

## **Brazilian interest payments on net equity (*Juros sobre o capital próprio*): an international perspective**

### **1. Interest on Equity and Dividends: the Brazilian perspective**

Brazilian companies have two main instruments for remunerating shareholders for the capital invested in companies: dividends and interest on net equity (“*Juros sobre o capital próprio*”, referred to as “IoNE” in this article). Both instruments can be used at the same time, but their tax treatment will depend on the particular characteristics of each case.

While dividends feature in most jurisdictions, IoNE is unique to the Brazilian system. The following paragraphs focus on describing -and characterizing IoNE- under Brazilian domestic legislation from the perspective of tax and corporate law.

#### **1.1 Introductory comments**

IoNE first appeared in the Brazilian legal system in Federal Law no. 9,249, of December 26, 1995, which contains the following provision:

*“Article 9. A legal entity can deduct, for the purpose of calculating its actual profit, the interest paid to the owner, members or shareholders, by way of return on net equity, calculated on the net equity accounts and to the extent of the variation in the long-term interest rate (“Taxa de Juros de Longo Prazo”) calculated pro rata per day.”*

Law 9,249/95 however, places two restrictions that must be observed simultaneously to set the upper deductibility limit:

- (i) IoNE must be calculated by reference to the net equity accounts. Therefore, if the enterprise does not have a significant amount of equity or has a negative equity figure, earnings cannot be distributed in the form of IoNE.

The rate applied to the net equity accounts must be the long-term interest rate, published annually by Banco Central de Brasil, Brazil’s central bank.

- (ii) The upper limit on IoNE is determined as the higher of: (i) 50% of net income for the year, before deduction of the IoNE and deduction of the provision for corporate income tax, but after the deduction of the social

contribution on net income<sup>1</sup>, and (ii) 50% of retained earnings plus profit reserves.

Brazilian tax law, for domestic fiscal policy reasons (basically to encourage the capitalization of Brazilian companies), allows IoNE to be treated, subject to the limits mentioned above, as a tax deductible expense.

Besides treating these payments as a tax deductible expense, Brazilian tax law also requires them to be taxed at source at 15%, even where the recipient is nonresident (as opposed to the absence of withholding tax on dividends paid to nonresidents, under Brazilian domestic law).

## **1.2 IoNE for the purposes of Brazilian Corporate Law**

IoNE is treated in Brazil as a share in profits under its corporate, stock market, accounting and exchange control legislation. IoNE is a share in corporate earnings that can only be received by owning the company's shares. Despite its name, it bears no relation at all to a return on loaned sums, the legal and economic basis for interest.

The corporate document that creates a right to receive IoNE is the minutes of the shareholders' meeting or board meeting that decides to distribute the company's income among the shareholders, in the form of either dividends or IoNE.

In this context, for instance, the Brazilian Securities Exchange Commission adopted a decision determining that the companies under its authority (e.g. listed companies) should give the same treatment to IoNE and dividends. Otherwise, the financial statements would be distorted, as companies with similar profitability would have completely different profits.

The Commission also determined that the same restrictions on dividends should also apply to IoNE payments. In one case, for instance, a Brazilian company earned profits in a given year and paid out IoNE to its shareholders before offsetting past losses. It is important to stress that the law allows IoNE to be paid if the payment is within (i) 50% of net income for the year – a condition met by the company or (ii) 50% of retained earnings plus profit reserves.

Nevertheless, the Commission found that as dividends could not be paid in this case, neither could IoNE, and that its directors should be fined for violating that rule<sup>2</sup>.

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<sup>1</sup> Because IoNE can affect the base for that contribution, the taxpayer could come up against a circular calculation. Nevertheless, this calculation method is expressly determined in the legislation.

