© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Brazil and U.S. Both Debate the Realization of Taxable Income

by Caio Malpighi and Leonardo Aguirra de Andrade

Caio Malpighi

Leonardo Aguirra de Andrade

Caio Malpighi is a specialist in tax law at the Brazilian Institute of Tax Law (IBDT), a researcher at the Research Center of the Professional Master's Program in International and Comparative Tax Law at the IBDT and tax attorney in São Paulo. Leonardo Aguirra de Andrade is a professor of tax law at the IBDT and a tax attorney in São Paulo.

In this article, Malpighi and Aguirra de Andrade compare the concurrent debates in Brazil and the United States regarding the realization of income.

Introduction

Recently, the U.S. Supreme Court established a significant precedent concerning income taxation and the principle of realization of income in *Moore*,[1] which addressed whether the United States could levy a tax on American resident shareholders based on profits earned by foreign corporations that were not effectively distributed.

The primary legal analysis by the Court was the constitutionality of the mandatory repatriation tax (MRT) established in 2017 under the Tax Cuts and Jobs Act, in light of the 16th Amendment, which limits the authority of Congress to levy income taxes. Ultimately, the Court upheld the constitutionality of the MRT, stating that it does not violate the 16th Amendment. Justice Brett M. Kavanaugh delivered the majority opinion, emphasizing that U.S. tax law includes various provisions for taxing individual shareholders based on corporate profits. Further, it noted that Supreme Court jurisprudence has established that this form of taxation is constitutional, as previously decided in *National Grocery*.[2]

The Court did not expressly say whether the realization of income is a constitutional requirement under the 16th Amendment. Instead, the Court limited itself to stating that the MRT does tax unrealized income because income was in fact realized by the foreign corporation.

In Brazil, like the United States, constitutional provisions circumscribe the federal government's authority to levy income taxes. Unlike in the United States, however, the exclusive power to impose income taxes lies squarely with the federal government.

Moreover, Brazilian legislation supplements its constitutional framework with detailed statutory provisions that meticulously delineate the taxable events and criteria for income tax liabilities. A norm that defines a taxable event for income tax lies under article 43 of the Brazilian Tax Code (CTN), enacted in 1966 after vigorous doctrinal debates on its draft legislation.

Even with all the methodological care tax legislators took to define generally what constitutes taxable income, similar controversies have arisen in Brazil regarding the timing of realization and availability of taxable income.

[1] *See Moore v. United States*, No. 22-800 (U.S. 2024).

[2] *See Helvering v. National Grocery Co.*, 304 U.S. 282 (1938).

For more *Tax Notes® International* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Thus, in Brazil, a debate comparable to *Moore* is unfolding — that is, whether it is constitutional to tax capital income that has not been effectively made available to investors. This debate has occurred in situations involving undistributed income earned by foreign-controlled corporations as well as accrued yet undistributed income from domestic investment funds.

In 2013 the Brazilian Supreme Federal Court ruled, in the Direct Action of Unconstitutionality No. 2.588,[3] that automatic taxation of profits from controlled and affiliated foreign entities by national legal entities, even without actual distribution, is constitutional, as instituted by Provisional Measure No. 2.158-35 (2001).

In 2022 the Brazilian Supreme Court made new rules on the concept of income in light of article 43 of the CTN, ruling that the collection of income tax from legal entities on interest received in the refund of taxes is unconstitutional because there is no patrimonial gain in a situation in which interest is paid by the government because of an undue tax charge (Theme 962 of the General Repercussion).

Recently, the debate over the validity of Provisional Measure No. 2.158-35 was revived in Extraordinary Appeal No. 870.214,[4] pending in the Brazilian Supreme Court. Justice André Mendonça expressed his opinion that when there is a double taxation treaty between Brazil and the jurisdiction of the controlled or affiliated entity, the rule of Provisional Measure No. 2.158-35 should be set aside.

Regarding the taxation of individual income, at the end of 2023 Federal Law No. 14.754 was enacted by the Brazilian government, establishing automatic, periodic taxation of accrued gains not distributed by closed-end investment funds in Brazil to Brazilian individuals, as well as profits earned by entities located abroad that are also not yet distributed to individuals. This recent legislative measure reignited debates on the legal concept of income for tax purposes.

Given the similarity of discussions in these two legal tax systems, this article aims to compare the debates in the United States and Brazil regarding the legal concept of taxable income and the requirement for income to be distributed before it's taxed.

To this end, this article discusses income taxation in the United States and Brazil, and it concludes by analyzing similarities and differences between the two systems.

Income Taxation in the U.S.

