

INTERNATIONAL TAXATION OF GOODWILL AND INTANGIBLES

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SUMÁRIO. Neste artigo pretende-se enfrentar diversos aspectos tributários derivados da titularidade, da alienação e da utilização de bens intangíveis em geral, e de “goodwill” em especial. Ele está decomposto nos seguintes capítulos: I – Definições. II – Ganho de capital internacional sobre “goodwill” e intangíveis. III – Renda derivada de “goodwill” e intangíveis. IV – Custos ou despesas derivados de “goodwill” e intangíveis.

ABSTRACT. This article seeks to discuss several tax aspects related to the ownership, transfer, and use of intangibles in general and goodwill in particular. It is divided into the following chapters: I – Definitions. II – International Capital Gains from Transfers of Goodwill and Intangibles. III – Income from Transfers of Goodwill and Intangibles. IV – Costs and Expenses from Transfers of Goodwill and Intangibles.

I - DEFINITIONS

In order to address the subject of international taxation of goodwill and intangibles we must first define the terms and concepts currently employed in Brazil in light of the recent changes in Brazilian accounting practices, aligning them with international standards, and identify in which cases some accounting concepts are not compatible with those provided for in our tax legislation.

To this end, I will begin by stating that the English word “goodwill” will be used here for the corresponding term in Portuguese, “*fundo de comércio*”, which in turn has the same meaning as “*fonds de commerce*” in French, “*aviammento*” in Italian, and “*azienda*” in Spanish, among other equivalent terms.

Any student of Brazilian law knows that legal scholars are not unanimous on the meaning of “*fundo de comércio*” itself, though there is a general notion that it represents a set of assets, in the sense of useful factors which an enterprise or entrepreneur may use in

the course of doing business. There is no strict definition, however, by legal norm¹, and there are doctrinal discussions as to what is or is not included in the set.

Likewise, the science of accounting has addressed “*fundo de comércio*” in a peculiar manner, at least as the Portuguese term is seen as a synonym for the English “goodwill”. I say that it is a synonym because the English term has already entered our current vocabulary and has almost become an accepted Anglicism that may be written in Portuguese without the use of quotation marks.

In fact, for accountants not just in Brazil, but also abroad, goodwill corresponds to the very product itself that may result from operating a business. In this regard it is the equivalent of what Brazilian corporate income tax law refers to as “expectations of future earnings”. Nevertheless, Prof. Eliseu Martins and Prof. Sérgio de Iudícibus are exact in their analysis of art. 20, par. 2, letter “b” of Law Decree 1,598 (1977) that alludes to expectation of future earnings. They write:

“Letter ‘b’ is exactly the same as goodwill, or better stated, it is the proof of the existence of factors and synergies that result in the same. Earnings are not the same as goodwill, but the consequence of the innumerable factors and synergies that have been tentatively and partially listed above. But both of them are totally related².”

The factors to which they refer derive from the following notion which they ascribe to goodwill, after transcribing the concept of “avviamento”: *“This concept is always linked to the capacity to generate abnormal profits due to customer loyalty[;] location[;] image[;] reputation[;] branding[;] monopoly power[;] technology[;] quality of the sales force, management, production, or other personnel[;] training[;] advertising[;] and almost always synergy between these and other factors.”*³

Some Brazilian dictionaries define the word “*fundo de comércio*” with the word “goodwill”, and vice versa, as does Manoel Orlando de Moraes Pinho⁴ who translates “goodwill” into Portuguese as: *“ ‘Fundo de comércio’; those intangible assets, such as the value of good customer relations, high employee morale, a good reputation in the business community, a good location, etc., which exceed the tangible net assets of an enterprise.”*

Therefore, even in our own language, “*fundo de comércio*” requires a conceptualization and, in its use for eventual tax purposes at the international level, it is appropriate to identify the Portuguese term with the English one.

¹ Perhaps the closest thing to a definition that one may find in express Brazilian law is the concept drawn from the old Decree 24,150 and the current Law 8,245, which will be mentioned shortly.

² MARTINS, Eliseu and IUDÍCUBUS, Sérgio de, “Intangível – Sua Relação Contabilidade/Direito – Teoria, Estruturas Conceituais e Normas – Problemas Fiscais de Hoje”, in “Controvérsias Jurídico-Contábeis (Aproximações e Distanciamentos)”, 2nd volume, Ed. Dialética, São Paulo, 2011, p. 69, excerpt from p. 77.

³ Ibid., p. 75.

⁴ PINHO, Manoel Orlando de Moraes, “Dicionário de Termos de Negócios”, Ed. Price Waterhouse and Altas, 1995, pp. 85 and 242.

Thus, I will begin by turning to the definition of the term in *Black's Law Dictionary*⁵ which defines goodwill as: “A business’s reputation, patronage, and other intangible assets that are considered when appraising the business, esp. for purchase; the ability to earn income in excess of the income that would be expected from the business viewed as a mere collection of assets. Because an established business’s trademark or servicemark is a symbol of goodwill, trademark infringement is a form of theft of goodwill. By the same token, when a trademark is assigned, the goodwill that it carries is also assigned.”⁶

In this definition (which does not collide with the previous ones) we may see that goodwill corresponds to intangible assets that are taken into account in appraising the value of a business, including for subsequent sale. It constitutes the possibility of generating income above and beyond that which would have been possible in the same business if it were seen as a mere conjunction of assets. However, to my mind, especially the final part of the definition clarifies even more that goodwill is not necessarily an isolated asset, but several assets, and ones that are always intangible.

The same notions also appear in “*Gilbert Law Summaries – Law Dictionary*”⁷: “GOOD WILL: An intangible asset which represents the favorable attitude of clients or customers of a business toward the operation of the business; the value of a business enterprise, above and beyond the value of the business’ tangible assets, which represents the enterprise’s reputation with the public and its managerial ability.”⁸

These definitions also lead me to the conclusion that goodwill also depends on the expertise a businessman exercises in uniting the collection of assets which will provide him or her the capacity to produce a profit greater than that possible from the mere asset collection itself and absent that management ability.

