Brazilian Tax Incentives to Startups

By:

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As entrepreneurial ventures, startups generally focus on capitalizing upon a perceived market demand by developing a viable product, service, or platform. According to the Brazilian Startup Association, there are approximately 13,000 startups in Brazil, and the number has been increasing year after year.

The Brazilian tax system is complex, with many direct and indirect taxes overlapping over enterprises' revenues and income, in addition to frequent law interpretation mismatches between taxpayers and tax administration, leading to considerable tax litigation. There are many general and specific incentives available to many companies and individuals, but not many to startups, empirically speaking. Even the so-called "simples nacional," a tax regime devised to simplify the computation and compliance for small entrepreneurs, sometimes is not the best option because there may be taxation even if the small company has not taxable income, which is regular in their early stages of life. Nonetheless, this regime is generally selected by them due to its simplification in terms of compliance. There is an annual revenue threshold of BRL4.8M to be eligible, and some activities are not allowed to benefit from it, primarily financial companies.

The most important existing tax incentives are related to technological innovation, compliant with Federal Law n. 11.196/2005. According to such law, “technological innovation is the conception of a new product or manufacturing process, as well as the addition of new features or characteristics to the product or process that implies incremental improvements and an effective gain in quality or productivity, resulting in greater competitiveness in the market.”

The startup must choose the book taxable income taxation regime to enjoy this tax incentive, which may be quite cumbersome because it carries a significant level of complexity. For that reason, the majority of the startups do not elect such book taxable income, turning out the incentive to not be remarkably effective. The primary benefits are the following:

1. Deduction of expenditures paid or accrued in the period for technological research and development of technological innovation defined as operating expenses by the income tax legislation and the same deduction, limited to 60 percent of the amount, in the case of general expenses.
2. Deduction limited to 20 percent of the sum of expenditures paid or accrued for technological innovation expenses related to patents already granted.
3. Exemption of fifty percent on the Manufactured Products Tax (“IPI”) levied on equipment and machines aimed at research and technological development.
4. Full depreciation, in the year of acquisition, of new machines, equipment, devices, and instruments, intended for use in technological research and technological innovation development activities.
5. Accelerated amortization of expenditures related to the acquisition of intangible assets, related exclusively to technological research and technological innovation development activities.

6. No withholding income tax on payments remitted to foreign countries for the registration and maintenance of trademarks and patents.

In addition to those, Federal Law n. 11.196/2005 grants a deduction to companies that transfer money to small entrepreneurs related to technological innovation developed in their interest, even when the later takes part in the economic benefit of the resulting product. The amount received by the small entrepreneurs is not computed in their gross revenue for tax purposes. This is not a direct incentive to startups, even if they collect some economic results from the project, because the targets of the tax benefit here are the companies – typically already grown companies – that are transferring the money to the startups.

Alternatively, companies benefit from a deduction for the non-operating expenses paid or accrued to certain nonprofit organizations (NPO) associated with technological innovation projects developed by the latter. Once more, there is no direct tax incentive even if the NPO is a startup because the deduction is allowed to the company that paid the expenses.

Recently – in 2016 – Congress enacted an amendment to the tax law applicable to small companies ("simples nacional") aimed to boost angel investment in those enterprises. To benefit from the tax reduction, small companies are classified as those with annual revenue up to BRL 4.8M. The amount invested by the angel is not computed as revenue for the purpose of benefiting from the "simplified" tax regime. This revenue exclusion is, indeed, a direct incentive to the startups. Additionally, the angel investor is protected against potential liabilities faced by the startup. What is problematic is the complexity designed by the law to this form of contract, which, empirically, may inhibit some prospective investors or entrepreneurs and result not remarkably effective.

In 2017, there was one more amendment to the small companies tax law ("simples nacional"), with the addition of provisions creating a special treatment for enterprises that elect themselves as "startups." For that purpose, "startup" is characterized as "the innovative company that aims to improve systems, methods or business models, services or products, which, when existing, characterize startups of an incremental nature, or, when related to the creation of something new, characterize startups of a disruptive nature."

The tax incentive consists of portraying the startups by “developing their innovations in conditions of uncertainty that require constant experiments and validations, including through provisional experimental commercialization, before proceeding to full commercialization and obtaining revenue.” Experimental sales of the service or product are allowed up to the annual limit of BRL 81,000, which is incredibly low for a company that plans to be of an incremental or disruptive nature. This threshold should be higher to truly accelerate the creation of startups enjoying the benefit.

In addition to not having empirically significant tax incentives to startups, Brazil does not have them to investors as well. For example, Italy’s recently approved Growth Decree introduces new tax measures to support investments and the need for Italian companies to obtain alternative new financing. One of the most innovative measures of the Growth Decree is the introduction of European Long-term Investment Funds (ELTIFs) (*see* bloombergtax.com).

ELTIFs are regulated by a European Union Regulation (EU) 2015/760. They have been set up to raise and channel capital towards long-term investment in European small and medium enterprises (SMEs). They are innovative funds that reflect the need for alternative funding structures to provide SMEs with long-term financing, whereby capital raised through ELTIFs can be addressed to finance long-term projects of small-cap entities such as start-ups and innovative companies. ELTIFs might have an active role in the financing of Italian SMEs through the subscription of bonds issued by the latter, granting financing or securities in favor of the latter.

Article 36 of the Growth Decree introduces a new tax regime for investments in ELTIFs that fulfill specific requirements. The mentioned Decree introduces a tax benefit for Italian resident individuals investing in ELTIFs: any income arising directly from investments in ELTIFs or indirectly from investments in mutual funds which invest their entire portfolio of assets in ELTIFs, and any capital gain arising from the disposal or the redemption of the above units or shares of ELTIFs, are not subject to tax.

The tax exemption applies for the fiscal period 2020 and only in direct or indirect investments in ELTIFs not exceeding €150,000 per year and 1.5 million euros overall when some other conditions are met. The investment must be held for at least five years ("vesting period"). If the disposal of the fund's shares or units is before the vesting period, the income derived from the transfer and that arising during the investment period is subject to a "recapture mechanism," therefore subject to taxation according to the standard fiscal rules, unless the equivalent value is invested in another ELTIF within 90 days of disposal or redemption.

What if, for instance, Brazil had a capital gain reduction associated with an exemption – subject to a reasonable threshold – arising from income obtained by angel investors who put money into startups in their early stages? What if they could offset their losses against their gains considering that the majority of them invest in more than one startup? What if startups could benefit from income tax exemption within the "simples nacional" tax regime? What if Brazil had a simplified book taxable income taxation regime pertinent to startups since they have a long run until they become profitable and such regime is quite complex for small enterprises to comply with?

Well, there is a bill in progress in Congress that addresses the capital gain incentives (but not the losses issue). Indeed, PLP 146-2019 creates the following tax treatment for capital gains arising from investments in startups, based on the equity holding period: (i) 12.5% in equity agreements with a term of up to 180 days; (ii) 10% in equity agreements with a term of 181 to 360 days; (iii) 7.5% in equity agreements with a term of 361 up to 720 days; (iv) 5% in equity agreements with a term of 720 days to 1800 days; and (v) 0% in equity agreements with a term greater than 1800 days.

Moreover, the same bill grants a deduction of the equity amount from the gross income of the investor, and a tax credit for the amount gifted by individuals to startups, subject to certain conditions.

Despite not many effective direct tax incentives, the number of startups is growing in Brazil. Still, if we genuinely had tax incentives that empirically worked for them, this number could grow exponentially, since it is well known that in Brasil the tax complexity is quite a hurdle above all during the early stages of enterprises.

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