TAXATION OF ROYALTIES

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AUGUST - 2025

TO TAX OR NOT TO TAX ?

5 points regarding...

the taxation of royalties

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August 2025

01

Royalties

The term "royalties" encompasses activities with varying legal classifications, which may be categorized as (i) assignment or licensing of rights and may or may not involve (ii) technology transfer. For instance, a license for the use of copyright. Clearly delineating each item in a contract and invoice (description and valuation) facilitates the application of specific tax treatment. Combining them results in more burdensome treatment.

02

Challenging legal qualification

The legal definition of the term can be contentious. For instance, does "know-how" pertain to the assignment or licensing of a right, or does it relate to the provision of a service? What distinguishes technical assistance from technical service? Furthermore, how do technical services differ from non-technical services?

03

Taxation on overseas remittances

Potentially, there are IRRF (Income Tax), CIDE (Contribution on the Consolidation of Income Tax), and PIS/COFINS-Importation Taxes. Concerning the ISS (Service Tax), it may be imposed on the assignment of rights to use and transfer trademarks, as the matter is pending judgment (STF Topic 1,210). The jurisprudence of the Supreme Court appears to favor the recognition of the constitutionality of the municipal tax. This is evidenced by the Court's previous rulings on franchise agreements (STF Topic 300) and software licensing agreements (ADIs 1,945 and 5,659; STF Topic 590).

04

Global agreements

Depending on the country of the income recipient, the incidence of IRRF in Brazil may be exempted or restricted due to the presence of an international treaty. For instance, technical services may be treated similarly to patent licensing (Article 12 - royalties) or differently (Article 7 - corporate profits), as outlined in ADI RFB 5/14.

05

Tax deductibility

The deduction of expenses associated with royalties paid abroad is permitted solely for payments essential to maintain possession, use, or enjoyment of the asset or right that generates the income. Recent amendments to the transfer pricing law, which now encompasses royalties, have altered certain rules that previously restricted their deductibility. Consequently, the registration of contracts with the Central Bank of Brazil (BACEN) and the Brazilian Institute of Industrial Property (INPI) is no longer mandatory, and the previous quantitative limit of 5% of gross revenue has been abolished.

CONCEPT OF ROYALTIES

In general, "royalties" refer to the compensation provided for the right to commercially utilize third-party industrial or intellectual property.

Royalties serve to compensate for copyright in literary, artistic, scientific, and technological works. They also address the ownership rights associated with intangible assets derived from these works. Additionally, they compensate for the transmission of knowledge into which these works are transformed.

Income tax legislation characterizes "royalties" as income derived from the utilization or exploitation of trademarks, patents, processes, and formulas.

Additionally, for Brazilian tax purposes, several payments are classified as royalties, including copyrights (excluding those paid directly to the author), government exploitation of natural resources, interest, commissions and expenses associated with royalty agreements.

Furthermore, all sums that compensate activities associated with the primary contract are classified as “royalties” under Brazilian tax legislation, encompassing technical services or technical, scientific, administrative, or analogous assistance.

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ISS AND PIS/COFINS-IMPORT

Strictly speaking, taxes imposed on the provision of services, such as services tax (ISS) and PIS/Cofins-Import, should not encumber royalty payments.

This is because "royalties" compensate for the economic exploitation of intellectual property rights or intangible assets (such as brands, patents, technologies, etc.), and in the provision of services, there is no transfer of assets or rights.

The service provider may utilize assets and rights to execute the service, but solely in a manner that serves the primary objective of the contract. This consistently involves the execution of an activity for the advantage of the contracting party.

Service Tax (ISS).

The Brazilian Supreme Court (STF) has consistently ruled that the traditional distinction between “obligations to give” and “obligations to do” has become outdated in light of contemporary realities (STF Themes #125 and #581), particularly following the emergence of the digital economy.

Consequently, the economic dimensions of service provision should be prioritized for characterization, rather than its purely legal aspects.

- In this context, the STF revised its jurisprudence, which established the application of ICMS for standardized software and ISS for customized software (ADIs 1,945 and 5,659; STF Theme #590).

- In a similar vein, it determined that intricate contracts—such as franchises—must be comprehensively classified as services for tax purposes (STF Theme #300).

PIS/Cofins-Import.

Until recently, the Brazilian tax authorities (RFB) maintained the conventional distinction between “obligations to give” and “obligations to do” to prevent the application of PIS/Cofins-Importation on the remittance of royalties abroad.