We may even note that the capacity to manage a business is at the heart of the legal definition of a businessman as spelled out in art. 966 of the Brazilian Civil Code. It reads: “A businessman shall be considered as one who professionally engages in organized economic activity for the production or circulation of goods or services.” The sole paragraph of that article reads: “A person is not a businessman if he engages in an intellectual profession of a scientific, literary, or artistic nature, even if aided by assistants and coworkers and except if the exercise of said profession constitutes an element of the enterprise.”

⁵ Brian A. Garner Editor, Eighth Edition, p. 715.

⁶ My translation of this definition into Portuguese is: “Uma reputação comercial, clientela, e outros intangíveis que são considerados quando da avaliação de um negócio, inclusive para sua aquisição; a habilidade de produzir renda em excesso à renda que seria esperada do negócio visto como um mero conjunto de bens. Porque uma marca registrada de um negócio estabelecido ou uma marca de serviço é símbolo de ‘goodwill’, a violação dessa marca é uma forma de apropriação ilegal de ‘goodwill’. Pela mesma razão, quando uma marca é transferida, o ‘goodwill’ que ela carrega também é transferido.”

⁷ Harcourt Brace Legal and Professional Publications Inc., p. 131.

⁸ My translation of this definition into Portuguese is: “Um ativo intangível que representa a atitude favorável de clientes e compradores de um negócio a respeito da operação do negócio; o valor de uma empresa, acima e além do valor dos ativos tangíveis do negócio, que representa a reputação da empresa perante o público e sua habilidade gerencial.”

In other words, a businessman is not an enterprise, just as the material and intangible assets that compose it are not goodwill. However, it is he who organizes those goods and an enterprise's economic activity and who engages in that organization (as an "element of the enterprise") its very professional capacity.

Thus, the businessman identified in the Code is not the same as the owner or partner of an enterprise, acting in that condition, but the person who exercises the professional activity of the enterprise, whether or not he is an owner or partner. This is why it is significant if he receives any compensation for his or her work, independent of any gains he also receives as a function of his or her holding title to the capital being used by the enterprise (or part of that capital, if any exists). In fact, the capital is used in the legal entity that operates the enterprise as its corporate purpose.

This is where the knowledge and experience of a businessman in the management of an enterprise arises. The word "enterprise" in Portuguese has many meanings (even as it is used in its legal sense). Among these are that of an establishment, not understanding that word as a mere physical location where the enterprise is located (as an enterprise may be located in several places, that is, composed of several establishments), but understanding an "establishment" as a complex of assets that are used in the operation of an enterprise. This sense of the word also brings us back to the Civil Code where it is defined in art. 1,142: "*An establishment shall be considered as a complex of assets which a businessman or business company organizes for the operation of an enterprise.*"

In this particular sense, therefore, an enterprise corresponds to an economic undertaking and the words establishment or enterprise come close to the concept of a "going concern"⁹: "*A commercial enterprise actively engaging in business with the expectation of indefinite continuance.*"¹⁰

However, an establishment may include much more than goodwill and generally does. In addition to goodwill, it may have the use of other assets, both those that it owns and those owned by third parties who have granted it the use of their assets. These may include the building where it is located and its furniture, equipment, machines, and stock. Therefore we may speak of the establishment by itself or only of its goodwill; one does not necessarily have to be accompanied by the other.

It is curious to note that, even though a businessman is not to be confused with any of the other assets of an enterprise, principally with regard to its intangibles, his or her expertise may be an element of the enterprise such that, in the last analysis, the maintenance of that expertise at the enterprise may represent a part of its goodwill and may be taken into consideration when appraising the latter. What I mean to say is that an enterprise may be worth more while a given individual is a part of it, acting as a businessperson, and who is capable of making it operative and profitable beyond the level which others would be capable of. This is why in various business transfer and combination agreements there are specific clauses mandating that certain individuals remain with the enterprise, at least for a certain number of years.

⁹ Ibid. p. 712.

¹⁰ My translation of this definition into Portuguese is: "Uma empresa comercial ativamente engajada em um negócio com a perspectiva de continuação indefinida."

It is well known that in medium-size and large corporations two or more businesspersons are usually active, participating on their boards of directors or executive committees and holding specific titles for their positions that vary according to use and custom. They are all “businesspersons”, though, according to the legal sense of that word as it is used in Brazil.

In short, businesspersons manage legal entities and their enterprises, enterprises (or establishments) that are made up of organized sets of material and non-material assets used in an organized fashion (by businesspersons) in the carrying out of economic activities and, obviously therefore, in the pursuit of profit.

Among a legal entity’s assets, there are the corporeal ones destined for use in the enterprise’s activities. Brazilian law—Law 6,404 (1976), as amended by Law 11,638 (2007) and Law 11,941 (2009)—classifies and denominates these as “premises and equipment”, that are tangible fixed assets (art. 179, item IV¹¹), in contrast to non-material assets, classified and denominated as “intangible assets” (art. 179, item VI¹²). It is important to keep in mind that both groups of assets do not constitute the totality of a legal entity’s property as they only include those assets destined for use in the entity’s economic activities, that is its non-current assets that may be identified as its “permanent assets” or fixed assets. However, besides those assets there are other material and non-material assets that constitute the objects to be placed in economic circulation (raw materials, intermediate products and packaging, manufactured products and merchandise for resale, services, etc.). This second set of assets, which compose the entity’s current assets and long-term receivables, are just as much a part of the entity’s business property as other rights in its current assets (such as cash on hand, bank accounts, accounts receivable, etc.). Finally, there are the obligations reflected in its current liabilities. (The mathematical difference between all of an entity’s assets and liabilities constitutes its net equity or non-current liability.)

