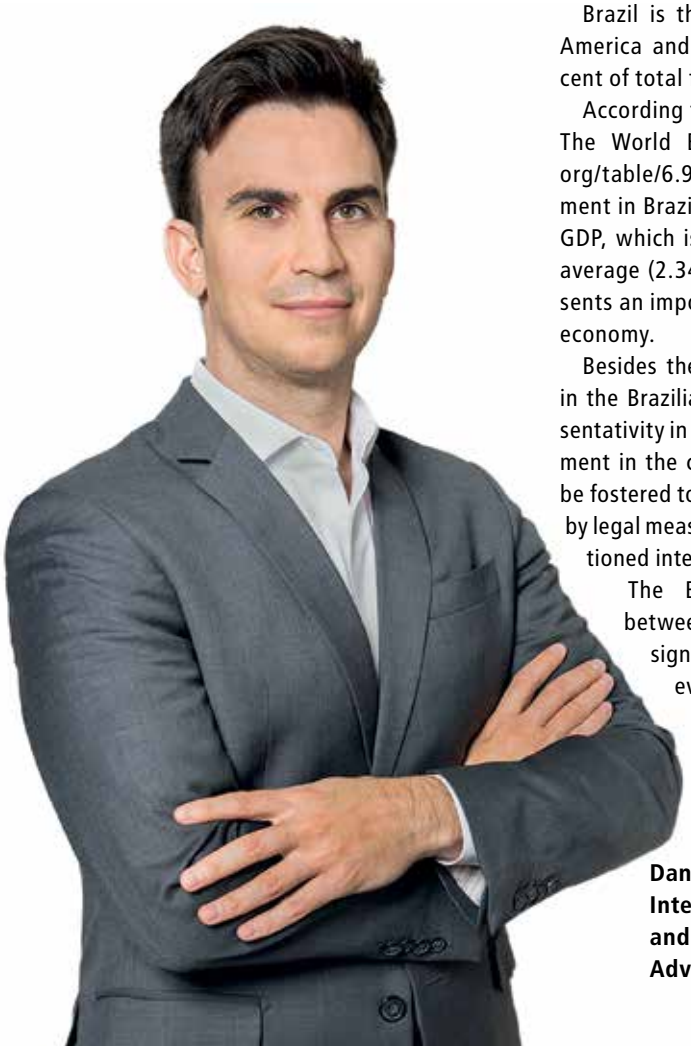
Enhancing Investments and Trade through International Treaties

Since the 1970s, the disagreement between developed countries and developing nations has led capital-exporting countries to increasingly require protection against expropriation carried out by host countries, especially through international treaties.



In this scenario, bilateral investment treaties (BITs) and double tax conventions (DTCs) are generally considered instruments of creating better conditions for investment and trade through liberalization measures in order to attract investments and enhance trade.

Brazil is the largest economy in Latin America and attracts more than 40 percent of total flows to the region.

According to the most recent data from The World Bank (http://wdi.worldbank.org/table/6.9#), foreign direct investment in Brazil corresponds to 3.4% of the GDP, which is higher than the worldwide average (2.34% of the GDP) and it represents an important source to the Brazilian economy.

Besides the important Danish presence in the Brazilian market, the overall representativity in terms of foreign direct investment in the country is still low and could be fostered to assure certainty to investors by legal measures, such as the above-mentioned international treaties.

The Bilateral Investment Treaty between Denmark and Brazil was signed on 4th May 1995. However, in order to be valid and enforceable, this agreement must be ratified by the Brazilian Congress in accordance with the Constitutional rules and the Vienna Convention on the Law of Treaties. The ratification has not been done so far.

Therefore, the BIT Denmark-Brazil is not yet in force and the protections to investors thereby are not applicable. It does not mean that Brazil is not serious about its commitments. But it rather implies that the perspective of the executive power that was committed to the adoption of liberalizing instruments in order to attract investments during the 1990s was not shared by the Brazilian Congress. At that time, there was no clear perception that BITs would have a significant economic impact. In addition, there were many possible incompatibilities between the treaties and the Brazilian Constitution, and severe concerns with respect to state-investor arbitration.

On the other hand, Denmark and Brazil signed the Double Tax Convention in 1974. This DTC has the aim to avoid double taxation and to prevent fiscal evasion with respect to taxes on income. The main rules are dedicated to the allocation of taxing rights between the signatory States, especially regarding profits, royalties, interests, dividends, etc. The DTC has been applied since then and it is an important tool to regulate tax aspects of the bilateral investment and trade relations between both countries.

On 20th February 2019, the Brazilian Congress approved the amending protocol, signed on 23rd March 2011, to the Denmark - Brazil Double Tax Convention

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(1974), by way of Legislative Decree No. 8/2019, as published in the Official Gazette of February 21, 2019.

The Protocol sets out substantial changes in the methods for elimination of double taxation (Article 23 of the DTC Denmark – Brazil). These methods are addressed to the residence state, when the residence state's taxing rights are not excluded and a certain item of income may be taxed in the source state, the provision obliges the residence state to either exempt the income or credit the tax paid in the source state.

First, the new wording of Article 23 of the DTC now foresees the credit method for both situations where a resident in Brazil derives income or owns capital in Denmark and vice-versa. It means that States will need to recognize as a deduction from the tax on the income or on the capital of their residents, an amount equal to the income or capital tax paid in the other State. The former version of the DTC foresaw the exemption method for the income derived from Brazil by a Danish resident.

In practical terms, a few consequences can be identified, such as: (i) Danish residents that derive income or own capital in Brazil should adapt themselves to the ancillary obligations provided by Brazilian Revenue Service in order to have the taxes paid in Brazil acknowledged; (ii) under the credit method only taxes effectively paid in Brazil will be recognized as tax credit in Denmark, which is a broader change in regard to the Brazilian tax policies over the past decades.

Eventual incentives provided by Brazil to attract foreign investment were not relevant for tax purposes in Denmark, since the exemption was assumed regardless of the effective taxes paid.

Now the taxes paid will need to be proved and only this amount will be accepted as tax credit. The maintenance of previous incentives will depend exclusively on Danish domestic law relief.

Second, and maybe the most important change, the new Protocol excluded the so-called "tax sparing clause" foreseen in the former and revoked Article 23, paragraph 4, of the DTC Denmark – Brazil.

The tax sparing clause was a treaty provision that required Denmark to grant tax credits at a deemed withholding tax (WHT) rate for specific payments made by Brazilian residents. The tax sparing credit is usually greater to the WHT rate applicable under the DTC or domestic law, as a tool to incentivize investments (especially in developing countries). In the DTC Denmark – Brazil, tax sparing credit was granted at the rate of 25% only on interests and royalties payments made by Brazilian residents.

This point has been a controversial issue in the Brazilian tax policy and it has been questioned by developed countries. The analyzed Protocol wording is a clear signal of the Brazilian tax policy shifting. The possible negative effect is that this measure could decrease Danish investments in Brazil, if they were exclusively attracted by this incentive.

The last substantial change brought by the Protocol is the repeal of the paragraphs 5 and 6 of the same Article 23. These provisions regulated non-distributed profits and the value of shares issued by corporations, respectively. The repeal aimed to avoid abusive tax planning, especially regarding non-distributed profits of Brazilian subsidiaries in Denmark.

In conclusion, the Protocol is a clear attempt to align the Brazilian tax policy with those of Denmark and other developed countries, but the side effects must be considered by all individuals and businesses immediately affected.

Nevertheless, Brazil should be aware of upcoming market considerations and accurately develop its international treaty network in order to enhance investment and trade in a country which is directly dependent on foreign investments.

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