Payments should only be taxed by PIS/Cofins-Import as services when the contract fails to clearly delineate, in terms of values, what constitutes a service and what constitutes royalties, as indicated in Cosit Divergence Solution 02/2019 and 11/2011.

However, following the STF decisions referenced in the previous section, the RFB issued a ruling in the contrary direction, affirming the applicability of PIS/Cofins-Importação on software licensing contracts, whether "off-the-shelf" or tailored (SC Cosit 107/2023).

Shortly thereafter, it was indicated that contributions should not be imposed solely on “pure” licensing contracts, which lack associated services or adequate contractual differentiation to separate the respective payments (SC Cosit 177/2024).

IRRF and CIDE

Royalties that are paid, credited, delivered, utilized, or remitted abroad are subject to withholding income tax (IRRF) at a rate of 15% and CIDE contribution (Contribution for Intervention in the Economic Domain) at a rate of 10%.

Let us examine each of these payment methods:

- **Remittances** are monetary transfers sent overseas.

- **Credit** refers to the act of making the amount owed accessible to the creditor, such as in your bank account, and should not be confused with the straightforward accounting entry of the debt.

The tax authorities recognize that "credit" refers to the documentation of the accounting credit on the date the obligation matures. The income will become accessible upon the debt's maturity, at which time the beneficiary is entitled to request the debtor's compliance with the obligation (SC Cosit 43/21).

- **Delivery** refers to the physical act of transferring funds to the beneficiary or their representative; and

- **Use** refers to the application of the amount for a purpose of interest to the creditor, at their discretion.

The Cosit Divergence Solution 6/2015 presents a noteworthy case regarding employment. A foreign entity invested capital in a Brazilian firm, which included a pre-existing know-how agreement. The tax authorities determined that the shares were issued as compensation for the contract and should be liable for IRRF and CIDE taxes as royalties.

Concerning IRRF and CIDE, it is essential to acknowledge the presence of two regulations that influence their application:

- The law stipulates that royalty payments made to countries with advantageous tax regimes (“tax haven”) are subject to the IRRF, at a rate of 25%; and

- The law exempts remittances sent abroad for the payment of licenses related to the use, commercialization, or distribution of computer programs that do not involve a transfer of technology from the CIDE-Royalties tax.

STF Theme #914 validated the constitutionality of CIDE-Remittances on remittances abroad, including technical services, administrative assistance and royalties, even when there is no formal transfer of technology.

ADJUSTMENT OF THE CALCULATION BASE

Income tax legislation presumes that royalties disbursed internationally are net.

This indicates that the law recognizes the remitted amount as having already undergone the IRRF deduction applicable to the transaction.

As the taxpayer is located overseas, the law assigns the obligation to remit the tax to the paying source.

Therefore, if the contract specifies that the rights holder will receive $100 in royalties, one of two scenarios will occur:

- or the source calculates the IRRF on $100 and remits the sum of $85 (which necessitates explicit contractual stipulation);

- or the source recalibrates the net amount of $100 to incorporate the IRRF amount and, on the adjusted amount (= gross amount), levies the source tax.

Ex.:

100 ÷ (100% - 15%) = $117.65
$117.65 x 15% = $17.65 (IRRF)
$117.65 - $17.65 = $100 (net value)

Otherwise, the Tax Authorities may require the difference, along with a 75% penalty and SELIC interest.

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INTERNATIONAL AGREEMENTS

The notion of "royalty" as defined by the OECD Model Convention (art. 12) acknowledges the legal characteristics of the term, excluding the provision of technical services and technical assistance, which are typically governed by the provision addressing corporate profits (art. 7).

However, the treaties signed by Brazil, whilst influenced by the OECD Model Convention, were formulated with careful consideration of the interests of the signatory countries and their implications for their respective domestic legislation.

- Consequently, the comprehensive notion of "royalties," which includes the provision of technical services and assistance, was embraced in the conventions signed by the country to prevent double taxation of income for IRRF purposes.

- Furthermore, the Brazilian tax authorities (RFB) recognizes that the tax treatment applicable to payments made abroad for the provision of technical services and assistance, whether or not involving technology transfer, must align with the stipulations of the relevant treaty (ADI RFB 05/2014).