This brief incursion into the accounting classifications required by Brazilian law is particularly important to the matter at hand as it allows us to see that, at least at this level, material assets are not part of an entity’s goodwill. Goodwill is part of an entity’s intangible assets, together with any other intangible assets that may be identified and considered separately—and even appraised separately. Corporeal assets are part of an entity’s premises and equipment.

By this means and for this purpose, the law takes sides in the doctrinal controversy, given that several Brazilian scholars have argued that goodwill includes all of the material and non-material assets of an enterprise, to the extent, in fact, of being easily confused with the enterprise or establishment itself.

¹¹ “IV – in the premises and equipment: the rights regarding corporeal assets used in maintaining the activities of the company or enterprise or exercised for that purpose, including those arising from transactions which transfer to the company the benefits, risks, and control of said assets;”

¹² “VI – in intangible assets: the rights regarding incorporeal assets used in maintaining the company or exercised for that purpose, including any goodwill acquired.”

But this is not the case. Indeed, goodwill may even be considered as not to include assets (utilities) that may be separately identified and appraised, but rather as a complex of assets that depend on each other in order to generate an enterprise's profits. Even the synergy of an enterprise's intangible assets may form part of its goodwill.

It should be noted that in the world of accounting there is no dispute as to the fact that tangible assets are not a part of goodwill. This is true to the point that Eliseu Martins and Sérgio Iudícibus have stated goodwill is the most intangible of all of the intangibles¹³.

Let us think more about what goodwill is and introduce some new notions in this regard, as well as in regard to the non-material assets (or intangibles) that an enterprise may work with.

Goodwill may be represented by a single asset if that asset is fundamental to the enterprise which uses it and the businessman managing it. Generally speaking, however, goodwill cannot be reduced to a single asset but usually presents itself as a set of non-material assets, instrumental in character, which a businessman uses in the exercise of business activities.

Thus, it is not a question of looking at the available assets considered individually, but rather one of seeing goodwill as an organized set, organically available for the enterprise's use, either by the whole enterprise or by one of its sectors, as it may be useful to the whole company and tied to more than one establishment, but may also serve only one or another establishment. This is principally so when the same legal entity is involved in more than one activity (in as much as multiple enterprises may be united in a single legal structure, that is, multiple concerns). For the same reason, it is possible to find multiple sources of goodwill in a single corporation spread out over more than one location, especially if it is engaged in distinct activities.

Therefore, after removing material assets from possible inclusion in goodwill, we will find a set of non-material assets that form part of (but without exhausting) an enterprise's means of production. Among these are its technical knowhow; the intellectual property rights it owns or licenses, including any brands, logos, and industrial designs; the confidence of its customers; its customers themselves; its operational expertise as it is disseminated throughout its workforce and not restricted solely to its businessman staff; its strategic location for its business activities, and many others which will obviously vary from company to company.

Of the several components of goodwill, I wish to highlight two: strategic location and brands.

An enterprise's strategic location, which is often linked to what is known as its "point of sale" or "retail location", may be essential to its business, either due to the state of the supplier market (including specially skilled labor) or due to the consumer market, especially for retail sales but also for other economic activities. After all, an enterprise should keep its clients or customers as close as possible in order to take their orders, execute their demands, or even provide post-sales service. This is due to the multiple obligations arising

¹³ Ibid., see p. 85.

out of supplying its products, including freight and insurance, warranties, and any technical assistance it offers in the installation or use of its products.

The geographic location of a business may be so important that property owners leasing out privileged locations began to charge an additional premium (or “key money”) for access to those locations, and leaseholders may also charge such premiums to assign their leases to new tenants. The old “Key Money Act” (Decree 24,150 (1934)) prohibited this practice (art. 29), and this prohibition was maintained for any amendments to or renewals of a lease agreement by art. 45 of Law 8,245 (1991) that replaced the “Key Money Act”.

It is worth considering some of the recitals of Decree 24,150 as they link a business’s location to the concept of goodwill and then further relate the latter to that of intangible assets:

“Whereas there is a universally felt need to regulate the relations between landlords and tenants based on uniform principles of equity, imposing the institution of specialized laws as has been imposed by persons of the highest legal education; Whereas, as this necessity has generally made itself manifest and become even more essential in the case of those establishments destined for use in commerce and industry, wherein the incorporeal value of goodwill may be partially integrated into the value of the property, carrying with it benefits to the landlord from the work of others; Whereas it would not be fair to attribute this quota of wealth solely to the landlord to the detriment, or better, the impoverishment of the tenant who created it;...”

Therefore, the decree begins with the supposition that an intangible asset exists known as goodwill. It goes on to state that, though goodwill is developed by the tenant, it results in a rise in the value of the property which does not belong to him and even adds that rise to the property’s long-term value, effecting future commercial users of the same location. Furthermore, the decree guarantees compensation for the tenant for any losses he incurs in being obliged to move due to his inability to renew his lease, and it does so precisely when it refers to goodwill and ties the latter to the retail location. That compensation is owed to the business owner who had to move in part due to the *“devaluation of [his] goodwill”* (art. 20).

The current law, Law 8,245, contains like provisions including art. 51 which guarantees the renewal of lease agreements for properties destined for commercial activities under certain conditions laid out in the law. Paragraph 2 reads: *“When an agreement shall authorize a tenant’s use of the property for the activities of the company of which he is part and this comes to form part of his goodwill, the right to renew may be exercised by the tenant or his company.”*

That is, par. 2 acknowledges that goodwill exists and may be transferred from the tenant to a company of which he is a part. Though it does not state it expressly, it implicitly recognizes that the right to lease the property is a part of goodwill.

Continuing on, art. 52 of the same law lists the cases in which a landlord is not obliged to renew a lease. Item II of art. 52 reads as follows: *“If he comes to use the property*

himself or in a transfer of goodwill existing for more than one year, provided that he, his spouse, and his ascendants and descendants hold the majority of the capital.” But, even in such a case, *“The property must not be destined for use in the same activity as that of the tenant, unless the lease agreement also included the goodwill together with the facilities and appurtenances”* (par. 1).