As widely discussed recently in academic circles,[5] the main legal issue in *Moore* boiled down to, "What is required for something to be income?" — in the words of Andrew Velarde.[6]

The reason for this is that, as stated in the 16th Amendment, "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

It is worth noting that this amendment was ratified in 1913, after the Supreme Court declared unconstitutional the establishment of a federal income tax because of the lack of federal competence in the landmark 1895 case *Pollock*.[7]

In this case, the central issue discussed was the constitutionality of a federal tax on income from rental property. The Supreme Court ruled that such a tax was unconstitutional under the prevailing interpretation of the Constitution at the time.

The distinction between direct and indirect taxes was crucial in the case because the Constitution, before the ratification of the 16th Amendment in 1913, required direct taxes to be apportioned among the states based on their population. This meant that if a state represented 10 percent of the U.S. population, it should pay 10 percent of any applicable direct tax.

In *Pollock*, the Supreme Court considered the tax on income from rental property to be a direct tax that was not apportioned. Therefore, under the prevailing interpretation, the tax was unconstitutional.

[3] *See* Supremo Tribunal Federal (Brazil), ADI no. 2.588 (Oct. 4, 2013).

[4] *See* Supremo Tribunal Federal (Brazil), Extraordinary Appeal No. 870.214 (May 2024).

[5] *See, e.g.*, Cara Griffith et al., "What's at Stake With *Moore v. United States*: Transcript," *Tax Notes Today Int'l*, Dec. 20, 2023.

[6] *Id.*

[7] *See Pollock v. Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895).

For more *Tax Notes® International* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

This decision prompted the need for a constitutional amendment to explicitly permit the taxation of income without apportionment, which was ultimately achieved with the ratification of the 16th Amendment.

In *Moore*, however, the discussion evolved into another question: Does the concept of income as outlined in the text of the 16th Amendment, for federal taxation purposes, include accumulated but unrealized profits? Ultimately, for the government to tax wealth, shouldn't that wealth be available to the taxpayer (cash tax basis)? Or conversely, does mere accumulation (accrual tax basis) suffice for taxation without the need for realization?

Notice that, depending on the semantic breadth given to the term "income," the Court would expand the scenarios under which Congress would have the power to levy taxes without apportionment.

The question whether realization is necessary in the constitutional understanding of taxable income was settled favorably by the Court in *Macomber*.[8] In that case, the Court ruled that the 16th Amendment prohibited Congress from taxing a stock dividend (receiving dividends in the form of additional common shares) until its shareholders had realized them. This established the principle of realization, whereby it was decided that there must be a separation of capital for the increase to be taxed as income.

Indeed, in that century-old case, the discussion centered around a very specific scenario that was more clearly distinguishable from the concept of income and more fittingly categorized as concerning capital (wealth). This limitation of *Macomber* was astutely identified by the Supreme Court in its 1943 judgment in *Griffiths*,[9] for example.

Specifically concerning undistributed income by corporations, the Court ruled in *Moore*:

> The Court's longstanding precedents plainly establish that, when dealing with an entity's undistributed income, Congress may either tax the entity or tax its shareholders or partners. Whichever method Congress chooses, this Court has held that the tax remains a tax on income.

At this juncture, the Court clarified that its established jurisprudence had previously allowed for the taxation of unrealized profits, as seen in *National Grocery*,[10] which upheld section 104 of the Revenue Act of 1928 as constitutional, imposing a 50 percent tax on accumulated corporate profits deemed excessive.

However, returning to the constitutional distinction between direct and indirect taxes that motivated the enactment of the 16th Amendment after *Pollock*, Kavanaugh clarified that "direct taxes are those taxes imposed on persons or property . . . property taxes remain direct taxes that must be apportioned." On the other hand, in the conception adopted by the majority in *Moore*, "indirect taxes are the familiar federal taxes imposed on activities or transactions."

Under this conception, a potential tax created by Congress to apply to large fortunes (for example, one that targets high-net-worth individuals) would not find support under the 16th Amendment.

Therefore, our understanding of *Moore* is that the Court did not provide a "blank check" for Congress to tax any wealth increase under the label of "income." For the Court, the concept of income still constitutes a constitutional limitation on the ability to impose taxes without apportionment. Within this concept of income, it is understood to include accrued profits, regardless of their distribution.

Income Taxation in Brazil

In Brazil, the constitution delineates the specific legislative powers of the federative entities (federal union, states, municipalities, and federal district) regarding the imposition of tax. For the purposes of this analysis, it is crucial to note that the 1988 Federal Constitution stipulates that the authority to levy income tax rests exclusively with the union, in the same manner as provided by the previous constitutional order (1967 constitution).

