Kluwer International Tax Blog

Why Brazil’s interest on net equity should not be affected by BEPS Action 2

Ramon Tomazela (Mariz de Oliveira e Siqueira Campos Advogados) · Wednesday, August 26th, 2015

In general terms, the application of anti-hybrid rules proposed by the OECD in Action 2 of the BEPS Project, with the aim of establishing a link between the tax treatment applicable to the remuneration derived from hybrid financial instruments in different jurisdictions, will depend on the fulfillment of four cumulative conditions: (i) the use of a financial instrument by the taxpayer; (ii) the existence of an actual payment; (iii) an effective mismatch in the tax treatment, characterized by the deduction of the payment in the source state without the taxation of the corresponding amount in the residence state; and (iv) the presence of a hybrid element as the cause for the conflict in the characterization of the payment under two different tax systems (OECD (2014), Neutralising the Effects of Hybrid Mismatch Arrangements, OECD/G20).

In order to define the legal scope of the anti-hybrid rules, the OECD proposed an express definition of the term “payment”, which comprises “*any amount capable of being paid including (but not limited to) a distribution, credit, debt or accrual of money but it does not extend to payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties”*[1]. In view of the wide scope of this definition, which reaches any payment, distribution, credit, debt or accrual of money, it is clear that the Brazilian interest on net equity (“*juros sobre o capital próprio*” – JCP), paid by a company resident in Brazil to a non-resident shareholder, may fall within the scope of application of a domestic anti-hybrid rule based on BEPS Action 2 to the extent that the corresponding amount is treated as exempt dividend in the state of residence.

The relationship between the payment of interest on net equity and the Action 2 of BEPS Project arises because, when a Brazilian company pays interest on net equity to a company resident abroad, the state of residence, in most cases, will characterize such payment as dividend under its domestic law, thus allowing the application of participation exemption regimes. For instance, the National Court (“*Audiencia Nacional*”) in Spain, in a decision handed down on 27 February 2014, classified the interest on net equity as dividend under Spanish domestic law, based on its typical characteristic of a corporate right.[2] Similarly, the German Federal Court of Finance (“*Bundesfinanzhof*”) also characterized Brazilian interest on net equity as dividend both under German domestic law and the tax treaty entered into by Brazil and Germany, which was in force at the time of the facts of the case.[3]

Based on the examples above, one can readily see that the interest on net equity may be characterized as an exempt dividend from the perspective of the residence state. If this occurs, the

payment of interest on net equity will fulfill the conditions for the application of anti-hybrid rules based on BEPS Action 2, since it represents a deductible expense under Brazilian tax law and, at the same time, an exempt dividend from the perspective of the residence state. Therefore, the characterization of Brazilian interest on net equity as an exempt dividend in the residence state may lead to a deduction and non-inclusion scheme targeted by the OECD.

However, from a tax policy standpoint, it is debatable whether the interest on net equity should be included within the scope of BEPS Action 2, in spite of the right to deduct its payment from the taxable profits of Brazilian companies.

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.

In addition, article 9 of Law No. 9,249/1995, which introduced the interest on net equity in the Brazilian tax system, already restricts the possibility of base erosion and profit shifting, by establishing a maximum amount to be deducted from the taxable profits. First, interest on net equity is calculated based on the application of long-term interest rate (TJLP) on the adjusted equity of the Brazilian company, considering all variations occurred during the calendar year, subject to the limits of either 50% of the current profits or 50% of the retained earnings. Second, the payment of interest on net equity is subject to the withholding income tax at a 15% rate, which is increased to 25% in the case of payments made to beneficiaries domiciled in low tax jurisdictions.

It follows that the leeway available for using interest on net equity as an aggressive tax planning mechanism to achieve base erosion and profit shifting is severely restricted by Brazilian tax law. This requires caution in the introduction of tax measures based on BEPS Action 2, because interest on net equity represents an important mechanism to address the debt bias caused by the tax deductibility of interest expenses and to offset the effects of the relatively high inflation in Brazil.

Moreover, interest on net equity mitigates economic double taxation of profits earned through legal entities, once in the hands of the company when the income is derived and a second time in the hands of the shareholders upon the profit distribution. Indeed, Brazilian interest on net equity is deductible from the tax base of the corporate income tax and taxed at the level of individual shareholders at a flat rate of 15%, which is lower than the top rate of the individual income tax (27.5%). Thus, it is a variation of a dividend deduction system, which has been used in the past by a number of countries, such Greece, Finland, Norway and Sweden, but with the introduction of a limit to standardize the deduction based on the opportunity cost of the share capital.

Currently, the vast majority of countries opt for other mechanisms to integrate corporate and individual income taxes, since the deduction of dividends can bring certain drawbacks, such as the possibility of temporal manipulation of expenses through the corporate distribution policy (i.e. recognition or deferral of expenses by means of distribution or retention of profits), as well as the lack of information and control in relation to the tax treatment applicable in foreign jurisdictions

when dividends are distributed to non-resident shareholders.

With regard to the first drawback, the dividend deduction at the time of its distribution may encourage companies to retain profits in order to recognize the expense in the most convenient moment. In Brazil, interest on net equity is deductible at the time of its payment or credit to the shareholders, but it is still a highly litigated issue whether the company is allowed to accumulate the long-term interest rate with respect to past years. As to the second negative effect, the problem relies on the high risk of double non-taxation, because the foreign shareholder may reside in a low-tax jurisdiction. In order to overcome this issue, Brazil increased the rate of the withholding income tax to 25% in the case of payments made to shareholders domiciled in low-tax jurisdictions. This solution prevents the risk of double non-taxation, since the rate of 25% levied on the gross amount of income is considered adequate at the international level.