Here, then, the law brings the lease of the property even closer to goodwill and the latter closer to the former’s facilities and appurtenances, that is when the lease covered the establishment itself.

Another provision of Law 8,245, also in art. 52, is par. 3 which states: *“The tenant shall be entitled to compensation to reimburse him for losses and lost profits which he shall have incurred with his move, loss of location, and devaluation of goodwill if a renewal is not granted due to an offer under better conditions of a third party or if the landlord, within three months of the property’s delivery, does not use the property as alleged or begin the improvements determined by the public authorities or which he himself stated he intended to make.”*

The case of a refusal to renew a lease due to a better proposal from a third party is also addressed in item III of art. 72, on which basis art. 75 mandates that a judge set the level of compensation and establishes the joint liability of the landlord and the third party proposer.

In sum, the location of an establishment may represent an integral part of its goodwill and the loss of that location may result in a devaluation of the goodwill remaining, given that it will have to be used in a new location.

The second group of intangibles which may form part of goodwill and which I wish to address here are brands (be they industrial, commercial, or for services), whether or not they are accompanied by a logo.

Their importance is such that international evaluation agencies attribute value exclusively to brands, without placing any great or sometimes no importance on the other elements of the enterprises that hold them.

In such a theoretical study, brand recall is particularly relevant as it brings two important aspects to light.

The first aspect is that a brand, like any other intangible, may be transferred. If this were not the case, no brand or any other intangible would have a market value.

This means that, in theory, any intangible may be transferred to another person without the corresponding transfer of the enterprise or establishment(s) in which it had previously been used. That enterprise or establishment may continue in existence even after the loss of part of its potential for profitability, a loss that may be lesser or greater depending on the relevance of the intangible that it ceases to own. It is this situation, the enterprise continuing after the loss of an intangible forming part of its goodwill, that Law 8,245 addressed in its factual hypotheses with regard to a business’s location.

The second aspect is that a brand, like any other intangible, may be transferred in conjunction with the totality of goodwill of which it is a part, in conjunction with only some of the other intangibles making up that same goodwill, or even by itself.

In those cases, as well, the transferor enterprise may continue to exist, though with a likely loss in its profitability.

The important thing, however, is to see the intangible as a singular asset or as a collective asset, a topic to which I will turn in a moment, after illustrating how such things may occur.

Thus, let us use by way of example the brand of a product known around the world but which is tied to a manufacturing formula for that product. This may represent a simple unpatented industrial secret (or know-how) or an internationally registered patent. In our example, the brand's value is tied to the technology behind the manufacture of the product and has no value without such a technology.

On the other hand, there are worldwide brands tied to certain types of products that may be transferred without the concurrent transfer of the technology behind those products. That technology may be in the public domain or simply be known to the competitors of the enterprise transferring the brand. They may use that technology to sell their products under the famous brand that they have just acquired.

Finally, there is still the possibility of the transfer of not only a brand, with or without the underlying production technology, but also of all of the goodwill of which it is a part. In such a case, it is unlikely that the legal entity transferor will be able to continue in existence, at least not in the same area of activity, even when there is no non-compete clause in the transfer agreement. It is also clear that the totality of goodwill may be transferred with the totality of all of the other assets of an enterprise, with only its non-current assets, with only its current assets, or with the totality of the operational business, including its respective liabilities, labor, and other components and elements.

Brazilian law is attuned to the variety of possible situations in the world of business as demonstrated by when, for example, it regulates the tax liability of a successor in interest. The National Tax Code distinguishes between a successor in interest who has acquired the transferor's establishment from one who has acquired only the goodwill, and art. 133 stipulates under what conditions either type of successor may be held liable for the tax debts of the transferor.¹⁴

From this point on, we have only to add a final observation regarding goodwill, one that is linked to everything which has been said up to now.

¹⁴ "Art. 133 – A natural person or private law legal entity which acquires from another, by any means, goodwill or a commercial, industrial, or professional establishment and continues the respective use of the same under the same or another business name or under an individual name or as an individual firm is liable for the levies due as of the date of the act that are related to the goodwill or establishment so acquired: I - fully, if the transferor ceases to engage in any commercial, industrial, or other activity; II – jointly with the transferor, if the latter continues to engage in the same or another area of commercial, industrial, or professional activity or initiates new activity within six months of the date of the transfer."

In fact, if intangibles looked at individually correspond to the legal concept of singular assets, goodwill corresponds to the concept of a collective asset.

According to art. 89 of the Civil Code, *“assets are singular which, though joined together, if considered by themselves, are independent of any others.”*

Thus, each and every intangible asset is a singular asset, even if it is joined with other intangibles in the form of goodwill or even if it is joined with other tangible assets in the same establishment.

Goodwill, on the other hand, is a collective or universal asset as it brings together an organic and functional set of assets for use by the business. It has its own identity even though each of the intangible assets that make it up may be identified as individual singular assets.

Thus, to a certain extent goodwill is similar to factual universals since, according to art. 90 of the Code, *“factual universals are made up of the plurality of singular assets that belong to the same person and have a single unitary destination.”* This is so even though each intangible maintains its individuality and may be the object of its own legal relations¹⁵.

After all, the same occurs in any factual universal and this is why an intangible may be removed from the universal in order to reacquire its singular identity and be the object of any other legal relation, including that of a transfer.

Nevertheless, when goodwill exists through the joining together of several intangibles, it is closer in its legal nature to a legal universal as, according to art. 91, *“a legal universal is made up of the complex of legal relations of a person invested with economic value.”*

The legal relations that form legal universals (*“universitas iuris”*) may have material and non-material assets as their object¹⁶, as may be seen in two well-known examples: inheritance and estates. In this way, goodwill fits the concept perfectly if we perceive that, in fact, much more than being made up of things (assets, even non-material ones), it is a set of rights over assets (rights to property or use), rights which belong to a person (a legal entity that holds them for its business) who uses them for their common and organized usefulness.

