



L.O. Baptista Advogados

TTN Conference

December 3, 2009 – São Paulo



Brazilian CFC Rules – background and status

Leonardo Castro

LL.M. Tax Law in progress – University of São Paulo (USP)

Specialization in International Taxation – Brazilian Institute of Tax Law (IBDT)



Worldwide Income Tax in Brazil - Background

- Until 1995 the income assessed by corporations offshore was not taxed in Brazil for Income Tax purposes (Territoriality Principle)
- From 2006 on Brazil adopted the Worldwide taxation for Income Tax levied on corporations.
- The Income assessed by corporations in Brazil is taxed by Corporate Income Tax (IRPJ) and Social Contribution on Net Profit (CSLL), at a total amount of 34%.
- **Corporate Income Tax (IRPJ):** As from January 1 of 1996, profits, proceeds and capital gains from offshore jurisdictions had to be added to the Actual Income Tax Regime (*Lucro Real*) by balance sheet on December 31 of every year (art. 25 of Law 9.249/95)
- **Social Contribution on Net Profit (CSLL):** As from October 1 of 1999 profits, proceeds and capital gains from offshore jurisdictions were also taxed by CSLL, and not only by IRPJ (Provisional Measure 1.858-6/99)



Taxation of Offshore Income

Supplementary Law 104/2001: added paragraph 2 to article 43 of Brazilian Tax Code (CTN):

“Art. 43. Federal Government tax on income and earnings of every nature will be assessed on the acquisition of economic or legal availability

(...)

§ 2 In regard to income and earnings from offshore, the law will set forth the conditions and the moment such availability will occur, for the tax mentioned herein”

Provisional Measure 2158-35/2001: introduced the supposed CFC rule in Brazil

“Art. 74. In regard to the tax base of income tax and social contribution on net profits, according to art. 25 of Law 9.249/95, and art. 21 of this Provisional Measure, the profits received by controlled and associated companies offshore will be considered available to the controlling or associated company in Brazil at the date in which they were accounted through balance sheet, in terms of this code.

Sole Paragraph: The profits assessed by the controlled or associated company offshore until December 2001 will be considered available in December 31, 2002, exception made if other forms of availability were made so before such date.



Definition of Controlled and Associated Companies

➤ The definitions of controlled and associated company is set forth in the Brazilian Law of Corporations, i.e., Law 6.404/76, which recently was broaden.

➤ Now, the current wording of Law 6.4040 (with modifications by Law 11.941/09) is:

Art. 243. (...)

§ 1º Associated companies are the ones in which the investor has relevant influence

§ 2º Controlled companies are the ones in which controlling company, directly or through other controlled companies, is entitled to shareholders' rights that assures it, permanently, the preponderance on company's resolutions and the power to elect the majority of its managers.

(...)

§ 4º There is relevant influence when the investor has or exercises the right to participate in the financial and operational policy of the invested company, without controlling it.

§ 5º It is presumed the relevant influence when the investor is holds 20% or more of the voting stock of the invested company, without controlling it.



Provisional Measure 2.158/01 (Brazilian CFC Rule)

- Doubt: what is really being taxed by Brazilian CFC rules: deemed dividends or presumed business profits?
- Brazilian CFC Rule taxes the business profits of controlled companies abroad, and not the dividends, since the tax base is the assessed profit (not deducted from local taxes, legal reserves and others).
- The foreign commercial legislation that is applicable to determine the profits subject to taxation in Brazil, and not the fiscal legislation.
- Brazilian CFC rules, referred on art. 74 of Provisional Measure 2.158-35/2001 does not follow the international standards of other countries, for ex:
 - (i) Applicable only to passive income (dividends, royalties, interests and real estate/lease);
 - (ii) Applicable only to tainted capital (passive and active income from related parties);
 - (iii) Applicable only to CFC located on tax havens or low tax jurisdictions; or
 - (iv) Also applicable to individuals residents in the country imposing the CFC rules, and not just for corporations.
- **ADIN 2588** (Declaratory Action Of Unconstitutionality): Claims the unconstitutionality of that paragraph 2 of art. 43 of CTN, included by Supplementary Law 104/01, and art. 74 of Provisional Measure 2.158-35/2001
- Status of the judgment at Brazilian Supreme Court (STF): **3** votes against x **3** votes in favor (Total of 11 possible votes).



