BRAZIL'S INTEREST ON NET EQUITY AND THE OECD BEPS PROJECT

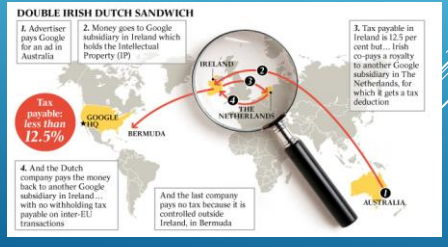
TAX AVOIDANCE, MISMATCHES AND AGGRESSIVE TAX PLANNING

TAX AVOIDANCE

- Tax avoidance, basically, is a legal way of reducing or eliminating the taxes that is payable. It opposes tax evasion exactly in this point: the legality of the means. Also known as tax planning (usually when the benefits were intended by lawmakers) or aggressive tax planning (when they were not), tax avoidance can be done through some mechanisms and schemes, depending on the region or country where it occurs. Some of them are: transfer mispricing, which is series of trades between related parties at prices neant to manipulate markets or to deceive tax authorities; tax inversion, that usually involves creating a new parent company that sits "on top" of the corporate structure and is incorporated in the desired foreign jurisdiction, becoming a subsidiary; earns stripping, by using loans between different divisions of the same company to shift profit sout of high-tax jurisdictions.
- In general, the tax avoidance activities almost always use tax shelters or tax havens within thein aggressive tax planning, shifting profits from developed and developing countries.

MISMATCHES

- Basically, a hybrid mismatch arrangement is an arrangement that results from a difference in tax treatment of the same financial instrument or entity between different jurisdictions, intended to secure a tax advantage within a multinational group, arising both from hybrid financial instruments and from hybrid entities.
- One example is the *dutch sandwich*. The revenues from sales of a product shipped by an Irish company are booked by a shell company in the Netherlands, taking advantage its generous tax law. This is usually the second part of the scheme referred to as the "Double Irish with Dutch Sandwich". The remaining profits are transferred directly to Cayman Islands or Bermuda.



BASE EROSION AND PROFIT SHIFTING - BEPS

- The BEPS is an arrange of tax planning strategies used to exploit mismatches and gaps between different tax systems, in order to legally lower the taxes paid to national governments by moving profits and expenses to more suitable jurisdictions. As a OECD's report stated:

  > "While these corporate tax planning strategies may be technically legal and rely on carefully planned interactions of a variety of tax rules and principles, the overall effect of this type of tax planning is to erode the corporate tax base of many countries in a manner that is not intended by domestic policy."

- There are key issues that must be tackled ir order to achieve fairness in global and national market competition, due to the advantage that multinational companies obtain with this scheme, alongside to the implementation of social and economic policies within the states.
- As a rule, they combine four elements: i) reduction of taxation; (ii) low or no withholding tax; iii) reduced or non-existent income taxation, with the right to substantial non-operating profits between related parties; iv) no taxation of profits at the level of the economic group.

OECD'S ANTI-BEPS

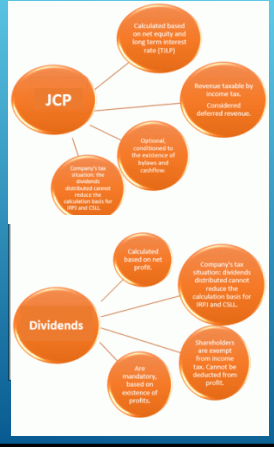
- The latest focus of anti-BEPS on international structures and activities was the use of anti-avoidance standards. The present international tax regulation norms made to avoid one kind of mismatch, aiming the economic development and international cooperation by avoiding the double taxation at international level. This initiative brought with it what was not foreseen: various possibilities to avoid taxes by multinational companies.
- There is lack of cohesion between the legislations. There are, nowadays, a variety of anti-avoidance policies used by countries to ensure the effectiveness of their tax systems. The most importants are: (a) General Anti-Avoidance Rules (GAAR), for operatrions without substance (based on some doctrines, like business purpose and substance over form); b) CFC (controlled foreign corporations) rules, to tax passive or low taxation incomes; c) limiting the deductibility of interest; (d) basic anti-erosion rules for limiting deductibility or increasing withholding tax on certain payments.
- OECD has developed the BEPS Project, which in its Action 2 (out of 15), sets out recommendations in order to neutralize the effect of hybrid mismatch arrengements. In this sense, the primary response should be to deny a deduction for payments made under a hybrid financial instrument in the payer jurisdiction. If the payer jurisdiction does not adopt the primary response, the payee jurisdiction should apply a defensive rule over redeemable preference shares, profit-participating loans and others.