As this is the case, goodwill may be the object of a transfer or some other legal relation with its own totality as an objective. In the case of a transfer, it may occur singularly (as in the transfer of rights) or universally (through consolidation, demerger, or some other type of universal succession). Likewise, as goodwill is composed of the rights its owner holds in it, there exists the possibility, indeed the legal guarantee, that it may be the object of

¹⁵ According to the sole paragraph of art. 90, *“the assets which form that universal may be the object of their own legal relations.”*

¹⁶ For example, the object of a legal relation of ownership which is valid *erga omnes* may be a vehicle, a house, a patent, etc.

continued use. Thus, for this reason (and as a requirement), goodwill may be transferred as a collective set.¹⁷

We have already seen that, strictly speaking, goodwill is not the same as an establishment itself as the latter contains (and uses) other assets that are not a part of goodwill, e.g. the building where the establishment is located, the furniture and other assets in its premises and equipment, its current and non-current assets, and much more. Nor is the establishment's building the same as the business's location, though the two are in the same place. It is the location of the establishment that forms part of goodwill due to its situational utility in conducting its business and not the building in itself. Both the location and the building have (or may have) their own values, and these are almost always different.

Following on this thought, if the other intangible assets are in use inside an establishment's building, and are available for the business activity to be conducted there, a transfer may include the two sets of assets (such as a transfer of both the establishment and its goodwill), but it may also only cover one of those sets (such as a transfer of only goodwill and not the establishment or vice versa). Also, the establishment's building may be transferred without the establishment itself, in which case it would move to a new location. Finally, establishments may even be sold which, due to their peculiar circumstances or economic activity, have no identifiable goodwill.

It is clear that any tax liability will depend on the concrete factual situation existing in each case.

To end this section on definitions, it should be noted that the expression "goodwill" should be understood in ordinary income tax legislation as a universal set of intangible means when that legislation refers to the economic basis for premiums or discounts which may occur in the acquisition of capital shares subject to equity method appraisal (Law Decree 1,598 (1977), art. 20, par. 2)¹⁸.

The legal and fiscal analysis of the possible basis for a premium or discount registered in the acquisition of such an investment is also useful as it once again reflects legal recognition for the variable economic and business scenarios which are possible. For tax purposes, such an analysis also establishes that:

¹⁷ The Civil Code does not address goodwill transfers and is silent on the question. But in line with what has been argued here, the Code governs the assets of an establishment and the possibility of their transfer, namely: "Art. 1,143 – An establishment may be the object of unitary rights and legal events which modify or constitute it and which are compatible with its nature. Art. 1,144 – An agreement for the transfer, use, or lease of an establishment shall only produce effects with respect to third parties after the addition to the margin of the businessperson's or the company's registration in the Public Commercial Companies Registry of a notice published in the Official Gazette."

¹⁸ "Paragraph 2 – The registration of a premium or discount must indicate, among other things, its economic basis: a) the market value of the goods of the controlled or associate company greater or lesser than the cost registered on its books; b) the amount of earnings of associate or controlled companies based on a forecast of future expected earnings; c) goodwill, intangibles, and other economic grounds."

- goodwill is not the same as other types of assets belonging to the target company (nor even the market value of those other assets), goodwill being listed in letter “c” and the other assets in letter “a” of par. 2, art. 20;

- goodwill is not the same as other intangibles which may be distinguished and separately appraised as letter “c” mentions goodwill separately from those other intangibles; and

- goodwill is not to be confused with the expectation of future earnings as the latter is listed in letter “b” and the former in letter “c”.

Indeed, with regard to this last distinction and given all of the previous arguments, we may conclude that goodwill, separately identifiable intangibles, and any other of an enterprise’s assets are all means by which it may generate profits. The expectations of those profits will necessarily depend on the previously mentioned elements just as much as on the other means of production without being one and the same as those elements. In other words, the tax treatment of a premium or discount based on expectations of future earnings should not be confused with that called for when the economic basis for such a premium or discount is goodwill or a specific intangible asset, especially since an expectation of future earnings may exist even when separately identifiable intangibles do not.

II – INTERNATIONAL CAPITAL GAINS FROM TRANSFERS OF GOODWILL AND INTANGIBLES

The term international taxation refers to taxes that may be levied on transactions that extend beyond the borders of a single competent tax jurisdiction, either in accordance with rules applying specifically to such taxes or in line with international norms arising from conventions between jurisdictions to avoid double taxation.

Thus, international taxation may cover earnings from a transaction carried out in a country different from that in which one or both of the parties reside. It may also cover a transaction involving an asset situated in a jurisdiction other than that of one or more of the parties. Finally, international connection may be the nationality of the parties.

We shall not attempt to analyze the laws of any country other than Brazil nor one or another specific treaty between Brazil and another state. Rather, we shall consider taxation as it is applied under Brazilian law and in accordance with the OECD Model Convention¹⁹, the latter due to its generalized use as a basis for several agreements that Brazil has entered into.

Starting from the Convention, and staying within the limits of this analysis, it should be noted that capital gains from the transfer of intangible assets (Article 13) are:

- similar to capital gains from the transfer of personal property and may be taxed by the Contracting State in which the permanent establishment is located whose business the intangible assets are a part of; the same is true if those assets are transferred along with the establishment as a whole (Paragraph 2) or with its goodwill.

¹⁹ OECD website, consolidated as of July 2010.

- only taxable in the Contracting State in which the owner of the assets resides (Paragraph 5, which refers to the transfer of all other types of property not included in the other paragraphs, the case of intangibles which are not otherwise listed in the other paragraphs).

When Brazil is entitled to the tax in question and the transferor is a legal entity residing in Brazil (or a permanent establishment in Brazil belonging to a legal entity located abroad), regardless of who the buyer is or where he resides, the capital gain adds to the earnings subject to corporate income tax levied at a total rate of 34%²⁰. In the event that the recipient of the capital gain is a natural person resident in Brazil, the general rate is 15%.