---

[8] *See Eisner v. Macomber*, 252 U.S. 189 (1920).

[9] *See Helvering v. Griffiths*, 318 U.S. 371 (1943).

[10] *See National Grocery*, 304 U.S. 282.

For more *Tax Notes® International* content, please visit www.taxnotes.com.

However, there is no definition of income in the Brazilian Constitution; it is up to the complementary law to establish a definition of income. Fulfilling this role, the National Tax Code (promulgated in 1966 and still in effect today) defines what is to be understood as income for taxation purposes. Below is an unofficial translation of what is stated in article 43 of the National Tax Code:

> Article 43. The tax, under the competence of the Union, on income and earnings of any nature has as its taxable event the acquisition of economic or legal availability:
>
> > I. of income, understood as the product of capital, labor, or their combination;
> >
> > II. of earnings of any nature, understood as increases in wealth not included in the preceding item.
>
> Paragraph 1. The tax liability applies regardless of the denomination of the revenue or income, the location, legal status, or nationality of the source, its origin, or the manner of receipt.
>
> Paragraph 2. In the case of revenue or income derived from abroad, the law shall establish the conditions and the moment at which their availability occurs, for the purposes of the incidence of the tax referred to in this article.

This legal text was the result of intense debates among jurists at the time of drafting its preliminary proposal. According to Brandão Machado,[11] the preliminary bill drafted by Rubens Gomes de Sousa to represent the National Tax Code drew inspiration from some tax codes around the world — especially the German tax code (1919), drafted by Enno Becker, and the Revenue Code of the Province of Buenos Aires, drafted by Dino Jarach and enacted into law in 1948.

In both Jarach's doctrine and that of Becker (who also served as a judge in Germany), the prevailing view was that economic essence should take precedence over the legal form of taxable events. In an article, Machado[12] mentions that Jarach also drew on the jurisprudence of the U.S. Supreme Court at the time of his work, citing *Griffiths*.[13]

This supports Jarach's idea that the obligation to pay income tax derives more from the taxpayer's economic power over income than from their legal ownership of it. However, the Brazilian scholars of tax law do not have a unanimous position on the subject.

Machado argued that this is why article 43 of the National Tax Code includes both "economic availability" and "legal availability" in describing the taxable event for income tax.[14]

This perspective is affirmed by Gomes de Sousa himself,[15] who wrote that the reference to legal and economic availability in the legal standard was drafted to encompass economic events representative of income irrespective of the legal ownership of the income recipient (regardless of the separation of income, which is articulated through legal availability).

As stated, it is a controversial issue in Brazil. Therefore, it is important to consider various perspectives on the matter.

Bulhões Pedreira[16] argues that economic availability corresponds to the accrual tax basis while legal availability corresponds to the cash tax basis.

Ricardo Mariz de Oliveira,[17] however, contends that economic availability corresponds to income earned through illicit activities, whereas legal availability corresponds to income derived from activities conducted within the boundaries of the law.

In turn, according to Luís Eduardo Schoueri (a member of the *Tax Notes International* Council of Eminent Persons), the concern reflected in article 43 of the CTN to distinguish between economic

---

[11] Machado, "Breve exame do art. 43 do CTN," *Imposto de Renda: conceitos, princípios, comentários*, p. 101 (1996).

[12] *Id.* at 104.

[13] *See Griffiths*, 318 U.S. 371.

[14] Machado, *supra* note 11, at 104.

[15] Gomes de Sousa, "A Evolução do Conceito de Rendimento Tributável, versão em português publicada," 14 *Revista de Direito Público* 339 (1970).

[16] Pedreira, *Imposto sobre a renda — Pessoas jurídicas* 199 (1979).

[17] Mariz de Oliveira, *Fundamentos do Imposto de Renda* 377-378 (2020).

For more *Tax Notes® International* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

and legal availability is futile. He asserts that what matters in this rule is that the condition for taxing income is simply the presence of control over it. He states that "there is availability when the beneficiary can, in essence, use the resources for whatever purpose they see fit."[18] Thus, income availability leads to the moment of its realization, and therefore the point from which income tax can be demanded from its beneficiary.

If in Brazilian doctrine the theoretical debate on taxable income is dense, in jurisprudence there are some landmarks that deserve highlighting regarding the notion of realization or availability of income.

A historical Brazilian Supreme Court precedent for shaping the constitutional concept is the Direct Action of Unconstitutionality No. 2.588, which ruled on the constitutionality of the periodic (automatic) taxation of Brazilian legal entities regarding profits earned but not distributed by their controlled or affiliated entities located abroad. Before we analyze this precedent, it is important to recount a brief historical overview of the legislative changes that led to establishing this taxation.