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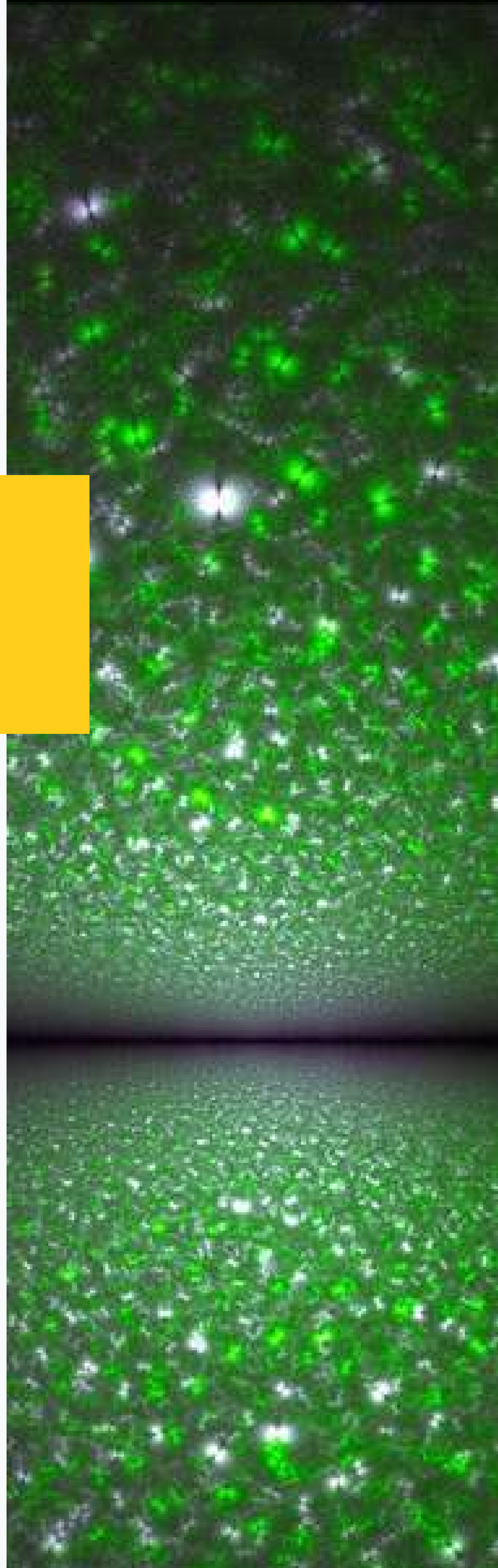

The general rule stipulated in treaties regarding royalties is as follows:

- **Art. 7:** are subject to taxation solely in the country of the income beneficiary; or

- **Art. 12:** may also be subject to taxation in the country of origin, provided that the amounts are confined to a range of 10%, 15%, or 25% of the gross royalties paid, depending on the specific right being compensated.

Royalties: Brazil's current IRRF rate stands at 15%. The maximum rates stipulated in treaties are typically 15%. Certain treaties impose a maximum rate of 10% on royalties not related to trademarks ("other cases"): **South Africa, Argentina, Slovakia, Spain, Mexico,** and **Turkey**.

Equivalence of Technical Services to Royalties: The majority of treaties signed by Brazil specify that technical services are to be treated in the same manner as royalties. The issue lies not in the equivalence itself, but rather in the absence of a clear definition of the term "technical service." In practice, revenues generated from the provision of services necessitating specialized knowledge are often classified as royalties, even when they do not pertain to technology or knowledge transfer. This practice stands in opposition to the principles established by the OECD.

This stance compels Brazil to impose taxes on IRRF remittances (art. 12), which, in strict terms, should solely be taxed by the country of residence of the income beneficiary (art. 7).

Only five treaties signed by Brazil lack a clause equating technical services to royalties: **Austria, Finland, France, Japan,** and **Sweden.**

TAX DEDUCTION ELIGIBILITY

Income tax legislation concerning royalties has remained largely unchanged for over six decades. For an extended period, the tax deductibility and actual remittance of royalties overseas were contingent upon:

- compliance with limits ranging from 1% to 5% of the net sales price of items manufactured using the technology;
- the registration of the contract with the National Institute of Industrial Property - INPI; and
- of the contract registration at the Central Bank of Brazil.

All these conditions have been eliminated.

Royalties may now be freely negotiated. Registration with the INPI is confined to its original purpose of safeguarding the exclusivity and rights conferred to the licensee regarding the technology.

At present, the only requirement for remitting royalties abroad is proof of payment of the applicable income tax.

For tax deductibility, adherence to transfer pricing regulations is mandated (Law 14,596/23).

Furthermore, an anti-avoidance rule was established, which deems royalty and technical assistance expenses payable to related parties as non-deductible when the deduction of these amounts leads to double non-taxation. This occurs when the amount deducted in Brazil is not recognized as taxable income for the beneficiary under the laws of its jurisdiction.

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