Likewise, if the transferor is a natural person or legal entity residing abroad and Brazil is entitled to tax the capital gain, income tax will be withheld at a rate of 15%.

In the event that the asset in question is located outside of Brazil, but Brazil is not barred from taxing the capital gain, said gain will only be taxed if the transferor is a natural person or legal entity residing in Brazil and the rates will be the same 15% and 34% mentioned above.

If the capital gain is subject to income tax in the country of origin, there will be a foreign tax credit in Brazil, in all cases if the party registering the gain is a legal entity and upon certain conditions if the party is a natural person. Those conditions are that there be a tax treaty between Brazil and the country of origin or, when there is no treaty, that the latter extends similar tax credits to its residents when their capital gains are taxed in Brazil.

In the event that taxation by Brazil is not disallowed and the asset in question is located in Brazil, Brazil may tax the capital gain registered by a person residing abroad. In this case Brazil may also tax natural persons and legal entities residing in Brazil (as well as any permanent establishment a person residing abroad may have in the country), but that taxation would not be due to any tax treaty, nor would it involve international taxation.

Another interesting case is the taxation of persons not residing in Brazil when they transfer assets located in Brazil, when Brazil is entitled to such taxation. In such cases, there is no difference between a natural person or legal entity transferor and the levy applied is a 15% withholding tax on the capital gain.

In both of the above cases involving taxation in Brazil, the cost of acquisition of the transferred asset, if there is any cost, must be identified and proven at the risk of the tax being levied on the gross capital gain, equal to the price of the transference. In the case of investments in cash or goods in order to pay in for subscribed shares in a Brazilian legal entity, the amount invested must be registered with the Brazilian Central Bank and that registration is proof of the cost of acquisition.

²⁰ In Brazil, the tax covering capital gains is income tax as there is no other specific or distinct tax on them. Furthermore, the rate of 34% is the total from two distinct taxes, income tax per se and Net Profits Contribution Tax (NPCT).

Furthermore, it should be noted that the 15% rate applicable in all of the above hypotheses involving persons not residing in Brazil becomes a 25% rate when the taxable capital gain is registered by a natural person or legal entity residing in a country or jurisdiction which does not routinely tax income or in which the maximum rate applied is less than 20% (Law 10,833 (2003), art. 47)

Regarding liability for payment of the withholding tax on capital gains, payable at the moment of transfer, the transferee is liable for the tax. If the transferee is not informed that the transferor is a person residing abroad, the transferor's agent in Brazil is then liable (1999 ITR, art. 685, par. 2).

In addition to this general rule, there is another special rule. If a natural person or legal entity transferee is resident in Brazil, that person is liable for the tax, but if the same person resides abroad, the agent is liable. This provision is in art. 26 of Law 10,833 which reads: *"A transferee, whether a natural person or legal entity, resident or domiciled in Brazil, or the agent of the same when the transferee is resident or domiciled abroad, is liable for withholding and payment of the income tax on capital gains referred to in art. 18 of Law 9,249 (26 Dec. 1995) and earned by natural persons or legal entities resident or domiciled abroad who transfer assets located in Brazil."*

It should also be noted that art. 18 of Law 9,249 stipulates that *"capital gains earned by persons resident or domiciled abroad shall be calculated and taxed in accordance with the rules applicable to persons residing in [Brazil]."*

From this series of norms we may extract the following rules:

- The transferee of a transferred asset is liable for the tax when said party is a natural person or legal entity resident or domiciled in Brazil; or
- The agent is liable for the tax when the transferee is not resident or domiciled in Brazil.

Thus, under these rules, taxation in Brazil is possible even when both parties to a legal event are resident or domiciled abroad, provides that the object of the tax is a capital gain arising from an asset located in Brazil. Before the advent of art. 26, all aspects of the tax-triggering event were provided for by statute, but there was no means to seek payment from persons outside the jurisdiction of Brazilian law. Art. 26 completed the norm establishing the tax by attributing tax liability to a person resident in Brazil, that is, to the natural person or legal entity transferee or to the latter's agent, resident or domiciled in country, if said transferee is also not resident in Brazil.

By this means it became possible to tax the capital gains earned by persons resident or domiciled abroad and arising from assets located in Brazil, whether or not the respective transactions are conducted inside or outside of Brazilian territory.

However, art. 26 is vague as to the figure of the agent who is liable for the tax due as it does not specify which party's agent is being referenced and with what powers an agent must be invested in order to be held liable for the tax obligation on the capital gains of an asset transferor resident or domiciled abroad.

This provision also does not state that said agent must be resident or domiciled in Brazil, but this condition is inherent in the factual and legal situation covered by the norm as a person not subject to the jurisdiction of Brazilian law could not be compelled to comply with a tax obligation in Brazil, at least not in practice and in the majority of cases.

As to which party's agent is liable, the law's silence on the matter would naturally lead one to the understanding that it may be either party's agent. But this can not be the case as who is the taxpayer must be clearly defined by law and, unless the transferor and transferee are jointly liable, the liability for the tax may not be randomly assigned to one or another person at the discretion of the tax authorities.

Moreover, specifically with regard to income tax withholding, the sole paragraph of art. 45 states that liability for payment must be attributed to the source of the funds, such that the agent of a person who is not the source of the funds is at a much greater distance from any liability.

Art. 26 of Law 10,833 itself is categorical in establishing the liability of the agent when the transferee is resident or domiciled abroad, a fact which seems to lead to the conclusion that the agent in question is that of the transferee who is also the source of the funds.

Thus, when a transferee is not resident or domiciled in Brazil, the only agent liable for the tax is that of the transferee who receives the asset located in Brazil because only the transferee has the duty to effect payment for the asset, from which funds the tax owed may be deducted.