Provisional Measure 2.158/01 x Double Tax Treaties

➤ Article 7: Business Profits (exclusive right to tax by the Residence State):

*“1) The profits of an enterprise of a Contracting State shall be taxable **only** in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. (...)”*

➤ OECD as from 2003 changed its original position of 1992 and stated that the CFC rules are not in conflict with the Convention since the CFCs do not tax the entity (*juridical* double taxation) but its shareholders (*economic* double taxation).

➤ OECD MC Commentaries nr. 40 on Art. 5 (7): subsidiary is a independent legal entity, which shall be respected (the effect would be the same as disregarding its legal personality).

➤ Due to Art. 7 the business profits, i.e., the profits attributable to controlled/associated company offshore could not be taxed in Brazil, until the effective payment/distribution.

➤ Unless there was a tax evasion, treaty shopping or treaty abuse that justified this procedure.



Provisional Measure 2.158/01 x Double Tax Treaties

- Article 10: Dividends (cumulative taxation, but limited to the Source State):
*“2) However, such dividend **may also** be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State (...)”*
- The article mention the term “paying” which gives the idea of putting funds at the disposal of the shareholder. In the “presumed dividends”, even by the wide interpretation, one cannot conclude that such dividends were “paid”.
- By adopting the approach that Article 10 allows the Residence State to tax the income, observing the 15% WIT, Brazil could tax it, but would still be subject to Article 23 (A or B), which often grants exemption for such income.
- Ex: Article 23 § 4 of Brazil-Spain Treaty:
*“Where a resident in a Contracting State derives income from dividends that, according to the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall **exempt** such income”*
- Doctrine: CFC Rules may only be applied on double tax treaties if either established in the treaty wording or in cases of treaty abuse or treaty shopping, and tax evasion.
- Brazil does not apply this understanding on its tax treaties. Ex: Eagle Case (still pending)



Provisional Measure 2.158/01 x Double Tax Treaties

➤ Rulings of the Administrative Federal Tax Court before and after art. 74 of Provisional Measure 2158-34/01:

Before: Court Decision 108-08765; Ruled on July 23, 2006.

