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Austrian holding companies and the Brazilian list of privileged tax regimes – A critical analysis

Ramon Tomazela (Mariz de Oliveira e Siqueira Campos Advogados) · Wednesday, October 5th, 2016

On September 14th, 2016, the Brazilian Federal Revenue Service ("RFB") published the Normative Instruction RFB No. 1,658/2016, which included legal entities incorporated as holding companies in Austria in the list of privileged fiscal regimes.

Although the list mentions "*legal entities incorporated in the form of holding company*", the wording is imprecise, because the administration of equity investments is a corporate object of the legal entity, rather than a corporate form. In Austria, a holding company can be incorporated either as an "*Aktiengesellschaft*" – AG (joint-stock company) or as a "*Gesellschaft mit beschraenkter Haftung*" – GmbH (limited liability company). In practice, the GmbH is commonly used for holding companies due to its uncomplicated formation and simplified corporate governance.

The Normative Instruction RFB No. 1,658/2016 does not expressly mention why holding companies established in Austria were included in the list of privileged tax regimes. Ever since the first time the matter was regulated in Brazil, the Brazilian tax administration has been adopting a system of listing countries and jurisdictions that fall under the concepts of low-tax jurisdictions and privileged tax regimes. However, it does not provide any express justification for the inclusion of a given country in the list.

Despite the lack of an express statement indicating the harmful tax treatment applicable in each listed country, the interpretation of Article 24-A of Law n. 9,430/1996, which defines the privileged tax regimes, may shed some light on the Brazilian tax authorities' reasoning.

According to this legal provision, it is considered as a privileged tax regime the one that presents one or more of the following characteristics:

- It does not tax income or taxes it at a maximum rate lower than 20% (twenty percent);
- It grants tax benefits to a non-resident individual or legal entity: (a) without requiring substantial economic activity to be carried in the country or dependency; or (b) contingent upon no substantial economic activity being carried out in the country or dependency;
- It does not tax, or taxes at a maximum rate lower than 20% (twenty percent), income earned outside its territory;
- It does not provide access to information related to shareholding composition, ownership of

goods or rights, or the economic transactions carried out.

The Executive Branch may reduce the percentages established in Article 24-A of Law n. 9,430/1996. Based on this legislative delegation, Brazil's Finance Minister issued the Ordinance MF nº 488/2014 reducing the minimum tax rate required from 20% to 17%, whilst maintaining all other conditions applicable.

Holding companies set up in Austria may benefit from a "*participation exemption regime*", according to which dividends received from foreign companies are not subject to tax if the parent company owns at least 10% of the share capital for a minimum period of 1 year. Similarly, capital gains derived from the disposal of shares of a non-resident company in which the parent company holds at least 10% of the share capital for a period of at least 1 year are exempt from Austrian corporate income tax[1].

At first sight, the Austrian participation exemption regime may fall under item (iii) above, since it does not tax dividends and capital gains earned outside its territory, provided that certain conditions are met. Nevertheless, this legal provision has to be interpreted in a narrow sense, in order to reach only countries that have adopted, albeit partially, territorial tax systems. Otherwise, any tax exemption granted to a specific type of income obtained abroad would fall under the concept of privileged tax regime, leading to the inclusion of such country in the list issued by the Brazilian tax administration.

It may be debatable whether a participation exemption regime is a partial territorial system or a simple tax exemption. In a pure territorial system, resident taxpayers are exempt from income tax in their state of residence on foreign source income, while in a partial territorial system, resident taxpayers are exempt from income tax only on certain types of foreign source income. In both types of territorial tax systems, the reason for the non-taxation lies in the fact that the income was obtained abroad.

In a simple tax exemption, the income obtained abroad is not subject to tax in the state of residence for other reasons that bear no relation with its source. When a given country does not tax certain types of income regardless of its origin (domestic source income or foreign source income), it should not be treated as a territorial tax system, since the tax exemption is based on other tax policy considerations. This seems to be the case in Austria, which also exempts domestic intercompany dividends (i.e. dividends received by a company resident in Austria from another domestic company are exempt from corporate income tax, regardless of the percentage of shares owned by the shareholder).