As to the extent of the powers of the agent liable for the tax in the course of the legal relation in question, such an agent may not be that nominated by the transferee resident or domiciled abroad for any act in the latter's name. Rather, it must be the agent specifically nominated to execute the act of acquiring the asset located in Brazil. This is so due to art. 128 of the National Tax Code, according to which the party liable for the tax must be a third party "*related to the tax-triggering event of the respective obligation*", that is, a person linked to the material situation constituting the tax-triggering event.

Furthermore, this requirement is based on a larger principle of Brazilian (and international) tax law which is that only those persons capable of contributing to the public treasury may be called upon to do so. This is why, for example, the person who is the source of the funds may be held liable for the tax in question as that person is directly linked to the tax-triggering event by paying or crediting income to the respective beneficiary. That same person has the right and the effective means to deduct the income tax owed by the beneficiary from the respective payment. The latter then has the corresponding contributive capacity and is the taxpayer.

Therefore, the agent alluded to in art. 26 must be equally capable of being liable for the tax through the use of the funds that the agent's principal owes to the transferor of the asset, at the very least as said agent participates in the act of acquisition of that asset.

In addition, art. 134, item III, of the National Tax Code makes persons administering the assets of third parties liable for the taxes owed by the latter. This demonstrates that the contributive capacity must be that of the person with power over and control of such assets. This is so because, in such a case, the Code (in the heading of art. 134) only allows for third-party tax liability precisely “*in cases in which it is impossible to enforce the taxpayer’s compliance with the principal obligation.*” The situation provided for in art. 26 is just such a case.

Finally, art. 135 also authorizes holding representatives personally liable for the taxes owed, as well as the persons alluded to in art. 134 (item I), but only when they exceed the powers granted to them or violate the law or their company’s bylaws.

In short, we may conclude that the agent residing in Brazil of a transferee residing abroad is liable for the tax and the liability of that agent is conditioned on his effective participation in the transfer of the assets.

Before leaving the topic of capital gains, we must first address the legal regime in Brazil governing transfer pricing. This regime is laid out in art. 18 and following of Law 9,430 (1996).

Different from the laws of other nations, Brazilian law lists specific and unavoidable methods for determining comparison values for the prices parties practice²¹. The tax authorities and taxpayers alike must employ those methods, even if the latter show that the prices and payment conditions they used are compatible with what independent third parties would have done under the same circumstances or if the tax authorities show the opposite is true.

Those methods set the limits on the maximum amounts deductible and the minimum taxable prices which may be practiced in transactions between related parties. They also apply to parties, even when unrelated, who are resident in countries or jurisdictions which do not routinely tax income or which tax it at a maximum rate of less than 20% or which guarantee the confidentiality of an enterprise’s owners and shareholders or which practice some other favorable tax regime²².

Additionally, the prices of transfers abroad are only controlled when they are less than 90% of the prices that the same transferor practices in the domestic market for the same assets. If the transferor does not sell such assets locally, transfer prices are controlled if they are less than 90% of domestic prices for similar assets that third parties practice.

This 90% standard practically invalidates any transfer pricing controls on transfers abroad of intangibles (including goodwill) by legal entities in Brazil. This is due to the difficulty in identifying internal transactions that may serve as parameters for transfers abroad.

Even if such a comparison were possible at least in theory, and the result of the comparison lead to the inescapable conclusion that the prices in question did not meet the 90% standard, the minimum price control could only be established using one of the methods

²¹ There are three methods for foreign acquisitions and four methods for transfers abroad.

²² All of the conditions referred to here generally are minutely detailed in the law.

specified by statute, that is, the Cost of Acquisition or Production plus Taxes and Profits Method (CAP+TP), with a minimum profit margin of 15% over the sum of the costs and taxes.

The other three methods could not be applied as they presuppose an active market for the same assets in Brazilian exports or in the final markets of destination. These practically do not exist when it comes to intangibles.

In short, in the case of transfers of intangibles from persons resident in Brazil to those residing abroad, the transfer pricing controls are largely theoretical.

In general, the same occurs in the case of transfers of intangibles from persons residing abroad to legal entities resident in Brazil.

In fact, regarding the maximum allowable costs for acquisitions abroad, two of the methods are excluded for practical purposes because one presupposes an active market and the other, the resale of the acquired or manufactured good for which the imported asset was part of the cost of production²³. Thus, only the Cost Plus Method (C+) is left, which adds a profit margin of 20% to the cost of production, in addition to any taxes owed in the country of origin.

However, even the Cost Plus Method is difficult to apply in practice due to the inability of the Brazilian tax authorities to determine an asset's foreign cost of production, especially in the case of intangibles, unless there is an information exchange agreement with the country where the transferor is located.

III – INCOME FROM TRANSFERS OF GOODWILL AND INTANGIBLES

According to Article 7 of the OECD Model Convention, earnings derived from the use of intangible assets are added to the earnings of the permanent establishment that receives them in the course of its business, and said earnings may be taxed in the Contracting State in which that establishment is located. Other cases follow under Article 21.

However, if one more specifically considers that a license for use of an intangible asset may result in earnings covered by the broad definition of royalties contained in Article 12, Paragraph 2, of the Convention²⁴, according to Paragraph 1, those earnings are only taxable in the Contracting State in which the asset owner resides. According to Paragraph 3, however, if the royalty earnings are part of the business of a permanent establishment in one Contracting State owned by an enterprise located in another Contracting State, the former state is entitled to the taxes owed.

²³ As the last chapter explains, the acquisition cost of intangibles may only be amortized for tax purposes if their use is limited in time: in that case, if the amortization is part of the cost of production, the Resale Price Method (RPM) may be used.

²⁴ "Paragraph 2 – The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."

When Brazil is so entitled to the taxes owed under the Model Convention, or when no taxation treaty exists with the country where the earnings arise, natural persons and legal entities resident in Brazil are subject to taxation of their earnings from the licensing for use of their assets to residents of other countries at a rate of 27.5% for natural persons and 34% for legal entities.