INTEREST ON NET EQUITY: WHAT IS IT?

- In the case of Brazil, there is a cross-border activity (financial instrument) that is treated differently for tax purposes. The Brazilian **interest on net equity** might fall under anti-hybrid rules, given the fact that it is **deductible from the corporate income tax due in Brazil (CSLL)** and, at the same time, it is **qualified as exempt dividends in certain countries**, based on participation exemption regimes.
- Brazilian companies have two main instruments for remunerating shareholders for the capital invested in companies: dividends and interest on net equity ("Juros sobre o capital próprio"), which is unique to the brazilian system and emerged in the legal system in 1995. In order to remunerate the invested capital, Brazilian companies are allowed to distribute earnings to their shareholders in the form of dividends or under the concept of interest on net equity (juros sobre o capital próprio – JCP). This deduction is up to a certain limit established in the Brazilian applicable law.

- Brazilian tax law, for domestic fiscal policy reasons (basically to encourage the capitalization of Brazilian companies), allows IoNE to be treated, subject to the limits mentioned above, as a tax deductible expense. Besides treating these payments as a tax deductible expense, Brazilian tax law also requires them to be taxed at source at 15%, even when the recipient is nonresident. When this nonresident is domiciled in a country or location classified as a favorable tax jurisdiction the IRRF rate is increased to 25%.
- For several reasons, there is no doubt that the companies cannot fund themselves using only capital of third-party investors, considering, for instance: (a) that the more capital of third-party investors, the greater are the risks involved in the business; and (b) that sometimes, the company cannot find satisfactory sources of capital of third-party investors.

WHY WAS IT CREATED?



- In an international context, when a Brazilian company pays interest on net equity to a company resident abroad, this payment is deductible in Brazil and, in most cases, it is also exempt in the payee jurisdiction. This is because several European countries grant exemption to dividends received from qualifying shareholdings in order to avoid double economic taxation, through the application of participation exemption regimes. Thus, Brazilian interest on net equity may fall under a "deduction and non-inclusion scheme", which is reached by OECD in Action 2 of the BEPS Project.

DIFFERENCES BETWEEN IONE AND DIVIDENDS

ACCOUNTING AND TAX LAW

- This instruments receive, in Brazil, two different treatments: the accounting and the tax ones. While accounting for economic essence prevails over form, in Brazilian tax law it is the substance or legal cause of the business that prevails. Accounting is based on economic reality while Brazilian law adopts the "legal reality" of the act or business carried out. It is not necessary to speak of prevalence of essence or form, as if the first, essence, was always the accounting north and the second, form, the legal north. On the contrary, in Brazilian law there is no form without essence, since form is only the means by which an act or legal transaction is embodied, but is always attached to a cause that contemplates the actual content of the legal transaction, the function intended by the parties.
- It is the legal substance of the business that allows you to differentiate whether it is true or simulated. In Brazilian law, the essence of the business or its substance is its legal cause, and the business must be framed in one of several institutes provided by Law. A financial instrument may be debt for tax purposes, but equity for accounting purposes and the reverse.,It is easy to see that Interest on Net Equity has a dual nature, to say the least.
- From a corporate perspective, the vast majority of instruments (and even accounting rules) consider that IoNE is simply a form of distribution of profits to the shareholders. From a tax perspective, IoNE should be regarded as a deductible expense.

IS IONE A MISMATCH?