### 1.3 Characterization of IoNE under Brazilian Tax Law

It is easy to see that IoNE, at least on the surface, has a dual nature. From a corporate perspective, the vast majority of instruments (and even accounting rules) consider that IoNE is simply a form of distribution of profits to the shareholders. Nevertheless, it is calculated by applying an interest rate (TJLP) to a predetermined amount (net worth at the beginning of the relevant period) and is capped at 50% of the net income for the year or 50% of the retained earnings plus profit reserves.

From a tax perspective, its treatment is largely determined in Law 9,249/95, which states that for income tax purposes, IoNE should be regarded as a deductible expense.

The Brazilian tax authorities also passed Regulatory Instructions that require IoNE to be treated as a financial expense in order to constitute a deductible expense<sup>3</sup>. Consistently, the tax authorities also stated that IoNE should be recorded and taxed as financial revenue for the recipient.

Thus, the current understanding of the characterization of IoNE is:

1. For social security contribution (PIS and COFINS) purposes:

IoNE is deemed to be a financial revenue and not a dividend. In general terms, this contribution is levied on companies' revenues, but there is a specific exemption for revenues derived from the net worth pick-up method (which usually makes dividends exempt from taxes).

Nevertheless, it could be considered that IoNE payments should be treated as equity pick-up revenues, particularly because accounting rules stipulate that IoNE must be subtracted directly from the company's income, and would thus qualify for the exemption described above.

The Brazilian Superior Court of Justice ruled, however, that IoNE did not qualify for the exemption, as it deemed that IoNE was an outright financial expenditure/revenue<sup>4</sup>. The main argument used by the court is that, as IoNE is calculated by applying a fixed rate to a fixed amount, it does not share the

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<sup>2</sup> Brazilian Securities Exchange Commission decision no. RJ2006/0594

<sup>3</sup> Particularly, Paragraph 3 of Article 29 and paragraph one of Article 30, both of Regulatory Instruction 11/96, clearly state that IoNE must be recognized in the company's accounts as if it were a financial expense.

<sup>4</sup> One example of such a decision is Special Appeal no. 952.566, where the Superior Court of Justice decided that IoNE should not be treated as income derived from the equity pick-up method but as financial revenue.

nature of profits, whose defining characteristic is that they are contingent upon the company's result.

2. For international taxation and tax treaty purposes:

On more than one occasion<sup>5</sup>, the tax authorities have decided that the benefits available for the interest from loans should also apply to IoNE. These decisions related to cases where no specific mention of IoNE could be found in the protocol to determine how they should be characterized.

As that view was given in ruling requests, which do not provide the details of the actual cases, we can only speculate as to the grounds for these decisions. In all likelihood, this reasoning stemmed from the tax authorities considering that all income treated as interest in Brazil should be considered as interest for the purposes of the tax treaty.

Therefore, based on previous decisions, it could be said that, for the tax authorities, IoNE will be regarded not as a dividend, but as a financial expense/revenue.

The view taken regarding the characterization of IoNE under treaties has not been definitely reviewed by the Brazilian Courts. From the wording of most Brazilian treaties, it is unclear whether IoNE should, in fact, be characterized as interest.

In the scenario described above, bearing in mind in particular that for corporate and accounting purposes IoNE is akin to a dividend, depending on the tax treatment that the country of residence of the investor gives to income of that type, the payment of IoNE can be a very attractive option, especially if the country of residence of the investor characterizes IoNE as a dividend/share in profits and a participation exemption regime applies to income of that type.

## **2. International Perspective – The Spanish Case**

IoNE has been widely used by international investors and several tax authorities have already had the opportunity to deal with them.

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<sup>5</sup> This issue was brought before the tax authorities in Divergence Solution no. 16/01, where the tax authorities decided that IoNE should be regarded as interest for the purposes of applying the Brazil-Japan tax treaty. This decision is particularly relevant because that tax treaty does not contain any specific reference to IoNE, much like the Brazil-Spain tax treaty.