This interpretation finds support in the wording of item (iii) above, which mentions countries that do not tax, or tax at a maximum rate lower than 20%[2], income earned outside its territory. Thus, for the inclusion of a country in the list, the non-taxation must be based on the fact that the income was earned outside its territory.

That being said, it is possible to turn now to item (ii) of Article 24-A of Law n. 9,430/1996, according to which a country or dependency is considered as a privileged tax regime if it grants tax benefits to a non-resident individual or legal entity without requiring the performance of substantial economic activity within the country or dependency.

The wording of the legal provision is misleading, since it mentions tax benefits granted to non-resident individuals or legal entities. However, upon the incorporation of a company in Austria or

in any other country that adopts the place of incorporation test, it starts to be considered as a resident legal entity for tax purposes.

It would not be accurate to imagine that this legal provision was enacted by the Brazilian legislator only to reach countries that grant tax exemption to non-residents on income derived from their territories, as generally occurs with cross-border investments carried out in the financial and capital markets. If it were so, there would be no reason for safeguarding the exercise of substantial economic activity in the foreign country or dependency, since passive income streams do not depend on the performance of productive activities (*v.g.* active trade or business).

For this reason, the third item of Article 24-A, sole paragraph, of Law n. 9,430/1996 is commonly interpreted as targeting "*ring-fenced tax regimes*", which are partly or fully insulated from the domestic market of the country providing the tax regime[3]. As pointed out by the OECD in its report on "*Harmful Tax Competition*" of 1998, the fact that a country protects its domestic economy from the tax regime by ring-fencing provides a strong indication that it has the potential to create harmful spillover effects[4].

Against this background, it is worth mentioning that the Austrian participation exemption regime is not ring-fenced, since it does not explicitly or implicitly exclude resident taxpayers from its tax benefits. On the contrary, as previously mentioned, dividends received by an Austrian company from other resident companies are also exempt from corporate income tax, regardless of the percentage of the equity participation owned by the recipient company. In addition, holding companies established in Austria are not explicitly or implicitly prohibited from operating in the domestic market. The only aspect of the Austrian participation exemption regime that would be considered as ring-fenced is the exemption granted to capital gains, since the results derived from the sale or disposal of business assets in a domestic context are generally treated as taxable income.

Therefore, the Austrian participation exemption regime should not be considered in itself as a harmful tax practice to be tacked by the Brazilian tax authorities through its inclusion in the list of privileged tax regimes. This interpretation is strengthened by the view expressed by the OECD in Action 5 of the BEPS Project, in which it stated that "holding company regimes" that provide tax benefits only to dividends and capital gains raise different policy considerations, because they primarily focus on alleviating economic double taxation. According to the OECD, the concerns about holding companies regimes are more related to transparency on shareholding composition and beneficial owners, as well as to use of tax treaty benefits in inappropriate circumstances[5].

Furthermore, the Austrian participation exemption regime may be considered as a tax measure enacted to comply with the free movement of capital, as set forth in Article 63 of the Treaty on the Functioning of the European Union (TFEU), which prohibits "*all restrictions on the movement of capital between Member States and between Member States and third countries*". This is the unique fundamental freedom that applies not only within the European Union, but also to third countries.

As differences in the tax treatment applicable to domestic and cross-border intercompany dividends would constitute an infringement of the free movement of capital[6], the participation exemption regime granted under section 10 of the KStG may be considered as a tax measure enacted to comply with EU law. Thus, dividends distributed by companies located in third-countries to parent companies in Austria became subject to a tax exemption similar to that granted in a purely domestic setting, albeit with additional requirements (*v.g.* minimum holding

requirement of at least 10 percent and a holding period of at least one year). For the purpose of this post, it is not necessary to analyze whether a restriction in the exercise of the free movement of capital is justifiable under the EU law, or even what would be the policy reasons for such a unilateral extension of the free movement of capital to third countries. What it important to stress here is the fact that the Austrian participation exemption regime may not represent a harmful tax practice, but rather a tax measure adopted in compliance with the EU law.

In the opposite direction, one could argue that Austria would apply the exemption method to domestic dividends and the indirect credit method to cross-border dividends, provided that the administrative burdens imposed on the taxpayer under the indirect tax credit method are not excessive. However, putting aside the discussion regarding the equivalence between the two methods, which is a debatable topic in itself[7], the fact is that that a participation exemption regime may not be considered as a harmful tax practice per se, because the goal of avoiding economic double taxation through the exemption method is supported by the capital import neutrality (CIN).