- What is striking in the application of defensive rules to the Brazilian interest on net equity is the fact that it does not have a hybrid element in the financial instrument. On the contrary, the Brazilian interest on net equity may be paid even when the financial instrument is a plain vanilla equity.
- In addition, the OCDE expressly mentions that, "while cross-border mismatches arise in other contexts (...), the only types of mismatches targeted by this report are those that rely on a hybrid element to produce such outcomes". As can be seen, the Brazilian interest on net equity does not have a hybrid element in the financial instrument itself, since it may be paid by any legal entity domiciled in Brazil. It also does not derive from complicate or non-orthodox financial instruments. Diversely, the Brazilian legislator just treated the interest on net equity as a financial expense for tax purposes.
- In fact, Brazilian interest on net equity is not an instrument used to achieve base erosion and profit shifting. It is, rather, a legal mechanism created by the Brazilian legislator to achieve the following tax policy objectives: (i) to mitigate the effects of the distinction between equity and debt, thus reducing the debt bias; (ii) to encourage the capitalization of Brazilian companies through formal capital contribution, in order to prevent leveraging and excessive level of indebtedness; (iii) to integrate corporate and individual income taxes, for the purposes of eliminating double taxation of corporate profits; (iv) to alleviate the undesirable effects of the prohibition on monetary adjustment of financial statements in a context of high inflation.

BRAZIL AND OECD'S BEPS PROJECT

- Therefore, notwithstanding its participation in BEPS Project, Brazil should evaluate very carefully what proposals actually fit into the Brazilian tax system, which already stands out for the austerity and peculiarities of its tax rules, which do not converge with the tax practices followed by most OECD countries. In particular, the application of anti-hybrid rules to restrict the deduction of interest on net equity may be undesirable and inappropriate under the Brazilian tax system, in which the corporate income tax rate of 34% (IRPJ/CSLL) is high compared to most OECD countries, standing at a level close to the statutory rate of 35% charged by the United States, which is the highest among the OECD countries.
- For instance, the Tax Court of Nuremberg (Germany) analyzed the instruments in its decision of December 14, 2010. In this case, the Nuremberg Tax Court concluded from the features of IoNE and according to German tax law that they qualify as dividends, since at the end of the day they derive from the investment by the shareholder in the equity of the Brazilian company.
- The issue that arose in Spain is whether their treatment under treaty rules would override the respective characterization under domestic law. While there is consensus that the characterization provided by international rules should prevail for treaty purposes, the point at issue is whether the characterization provided for treaty purposes would also automatically apply for domestic law purposes. Since IoNE are considered tax deductible at the level of the distributing Brazilian subsidiary (if certain conditions are met), the Spanish domestic participation exemption (as amended) is no longer applicable to IoNE income received from 1 January 2015 onwards.

TAX TREATIES AND THE SPANISH CASE

- We cannot forget that tax treaty's role is confined to distributing the power to levy taxes between the states, without depriving domestic laws of their enforceability in their respective spheres of application. The characterization of an item of income on the basis of a tax treaty is only for the purposes of applying that tax treaty, which will determine which state has the power to levy tax on that income, but, beyond that, it will be the legislation of the state to which the income has been assigned that will determine how it is to be characterized and taxed.
- The Economic Administrative Court of Nüremberg (Germany) in its decision of December 14, 2010, similarly, decided that regarding the receipt of IoNE payments from Brazil by a German resident shareholder, the court concluded, that (i) the IoNE payments had to be treated as shares in profits for the purposes of the domestic exemption regime, "as they originate from the corporate relationship and are only received by shareholders" and (ii) Germany, as the country of residence of the recipient of the income, must make an independent characterization of the income based on its own domestic law, on which neither the characterization nor the treatment of the IoNE payments (ability to deduct them and withholding tax at source) for the purposes of Brazilian domestic law have any bearing.
- Among the potential effects tgat the spanish decision may have is the denial of the independence of the Spanish tax and legal system to characterize income from a non Spanish source, which could be translated, as in the case under analysis, into a type of "importation" of elements of the tax obligation from other jurisdictions that would override Spain's own, which, we must not forget, arise from the legislative power conferred by the Spanish people on their parliament.

- THANK YOU VERY MUCH!

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