Although Brazilian tax law (and more recently, Brazilian tax treaties, with Mexico, South Africa and Israel) draw a distinction between IoNE and dividends, several jurisdictions consider, based on their domestic provisions, that IoNE is akin to income deriving from equity and thus apply the associated rules, which, depending on the facts of the case and the jurisdictions involved, might be participation exemption rules.

For instance, the Tax Court of Nuremberg (Germany) analyzed the instruments in its decision of December 14, 2010. In this case, the Nuremberg Tax Court concluded from the features of IoNE and according to German tax law that they qualify as dividends, since at the end of the day they derive from the investment by the shareholder in the equity of the Brazilian company.

This also used to be the opinion of the Spanish tax authorities, which over recent years have audited many Spanish companies that have used IoNE in their Brazilian investments, until it recently changed its point of view on this matter in 2010.

The issue that arose in Spain is whether their treatment under treaty rules would override the respective characterization under domestic law. While there is consensus that the characterization provided by international rules should prevail for treaty purposes, the point at issue is whether the characterization provided for treaty purposes would also automatically apply for domestic law purposes.

As an example, if an item of income is considered as a dividend under treaty rules, would this automatically cause this amount to be deemed as a dividend for the purposes of domestic legislation? Conversely, if an item of income is deemed as interest under treaty rules, would this also mean that it is interest for the purposes of domestic legislation?

Spanish corporate income tax legislation contains a participation exemption regime, aimed at avoiding international double taxation on dividends and income derived from investments in nonresident companies.

Under that regime, dividends or shares in the profits of non Spanish resident companies are exempt subject to the following requirements:

- (a) The direct or indirect ownership interest in the capital or equity of the nonresident company must be at least 5%.
- (b) The investee must have been taxed in respect of a foreign tax that is identical or similar to Spanish corporate income tax in the tax period in which the income being distributed or shared was obtained.

This requirement will be deemed to be fulfilled where the investee is resident in a country with which Spain has entered into a tax treaty, which applies to it and contains an exchange of information clause.

- (c) The income being distributed or shared must come from the performance of business activities abroad.

Most Spanish companies with investments in Brazil that had been using IoNE payments considered that they fulfilled the above requirements to apply the participation exemption regime. Many of these companies, which include large listed Spanish multinationals, have been audited in recent years and this matter was not challenged by the auditors.

The Spanish tax authorities appear to have had a recent change of opinion, however: the TEAC (the Spanish Central Economic-Administrative Court<sup>6</sup>), in a decision rendered on April 13 2011, confirmed the first tax audit report we have heard of that takes the view that the participation exemption does not apply to IoNE (although there is an option, in certain cases, to deduct withholding taxes). The reasons underlying the views of both the auditors and the TEAC are listed below:

1. The IoNE payments are characterized as interest, not as dividends:
  - a. To determine how to characterize IoNE for the purpose of applying the domestic participation exemption regime, the TEAC examined the tax treaty signed by Spain and Brazil. The TEAC held that IoNE falls within the definition of interest contained in article 11 of the Spain-Brazil tax treaty, which in its definition of interest refers to the domestic tax legislation of the source country in relation to any other income (“other income assimilated to income from money lent by the taxation law of the Contracting State in which the interest arises”).
  - b. The TEAC analyzed Brazilian tax law and concluded that it treats IoNE as tax deductible interest, even though it recognizes that from a corporate and accounting law perspective, IoNE is considered as a dividend and derives from an investment in capital stock.
  - c. As a result, the TEAC held that this characterization for the purposes of Brazilian tax law defined and conditioned the characterization of IoNE as interest both for the purposes of applying the tax treaty and for the purposes of the treatment required for them under Spanish tax law at the recipient.
2. Additionally, the TEAC considered that no double taxation arises: in view of the characterization for tax purposes of IoNE as interest, the TEAC held that the international double taxation triggering the domestic participation exemption regime will never take place since by being deductible, IoNE gave rise to zero tax in Brazil.

