U.S. and Brazilian Tax Planning for Cross-Border Acquisitions of Brazilian Companies

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Asset or Share Purchase - Brazilian Tax Issues

- Most acquisitions in Brazil are structured as stock acquisitions (rather than asset acquisitions).
  - Acquisition of shares allows the acquirer to amortize goodwill as a deductible expense over a minimum period of 5 years.
    - Goodwill measured by (i) market value of assets above book value; (ii) expectation of future profitability; or (iii) intangibles or other economic reasons.
- To take advantage of the ability to amortize goodwill on a share purchase, acquisition generally needs to made through a Brazilian acquisition vehicle.
  - The liquidation or merger of the acquisition vehicle and the target allows the premium to be recoverable.

Asset or Share Purchase - Brazilian Tax Issues (cont).

- Acquisition of assets may be subject to indirect taxes in Brazil that can be avoided with acquisition of shares.
- Regardless of whether acquisition is structured as asset or stock deal, tax indemnities and warranties should be sought by the buyer because of successor (or transferee) liability of target taxes that are payable up to the date of the transaction.
- Tax losses of target company generally are not limited in share transfer.
  - Target losses may disappear for Brazilian tax purposes if target company is merged into another entity.
- Pre-sale dividend may be advantageous to seller as dividends currently exempt in Brazil but gain on sale of shares is taxable (purchase price would be lower).

Asset or Share Purchase - U.S. Tax Issues

- For U.S. tax purposes, Section 338(g) election would allow share acquisition to be treated as an asset acquisition and generate higher depreciation/amortization deductions.
  - If election is made, all tax attributes of target company disappear for U.S. tax purposes (e.g., net operating losses, etc.)
- Acquiring company needs to purchase 80 percent or more of the vote and value of target company within 12-month period to be eligible to make election.

Choice of Acquisition Vehicle - Brazilian Tax Issues

- A Brazilian holding company is typically used where buyer wishes to ensure tax-deductibility of goodwill.
- U.S. company may make direct acquisition of Brazilian target company.
  - This should not cause any tax problems in Brazil as dividends are exempt from withholding tax. However, Brazil does impose withholding tax on interest.
- Brazil imposes withholding tax on capital gains, even if buyer and seller are both non-residents of Brazil, whenever Brazilian assets or shares are sold.
  - 15 percent withholding tax generally but increased to 25 percent if beneficiary resident in tax haven.
  - Non-resident intermediate holding company may be used when seller is non-resident of Brazil in an attempt to defer this tax.
  - Brazilian tax authorities may try to argue that the holding company has no substance in order to look through entity.
  - Spain and Netherlands are popular jurisdictions for this.

Choice of Acquisition Vehicle - U.S. Tax Issues

- Need to consider how to treat Brazilian target for U.S. tax purposes.
- Is Brazilian entity an SA or limitada?
  - Can elect to treat limitada as a corporation or a pass-through entity for U.S. tax purposes.
  - An SA is a "per se" entity for U.S. tax purposes and will be treated as a corporation for U.S. tax purposes.
- If acquire an SA or elect to treat limitada as a corporation, need to be concerned with controlled foreign corporation rules in U.S.
- If elect to treat limitada as pass-through entity,
  - no deferral of income,
  - pass through of tax losses,
  - pass through foreign tax credits (which Brazilian taxes are creditable?)
  - results in step up in basis in assets for U.S. tax purposes (similar to a Section 338(g) election)

Acquisition Funding - Brazilian Tax Issues

- From Brazilian perspective, the capitalization of an entity with debt or equity is determined based on expected profitability of company.
- Dividends are exempt from withholding tax but non deductible.
- Financing through debt generally more advantageous for non-residents.
  - Benefits of interest deduction may outweigh the withholding tax.
  - Brazil has 15 percent withholding tax on interest (although many treaties reduce that rate) but 25 percent rate if interest is paid to a tax haven.
  - Brazil thin capitalization rules limit amount of interest that can be deducted.
- Brazil also allows for a company to elect to pay interest on equity, which is generally deductible (up to 50 percent of company's profits).
  - Calculated by reference to Brazilian long term interest rate.
  - Subject to same withholding tax rates as other interest.
  - Some recipient countries may treat the interest on equity payments as a dividend and therefore exempt from tax.

Acquisition Funding - U.S. Tax Issues

- Interest payments treated as ordinary income and generally do not carry foreign tax credits.
- Dividends carry foreign tax credits if recipient is U.S. C corporation.
- Dividends from Brazil paid to U.S. individuals (or pass-through entities owned by individuals) not eligible for qualified dividend rates.
  - The U.S. and Brazil do not have a comprehensive income tax treaty.
  - Foreign holding company may be used to repatriate dividends from Brazil at qualified dividend rates (currently 20 percent plus 3.8 percent Medicare tax).
    - Spanish ETVE is popular choice for this alternative.

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