The comparison of the Brazilian interest on net equity with the dividend deduction system is important because a mismatch in tax outcomes caused by the relief of economic double taxation through dividend deduction along with a participation exemption regime would not be covered by the anti-hybrid rules proposed in BEPS Action 2, due to the lack of the hybrid element required for its application.

Similar reasoning may be extended to the Brazilian interest on net equity, since its hybrid character arises from differences between corporate legal regime and tax treatment, but not from hybrid features of the underlying financial instrument. In fact, the Brazilian interest on net equity does not require the use of financial instruments that combine both equity and debt characteristics. Conversely, even when the shareholder makes a plain vanilla equity investment, the company may pay interest on equity if the legal requirements are met, with the recognition of deductible expenses for tax purposes. Therefore, it is not a tax planning strategy that involves the use of complex financial instruments, which is precisely what the OECD wants to tackle by stating that "*the recommendations are intended to drive taxpayers towards less complicated and more transparent cross-border investment structures that are easier for jurisdictions to address with more orthodox tax policy tools*"[4].Thus, it represents a possible way to exclude the interest on net equity from the scope of BEPS Action 2.

It should also be mentioned that BEPS Action 2 does not reach the deduction of notional interest ("*déduction d'intérêt notionnel*") introduced by Belgium in 2006 in order to replace the old "coordination center regime", which was considered as an illegitimate state aid by the European Commission. As the Brazilian interest on net equity, the notional deduction granted by the Belgian law reduces the role played by the distinction between equity and debt capital in corporate financing decisions.

The report on BEPS Action 2 expressly states that anti-hybrid rules are not applicable to "*payments that are only deemed to be made for tax purposes and that do not involve the creation of economic rights between the parties*"[5]. Thus, as the Belgian tax law only provides for a notional deduction, without requiring an actual payment to the shareholders, it is certain that this tax measure is not reached by the proposals presented by the OECD. It could not be otherwise, since in the absence of actual payment, there is neither a conflict in the characterization of a payment in two jurisdictions (hybrid mismatch), nor the deduction of a payment without the corresponding taxation at the level of the beneficiary (deduction and non-inclusion).

What is not clear is whether the existence or not of an actual payment is a reasonable criterion to

distinguish the Belgian notional interest deduction and the Brazilian interest on net equity, since both tax measures are inspired in the same idea (“*Allowance for Corporate Equity*” – ACE) and have in common the same object and purpose. From the perspective of the OECD’s goals of avoiding base erosion and profit shifting, Brazilian tax law at least requires the existence of current profits or retained earnings in an amount two times higher than the deductible expense, whereas the Belgian notional interest deduction can be carried forward when the profits ascertained in the calendar year are insufficient to offset the deduction available[6].

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 (Brazil adopts broad CFC rules, fixed profit margins to simplify transfer pricing, objective limits to deduct royalties, high taxation at source, among other tax measures departing from the international standard). 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.

---

[1] OECD. *Neutralising the Effects of Hybrid Mismatch Arrangements*. OECD/G20 Base Erosion and Profit Shifting Project. Paris: OECD, 2014, p. 74.

[2] Audiencia Nacional, Appeal No. 232/2011, judged on 27/02/2014.

[3] Bundesfinanzhof, I R 6/11, judged on 06/06/2012.

[4] OECD. *Neutralising the Effects of Hybrid Mismatch Arrangements*. OECD/G20 Base Erosion and Profit Shifting Project. Paris: OECD, 2014, p. 13.

[5] OECD. *Neutralising the Effects of Hybrid Mismatch Arrangements*. OECD/G20 Base Erosion and Profit Shifting Project. Paris: OECD, 2014, p. 30.

[6] According to Stijn Vanoppen: “*If there are insufficient profits to offset the available NID, any unused portion can be carried forward for seven years*”. (VANOPPEN, Stijn, “Belgium National Report”, The Debt-Equity Conundrum, *Cahiers de Droit Fiscal International,* Volume 97b. International Fiscal Association. 2012 Boston Congress. Rotterdam: IFA, 2012, pp. 117-118).

To make sure you do not miss out on regular updates from the Kluwer International Tax Blog, please subscribe here.

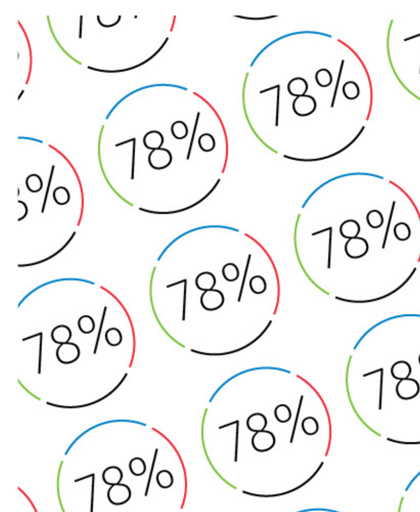
Kluwer International Tax Law

The **2022 Future Ready Lawyer survey** showed that 78% of lawyers think that the emphasis for 2023 needs to be on improved efficiency and productivity. Kluwer International Tax Law is an intuitive research platform for Tax Professionals leveraging Wolters Kluwer's top international content and practical tools to provide answers. You can easily access the tool from every preferred location. Are you, as a Tax professional, ready for the future?

Learn how **Kluwer International Tax Law** can support you.

78% of the lawyers think that the emphasis for 2023 needs to be on improved efficiency and productivity.

Discover Kluwer International Tax Law.
The intuitive research platform for Tax Professionals.



2022 SURVEY REPORT
The Wolters Kluwer Future Ready Lawyer
Leading change

This entry was posted on Wednesday, August 26th, 2015 at 8:00 am and is filed under BEPS
You can follow any responses to this entry through the Comments (RSS) feed. You can skip to the end and leave a response. Pinging is currently not allowed.