In conclusion, it is fair to say that the inclusion of Austrian holding companies in the list of privileged tax regimes, without any reference to the lack of substance or operational capacity, was a precipitated measure adopted by the Brazilian tax administration without a careful analysis of all aspects involved. In an ideal scenario, Brazil should have made the same reservation applied to holding companies in Denmark and the Netherlands, which are only regard as privileged tax regime when the legal entity's operational capacity is insufficient for the development of its core business.

This would be the right approach to be taken in view of the harsher tax treatment to be applied to cross-border transactions carried out with holding companies in Austria as from October 1st, such as: (i) automatic application of transfer pricing and thin capitalization rules, regardless of the relationship between the holding company in Austria and the Brazilian legal entity; (ii) reduction of the equity-debt ratio for thin capitalization purposes, according to which the sum of indebtedness shall not exceed 30% of the net worth value of the company resident in Brazil (the normal ratio would be 200% of the net worth value); (iii) additional restrictions to deduct expenses related to payments made to the company in Austria from the tax base of the corporate income tax due in Brazil; (iv) taxation of profits earned by the holding companies located in Austria on December 31 of each taxable period, regardless of its characterization as an affiliated company and of the deferred payment system (payment in installments over a period of up to 8 years); (v) prohibition of the use of the deemed tax credit of 9% granted by Law No. 12.973/2014; (vi) exclusion of the profits obtained by the holding company and its invested companies from the tax consolidation regime applicable to profits and current losses obtained abroad.

Finally, it should be noted that, as a listed country, Austria may file a review claim before the Brazilian tax administration explaining with more details the tax treatment applicable to holding companies incorporated in its jurisdiction[8]. Austria may require its exclusion from the list of privileged tax regimes, or the inclusion of an express provision clarifying that it only applies to holding companies without substance or operational capacity. Based on this claim, Brazil may eventually change its initial interpretation, irrespective of any amendment to the Austrian legislation.

[1] Section 10(1) and 10(2) of the Körperschaftsteuergesetz (KStG).

[2] As mentioned earlier, the Ordinance MF nº 488/2014 reduced the minimum tax rate required from 20% to 17%.

[3] Alberto Xavier, *Direito Tributário Internacional do Brasil*, 8th Edition, Rio de Janeiro: Forense, 2015, p. 302.

[4] OECD, *Harmful Tax Competition – An Emerging Global Issue*, Paris: OECD, 1998, pp. 26-27.

[5] OECD, *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance*. Action 5: 2015. Final Report. OECD/G20 Base Erosion and Profit Shifting Project. Paris: OECD, 2015, pp. 39-40.

[6] *See* Georg W. Kofler and Clemens Philipp Schindler, Finance Ministry Targets Participation Exemption Regime, *Tax Notes International*, Volume 53, No. 13, 2009, pp. 1163-1165.

[7] *See* Giulia Gallo, Equivalence of a Dividend Exemption and an Underlying Tax Credit, *Non-Discrimination in European and Tax Treaty Law – Open Issues and Recent Challenges*, Kasper Dziurdz and Christoph Marchgraber (eds.). Linde: Vienna, 2015, pp. 195-216.

[8] Article 2 of Normative Instruction No. 1,530/14.

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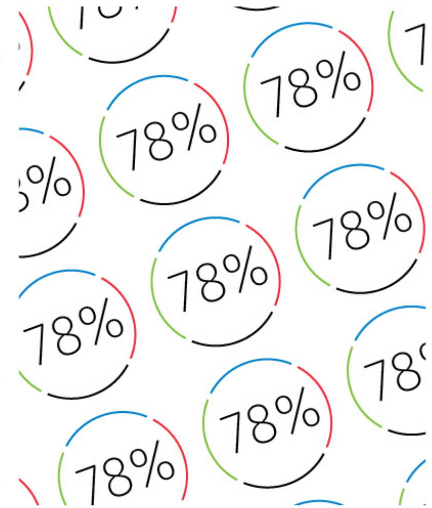

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