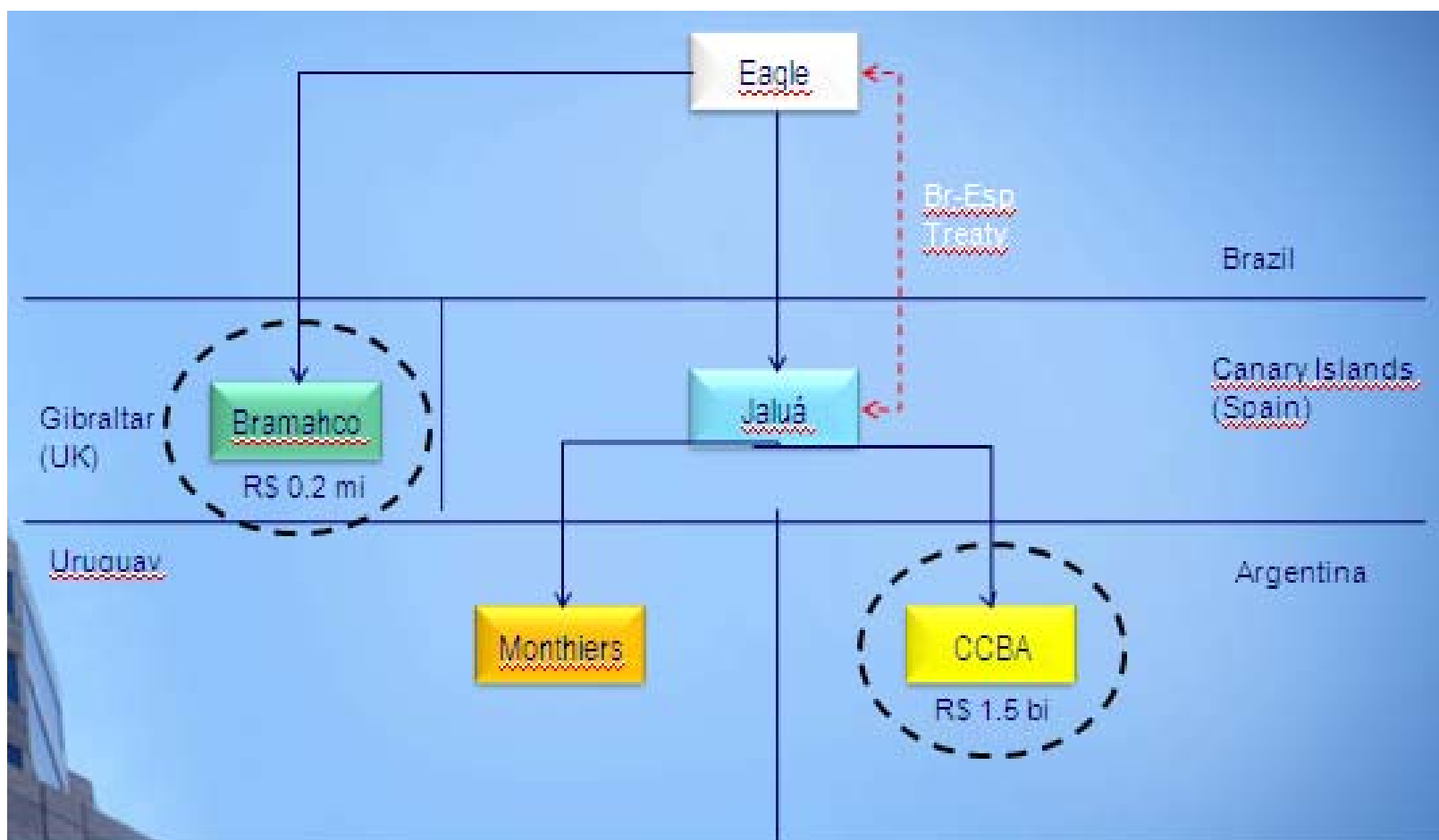
*IRPJ – CONTROLLED COMPANY IN PORTUGAL – PROFITS OF THE YEARS 1996 AND 1997 – LAW 9249/95 – TAX TREATY – Art. 25 of Law 9249/95 (...) However, for a Brazilian company that had a controlled company in Portugal, **this rule does not apply due to the Double Tax Treaty signed between Brazil and Portugal** (Decree 69.393/71), in which Article 7 set forth the impossibility of a contracting state imposing tax on business profits of a company located in the other State.*

After: Court Decision 108-08765; Ruled on July 23, 2006

*IRPJ – CONTROLLED COMPANY IN SPAIN – PROFITS AS FROM 2001 ON – MP 2158-34/2001 – TAX TREATY – Art. 74 of MP 2158-34 (...) the **Tax Treaty signed between Brazil and Spain does not prohibit** the taxation of a company located in Brazil in regard to the **business profits of the Spanish company** considered available.*



The Eagle case





The Eagle case

- The proper interpretation of Article 7 and Article 10 of Brazil-Spain tax treaty would not allow Brazil to tax the income of the controlled company in Spain (**Jalua**) that was not yet distributed to the controlling company in Brazil (**Eagle**).
- Tax Authorities decided that, Article 7 of the Tax Treaty only includes the Jalua's profits itself, i.e., the profits generated by the business activities of Jalua, but not the profits of Jalua's controlled companies located at other jurisdictions that Jalua is entitled to: Monthiers (in Uruguay) and CCBA (in Argentina).
- Brazilian Tax Authority argued that, in this case, Article 7 (Business Profits) would not be violated, and Brazil may still tax it.
- Since Spanish law does not impose the need for equity accounting method, the only way to tax such income at in Brazil would be to consider CCBA and Monthiers' profits as fictitiously distributed directly to Eagle, since they are not yet reflected at Jalua's level.
- This interpretation completely disregards the legal entity in Spain (Jalua), the profit calculation method in Spain and it does not even sustain any abuse/tax evasion for doing such procedure.
- **Final Administrative Decision has not yet been formally published, but the taxpayer lost.** There is possibility of an administrative appeal and, afterwards, the judicial procedure to discuss this matter.

Thank you!

Email: ifc@baptista.com.br