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Tax Planning – Beyond Substance and Business Purposes Analysis

Ana Claudia Akie Utumi (Utumi Advogados) · Tuesday, June 2nd, 2015

Along the last 15 years, the discussion of tax planning in Brazil evolved significantly, changing from a very formalist approach to an approach that scares taxpayers by its aggressiveness and lack of limits. Changes that have happened without significant change of law.

Brazilian doctrine used to defend that transactions should have been analyzed from legal and formal standpoints, rejecting the use of any kind of economic interpretation. At that time, step transactions with very short time in between each step used to be largely adopted, without much concern about substance or business purposes. Just as an example, most of the M&A transactions during the 90's and early 2000's used to adopt steps that involved (a) creation of a new company ("Newco") by the seller; (b) capital contribution to this new company with the assets/business to be sold; (c) capital contribution in cash by the buyer, paying premium on the issuance of shares; (d) spin-off of Newco, in which the seller used to receive the cash, and the buyer used to retain the targeted assets/business. By doing such a transaction, the premium paid by the buyer was converted into equity-pick up profits for the seller, which were exempt from Corporate Income Taxes.

During the 90's, there were plenty of court decisions upholding the right of taxpayers to organize their businesses as they thought fit regardless the analysis of business purposes or the substance, in such a way that, even in cases in which the capital increase happened in day 1, and the spin-off in day 2, the decisions were favorable.

However, in 2001, an amendment to Brazilian Tax Code can be viewed as the starting point for the changes. Such amendment established that "the administrative authority may disregard acts or deals practice to disguise the occurrence of taxable event or change the nature of tax obligation's elements, observed procedures to be regulated by ordinary law." This change is not self-applicable, since it depends on enactment of ordinary law, something that has never occurred. Even not being self-applicable, such change inspired the approaches and interpretations of tax authorities and the Administrative Court of Tax Appeals ("CARF", previously called "Taxpayers' Court").

Of course that, with today's all-connected world, believing that companies could continue to count on such a formal approach that used to reject any economic analysis was a illusion. However, the shifting that we are witnessing is quite scary in a sense that, oftentimes, Brazilian tax authorities have gone beyond substance and business purposes analysis.

In the last years, the tax authorities have been imposing assessment under the argument that taxpayers practiced “abuses” to save taxes, trying an an approach similar to what is found in France. In such tax assessments, they also impose an increased penalty of 150%, applicable to tax evasion cases.

Despite of looking correct from international tax standpoint, the fact is the approach adopted by the Brazilian tax authorities oftentimes goes beyond any substance or business purposes analysis adopted internationally, to the extent that they often disagree with any of the company’s decision that they would have taken differently if they were the officers of such a company. But they are not!

In other words, instead of trying to understand the economic reasons, the business reasons beyond whatever the company might had done, oftentimes tax authorities may try to construe that the transaction only occurred due to tax reasons. One example lies in the several tax assessments disallowing goodwill amortization. Even though Brazilian tax law assures the right to amortize goodwill to any Brazilian company that buys participation in another Brazilian company at a premium (amortization starting after a downstream or upstream merger), the tax authorities try to construe that the M&A transaction only occurred to generate and amortize goodwill, ignoring completely whatever business reasons that might have driven the acquisition of the target company.

Another example was a case of a subsidiary of a US company, in which the authorities understood that the parent company did not need to raise funds in the US markets to lend to this subsidiary to buy a significant business of another Brazilian company. The argument adopted by the tax authorities to disregard interest expenses in an intercompany lending (from US parent to the Brazilian subsidiary) involving funds raised in the US markets was that, if such a group wanted so much to buy this other company, this group could have sold assets and making capital contribution in the Brazilian subsidiary, instead of raising funds from US banks and lending them.

With this approach, several companies – including listed companies, multinational groups, etc. – have been surprised by tax assessments that can easily value more than hundreds of million dollars, if not billions.

In addition, one could ask how the courts are viewing this new approach. Until few years ago, the Federal Administrative Court of Tax Appeals (“CARF”) used to adopt a more balanced and business-driven view on the cases that arrived there. CARF decisions against taxpayers may be reviewed by judicial courts, but often require to post court deposits or bank guarantees, and the judicial process may easily take 8-10 years. For the time being, there are no final decisions on this substance and business purposes analysis rendered by the Supreme Court or Superior Court of Justice, highest Brazilian courts for constitutional and non-constitutional matters, respectively.

Notwithstanding, CARF has suspended its activities in the last March and a re-modelling of the Court is under discussion, including who can be appointed judge. During this process, very experienced and skilled judges representing taxpayers resigned, which raises the concern on whether the new judges will be as skilled and as balanced to analyze the cases as prior judges. Only time will tell.

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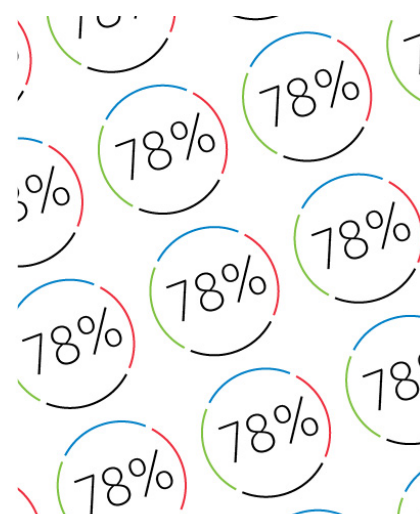
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