

Thin Cap and Delaware from a Brazilian perspective

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1. Thin Capitalization Rules

(a) Background

- Before MP 472/09:
 - Deductibility of interest paid abroad used to be subject only to the limits established by article 299 of Decree 3,000/99 and to the transfer pricing rules.
 - August/2009: Decision CSRF (Colgate's case).
 - Thin capitalization occurs when a company receives massive loans from its controlling shareholder, resulting in an excess of debt in relation to the company's equity (hidden equity capitalization or high debt/equity ratio).
 - Tax consequences are, on the one hand, the treatment of interest as dividends (not deductible for the borrower) and, on the other hand, an increase to the borrower's equity (implying higher taxation over the equity, where this tax exists).
 - Thin capitalization rules exist in most OECD's countries, including Argentina, Chile and México.
 - There are two trends to determine the ratio between equity and debt:
 - Arm's length
 - Fixed ratio approach
- MP 472/09: Introduced Thin Capitalization rules, based on the Fixed ratio approach.

1. Thin Capitalization Rules

(b) Recent rules

- Thin Capitalization Rules for companies:
 - ***Related Parties***
 - Interest should be necessary and normal expenses
 - Debt/Equity Ratio: 2 to 1
 - Test should be made in two steps: (i) first - with respect to the specific creditor; (ii) second - with respect to all loans with related parties
 - Applicable to all kind of loans and credit facilities, as well as to loans or credit facilities guaranteed by related parties
 - ***Tax haven jurisdictions and special tax regime jurisdictions***
 - Interest should be necessary and normal expenses
 - Debt/Equity Ratio: 0,30 to 1
 - Test should be made in two steps: (i) first – with respect to the specific creditor; (ii) second- with respect to all loans with tax haven jurisdictions and special tax regime jurisdictions
 - Applicable to all kind of loans and credit facilities, as well as to loans and credit facilities guaranteed by residents of such jurisdictions.

1. Thin Capitalization Rules

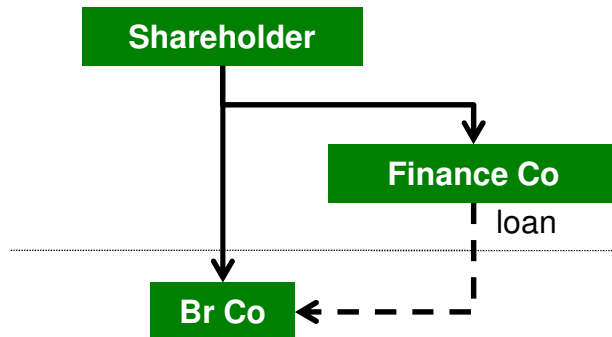
(c) Debatable Issues

- Exchange variation.
- Indirect ownership.
- Indirect creditor.
- New rule effective date: article 62, § 2º, of the Federal Constitution.
- Treaties to avoid double taxation.
- Article 26: Expenses with Tax Havens (applicable to the payment of goods, rights and services).

1. Thin Capitalization Rules

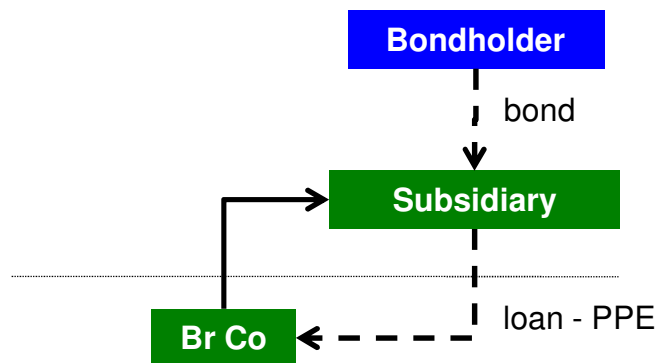
(c) Debatable Issues (cont.)

- Ex. 1.: Finance Co



- Interests are not deductible (?)
- literal interpretation could be questioned

- Ex. 2.: Subsidiary



- Interests are not deductible (?)
- Is this in accordance with the rational of the rule?
- literal interpretation could be questioned

1. Thin Capitalization Rules

(d) Legislative Bill

- **Related Parties:**
 - even when the creditor does not hold a direct interest, if related part, the debt/equity ratio should be 2 to 1.
- **Tax Havens:**
 - only one test, with a debt/equity 0,30 to 1.
- **Onlending Transactions (Repasse)**
 - Paragraph 7 of article 24 and 25: Articles 24 and 25 are not applicable to transactions of raising of funds carried out abroad, by the entities listed in paragraph 1 of article 22 of Law 8.212/91 (banks), in relation to funds raised abroad and used in onlending transactions, as defined by the Federal Revenue.

2. Tax Havens - Delaware

- **Tax Haven: Normative Instruction 188/02**

- There has been a discussion on whether the list established by Normative Instruction 188/02 is exemplifying or exhaustive.

- **Tax haven x tax favorable jurisdiction**

- Tax favorable jurisdiction: need of issuance of a new list.

- ✓ Effects to Tax Havens:

- high rates for financial- high rates for capital gain and income out of the financial market
- limitations on the Custom area
- transfer pricing

- ✓ Effects to Special Tax Regime Jurisdictions:

- transfer pricing
- thin capitalization rules
- residence transfer

2. Tax Havens – Delaware (cont.)

- Delaware is currently not in the list of Normative Instruction 188/02.
- The list of Normative Instruction 188/02 is exhaustive.
- There is a risk that Delaware is included in the black list.
- Decision ruled that Delaware is a tax haven jurisdiction.

Future Perspectives:

- Expectation of issuance of a new black list.
- Discussion regarding the applicability of the new concept for transfer pricing purposes only or also to apply higher rates of taxes.
- Clarification on article 24 and 24-A.
- OECD Concept.
- Other jurisdictions on the spotlight? (Switzerland, Netherlands, Luxembourg)

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