If any income tax applies in the country where the earnings arise, in all cases legal entities in Brazil are entitled to a foreign tax credit. Natural persons in Brazil are also entitled to such a tax credit if there is a tax treaty with the foreign jurisdiction or, even if no such treaty exists, if the foreign jurisdiction guarantees a similar tax credit to its residents for taxes that they owe in Brazil.

Also, when Brazil is entitled to tax, if natural persons or legal entities residing abroad grant licenses for use of their intangible assets to legal entities residing in Brazil the resulting earnings are subject a withholding tax of 15%. In case of earnings which may be characterized as royalties, including for technology transfers, or in the case of technical services, there is an additional Intervention in the Economic Domain Contribution Tax (IEDCT) tax at a rate of 10%. The Brazilian legal entity is responsible for collection of either tax unless it is unaware that the owner of the intangible assets is abroad, in which case the latter's agent in Brazil is responsible for payment.

These rules undoubtedly apply to earnings from intangibles that are covered by the broad concept of royalties under Article 12, Paragraph 2, of the Convention.

On the other hand, given the breadth of the concept of intangibles and the idea of goodwill as a set or universe of intangibles, it is possible to imagine some earnings from intangibles that are not covered by the concept of royalties. Even under Brazilian law standpoint, it is possible to conceive of earnings from the licensing for use of intangibles that are not considered royalties.

For such situations in which Article 12 of the Convention does not apply, earnings from the licensing for use of intangibles are covered by Article 21 and are taxable only in the Contracting State of the owner's residence, or when they are attributed to the business of a permanent establishment they may be taxed in the Contracting State of such establishment as per Article 7.

In either case, if Brazil is entitled to tax those earnings the above mentioned rates of income tax apply, and the same foreign tax credit rules as explained above also apply.

IV – COSTS AND EXPENSES FROM TRANSFERS OF GOODWILL AND INTANGIBLES

Legal entities resident and operating in Brazil, as well as any permanent establishments in Brazil belonging to persons residing abroad, may deduct their costs and expenses from the use of goodwill and other intangibles belonging to third parties from their taxable income in Brazil related to their activities in the country, whether or not said third parties are also resident in Brazil.

This deduction exists because those costs or expenses are necessary to the production of taxable income in the country or the maintenance of the respective productive resource (1999 Income Tax Regulations (ITR), arts. 290 and 299).

This being the case, they are not counted as part of the acquisition cost of title to the assets in question. If they were, they would be charged to intangible assets and would not result in any deduction, except if said acquisition was limited in time, by contract or law, in which case they might be amortized in proportion to how long the acquisition right persisted (1999 ITR, art. 325, item I). The amortizable cost would also be subject to the transfer pricing rules referred to in Chapter II above.

Thus, we are dealing with the costs or expenses of the licensing for use of assets owned by third parties, a fact which constitutes a typical operating cost (of production) or a typical operating expense (not related to production, but to a legal entity's business activity). These are both deductible under the general rules set forth in arts. 290 and 299 of the 1999 ITR.

However, it should be noted that there are specific provisions for deducting such costs and expenses when they constitute consideration for the licensing for use of intellectual property (patents, trademarks, designs, etc.) registered with the National Intellectual Property Institute (NIPI) or for technology transfers not subject to NIPI registration due to the non-exclusive nature of the property in question.

These provisions are in arts. 351 to 355 of the 1999 ITR, and their principal points include:

- As such costs and expenses involve international agreements generating payments and remittances to natural persons or legal entities residing abroad, they must be registered with the Brazilian Central Bank (BCB) and the NIPI, even when no exclusive property is involved.

- Any deduction is limited to a percentage of net earnings obtained from the use of the intangibles or the employment of the technology transferred. That percentage will vary depending on the essentialness of the product or activity, up to a maximum of 5%, and will be of 1% in the case of trademarks.

- Deductions for technology transfers are limited to a maximum of five years, though this may be extended for an additional five years.

In the above cases, the normal transfer pricing rules do not apply on account of the specific limits and conditions set forth in arts. 351 to 355 of the 1999 ITR.

Other specific legal provisions that may affect goodwill and intangibles are arts. 7 and 8 of Law 9,532 (1997) that deal with share price premiums and discounts in the acquisition of capital shares in controlled or associate companies. According to art. 20 of Law Decree 1,598, referred to in Chapter 1 above, such premiums and discounts are subject to appraisal using the equity method.

If the acquiring and target companies are involved in a consolidation, demerger, or acquisition (either upstream or downstream), the amortization of premiums or discounts whose economic basis is the existence of goodwill or individualized intangibles may not be deducted for corporate income tax purposes. They may be registered as deductible losses or taxable gains, though, if the activity to which they are linked ceases, unless they remain in existence following the end of that activity and are available for reuse.

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List of Translated Terms

Original Term	Translation
<i>Ativo imobilizado</i>	<i>Premises and equipment</i>
<i>Registro Público de Empresas Mercantis</i>	<i>Commercial Company Registry Office</i>
<i>Contribuição Social sobre Lucro Líquido (CSLL)</i>	<i>Net Profits Contribution Tax (NPCT)</i>
<i>Método do Custo de Aquisição ou de Produção mais Tributos e Lucro (CAP)</i>	<i>Cost of Acquisition or Production plus Taxes and Profits Method (CAP+TP)</i>
<i>Método do Custo de Produção mais Lucro (CPL)</i>	<i>Cost Plus Method (C+)</i>
<i>Método do Preço de Revenda menos Lucro (PRL)</i>	<i>Resale Price Method (RPM)</i>
<i>Contribuição de Intervenção no Domínio Econômico (CIDE)</i>	<i>Intervention in the Economic Domain Contribution Tax (IEDCT)</i>
<i>Regulamento de Imposto de Renda (RIR)</i>	<i>Income Tax Regulations (ITR)</i>
<i>Instituto Nacional de Propriedade Industrial (INPI)</i>	<i>National Intellectual Property Institute (NIPI)</i>
<i>Banco Central (BC)</i>	<i>Brazilian Central Bank (BCB)</i>