Throughout its history, Brazil has typically adhered to a territorial tax model, though there were intervals during the 1980s and 1990s when it shifted toward a worldwide taxation approach. In 2001 Complementary Law No. 104 brought amendments to article 43 of the National Tax Code, clarifying that legislation would define when income and earnings from overseas are deemed accessible for income tax purposes.

In line with this authorization under the CTN, Provisional Measure No. 2.158-35/2001 stipulated that profits earned by foreign subsidiaries or affiliates would be considered accessible to their Brazilian parent companies or affiliates as of the balance sheet date on which they were accrued for corporate income tax purposes.

Like the MRT discussed in *Moore*, paragraph 1 of article 74 of the aforementioned provisional measure specified that profits earned by foreign subsidiaries or affiliates until December 31, 2001 — that is, before the implementation of the worldwide taxation system — would be deemed accessible to Brazilian parent companies or affiliates on December 31, 2002.

Article 74 of Provisional Measure No. 2.158-35/2001 introduced a new tax framework for profits earned by foreign subsidiaries and affiliates, departing from the previous rule under which those profits were only considered accessible to Brazilian parent companies or affiliates "upon payment or upon credit in the account representing the obligation of the foreign company."

Upon examining the constitutionality of this measure, the Brazilian Supreme Court ruled in the Direct Action of Unconstitutionality No. 2.588 that the automatic taxation rule would not apply to domestic companies affiliated (not controlled) with legal entities in non-tax-advantaged countries but would apply to domestic companies controlling legal entities in tax-advantaged countries. Further, the court found unconstitutional the retroactive application of the new rules for taxing profits generated before their enactment.

In the prevailing view, Justice Ellen Gracie emphasized that regarding profits earned by their foreign subsidiaries, for Brazilian parent companies there is a clear indication of their acquiring legal availability of the profits when the profits are recognized in the financial statements prepared by the parent companies in Brazil. The necessary availability for taxation exists because, under Brazilian corporate law, the subsidiary has full discretion over how profits will be allocated.

It's noteworthy that Gracie departed from the earlier supreme court's ruling in Extraordinary Appeal No. 172.058-1/SC.[19] That case established that the income tax could not be imposed when profits were determined by publicly held companies because shareholders did not automatically have the right to distribute income at that time. The allocation of profits, including their potential distribution to shareholders, depends on specific shareholder deliberations. This contrasts with the situation of foreign

[18] Schoueri, "Considerações acerca da Disponibilidade da Renda: Renda Disponível é Renda Líquida," *Direito Tributário: princípio da realização no imposto sobre a renda — estudos em homenagem a Ricardo Mariz de Oliveira* 19-32 (2019).

[19] *See* Supremo Tribunal Federal, Extraordinary Appeal No. 172.058-1/SC (1995).

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® International* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

subsidiaries, in that parent companies have direct control over profits earned by their subsidiaries, as emphasized during the proceedings. Further, it was considered — and maybe it was the most important argument — that the profits earned by foreign subsidiaries have reflective effects on the accounting of their parent companies in Brazil because of the equity method.

The argument proceeded with some reservations regarding affiliated companies when there is no control by the Brazilian legal entity. In those cases, the court considered that the rule of automatic taxation would apply only to affiliates located in tax havens. This illustrates the Brazilian Supreme Court's acceptance, under the federal constitution, of a purported antiavoidance objective of the legal norm (in terms of combating tax deferral).

Recently, the issue resurfaced in the Brazilian Supreme Court through Extraordinary Appeal No. 870.214, which focused on the application of international treaties to prevent double taxation of profits from foreign affiliates and subsidiaries. This is an appeal by the National Treasury of a 2014 decision of the Superior Court of Justice,[20] which ruled that corporate income tax should not be imposed on profits earned by subsidiaries located in Belgium, Denmark, and Luxembourg (countries with which Brazil has treaties aimed at avoiding double taxation).

The Superior Court of Justice based its decision on article 7 of treaties aligned with the OECD model, which stipulates that profits should only be taxed in the company's country of residence. Consequently, these subsidiaries would be exempt from taxation in Brazil, contrary to the provisions of article 74 of Provisional Measure No. 2.158-35.

Justice Regina Helena Costa emphasized in her opinion that, according to established court precedent, profits earned by foreign-controlled companies, which have distinct legal personalities from their parent entities, are subject to taxation exclusively in the country of their domicile, as outlined by international treaties.

[20]Superior Tribunal de Justiça, Special Appeal No. 1.325.709/RJ (2014).

At the Brazilian Supreme Court, Justice André Mendonça, acting as rapporteur, argued that once treaties are ratified, Brazil cannot unilaterally disregard them, and companies cannot exploit them in an abusive manner.

In addition to the ongoing debate regarding corporate income tax on profits of foreign subsidiaries under double taxation treaties, the issue of income realization has resurfaced following the enactment of Law No. 14.754 at the end of 2023. This new legislation introduced rules for taxing income earned by individuals with investments abroad and for withholding tax on investments in funds domiciled in Brazil.

For the taxation of investments by individuals abroad, article 5 of Law No. 14.754 mandates automatic taxation of undistributed profits earned by controlled companies located in tax havens or nonoperational entities situated abroad, regardless of their jurisdiction.

Respected legal opinions contend that article 5 of Law No. 14.754 may be unconstitutional because it potentially violates the concept of taxable income delineated in article 43 of the CTN. Ramon Tomazela[21] underscores that this case diverges from the taxation of subsidiaries by legal entities, which was upheld by the Brazilian Supreme Court in the ruling on Direct Action of Unconstitutionality No. 2.588. Unlike legal entity controllers, individuals affected by Law No. 14.754 do not recognize the financial effect of their subsidiaries through the equity method. And, as mentioned above, this was one of the reasons for recognizing the availability of accrued but undistributed profits by subsidiaries for a corporate parent company.

Finally, the new tax regulations introduced by Law No. 14.754 have noteworthy provisions regarding automatic source taxation of accrued income from investments in Brazilian investment funds on a periodic basis.

Historically, many investors (both individuals and legal entities) have invested, reinvested, and grown their capital by maintaining investments in Brazilian closed-end investment funds. Under the

[21]Tomazela, "A Lei no. 14.754/2023 e o objetivo de combater o diferimento da tributação da renda proveniente de investimentos detidos no exterior por pessoas físicas," 22(127) *Revista Fórum de Dir. Tributário* 23-50 (Jan./Feb. 2024).

For more *Tax Notes® International* content, please visit www.taxnotes.com.

prior legislation, income generated from these investments was deferred until the occurrence of certain specific events (like income distribution by means of amortization or redemption, or asset disposal).

Under the new regulations, income derived from investments in funds will generally be subject to periodic withholding income tax, regardless of any realization event. This development has sparked discussions about income availability.

Exceptions may arise when liquidity exists within investment structures, such as unallocated financial resources in fund portfolios retained to avoid taxation. Further, some argue that the appreciation of investment vehicle holdings provides controllers with financial leverage, enabling them to access new capital at potentially lower costs without realizing their investments.

However, it is crucial to recognize that these exceptions are not absolute and should be assessed on a case-by-case basis under the new law to prevent potential violations and abuses.

Therefore, the enactment of Law No. 14.754 is anticipated to intensify the ongoing debate about taxable income realization in Brazil.

Comparing Income Tax in Brazil With the U.S.

In both Brazil and the United States, the authority to collect income tax is provided by constitutional fundamentals. A relevant difference between them is the fact that the Brazilian Constitution assigns a definition of income to the complementary law, which depends on the concept of availability, which is therefore an insurmountable element in Brazil.

It is noteworthy that two fundamentally distinct legal systems, each having structured its tax regime uniquely, have nonetheless sparked remarkably similar debates regarding the concept of taxable income.

In the United States, income tax emerged as a legislative measure by Congress to finance the Civil War effort. The decisive response came through judicial review by the Supreme Court in *Pollock*, followed by explicit inclusion in the 16th Amendment. Because of the Constitution's nonexhaustive and abstract reference to taxable income, numerous subsequent debates arose in leading cases aimed at delineating what constitutes taxable income across various specific tax rule disputes.

Similarly, in Brazil, the Constituent Assembly did not provide substantial elements for conceptualizing taxable income. However, academic discourse since the 1950s, heavily influenced by German tax law, culminated in the passage of a national tax code aiming to offer a more detailed general concept of taxable income. Despite these efforts by the infraconstitutional legislator, controversies persisted and led to numerous disputes resolved by the Brazilian Supreme Court, echoing debates in the United States. Many of these discussions, both in Brazil and in the United States, centered on fundamental concepts like income availability and realization.

Our conjecture to explain these comparable legal phenomena is the theoretical challenge of precisely identifying what constitutes income, which is particularly evident in examining academic debates on the topic in Brazil.

This debate will probably affect the exam of validity of the new Brazilian legislation to tax income earned by individuals with investments abroad, because in this matter also we will likely see income without availability, which is contrary to article 43 of the CTN. ■

For more *Tax Notes® International* content, please visit www.taxnotes.com.

© 2024 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.