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<sup>6</sup> An institution belonging to the Spanish Administration that entertains administrative claims against the decisions by the tax authorities themselves before the decision is submitted for judicial review.

We have no difference of opinion as to the difficulty involved in characterizing IoNE. We cannot, however, share either the conclusion reached by the TEAC, or, basically, the arguments underlying that conclusion, particularly for the following reasons:

1. Firstly, the TEAC has interpreted Spanish domestic law in light of the provisions in the tax treaty. As mentioned above, the TEAC took the characterization of income for the purposes of Brazilian domestic law (to which the tax treaty is supposed to make a referral) and extended it for the purposes of applying both the tax treaty and Spanish domestic law.

We cannot lose sight here that the tax treaty's role is confined to distributing the power to levy taxes between the states, without depriving domestic laws of their enforceability in their respective spheres of application. We could take this discussion further, but suffice it to say, by way of conclusion and as the Spanish tax authorities themselves have acknowledged on several occasions, that the characterization of an item of income on the basis of a tax treaty is only for the purposes of applying that tax treaty, which will determine which state has the power to levy tax on that income, but, beyond that step of determining which state has the power to tax the income, it will be the legislation of the state to which the income has been assigned that will determine how it is to be characterized and taxed.

It serves to bring to mind a long list of judgments<sup>7</sup> in which the Spanish Supreme Court has overturned the referral to foreign law for the characterization or definition of some of the elements of the tax obligation.

Also worth recalling is the view taken by the Economic Administrative Court of Nuremberg (Germany) in its decision of December 14, 2010, on a very similar –if not identical- dispute to the one we are analyzing. In that decision, regarding the receipt of IoNE payments from Brazil by a German resident shareholder, the court concluded, contrary to the opinion of the German tax authorities, that (i) the IoNE payments had to be treated as shares in profits for the purposes of the domestic exemption regime, “as they originate from the corporate relationship and are only received by shareholders” and (ii) Germany, as the country of residence of the recipient of the income, must make an independent characterization of the income based on its own domestic law, on which neither the characterization nor the treatment of the IoNE payments (ability to deduct them and withholding tax at source) for the purposes of Brazilian domestic law have any bearing.

We cannot fail to mention here that the TEAC's reasoning, which makes the characterization of an item of income of a Spanish taxpayer depend, regarding the taxable event and tax base, on the parliamentary activity of another country (Brazil,

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<sup>7</sup> Judgments of June 25, 2004, May 5, 2008, and November 16, 2009 for example.

in this case) and even on the interpretation by its tax authorities, could harbor a direct infringement of the principles of the right to have tax matters determined by the law, as contained in the Spanish General Taxation Law, of legal certainty and of the right to due process of law, all appearing in the Spanish Constitution.

Having said that, we believe IoNE must be characterized independently from the standpoint of the tax law that is being applied, namely the participation exemption regime mentioned above, which places no obstacles to characterizing IoNE as a dividend for these purposes.

2. Secondly, and as an additional point, although this analysis is not necessary, IoNE falls neatly within the definition of dividends in article 10.4 of the Spain-Brazil tax treaty, which implies that the characterization by the Brazilian tax authorities may not be correct from a Spanish perspective. According to that article, the term “dividends” includes income from shares and from other rights that allow a share in profits, other than debt claims. Given that, under Brazilian corporate and accounting law, and as the TEAC itself has recognized, IoNE is treated as a share in profits, we fail to see any technical reason why they should not fall within the definition of dividends in the Brazil-Spain tax treaty.
3. Thirdly, on the subject of double taxation, it should be recalled that the Spanish domestic legislation mentioned above contains an irrebuttable presumption, as it provides in relation to the requirement regarding the foreign taxation of the income that is being distributed (i.e. the first tax), that it will be considered to have taken place when the investee is resident in a country with which Spain has signed a tax treaty, which is applicable to it and which contains an exchange of information clause.

In the case we are analyzing, that requirement is fulfilled and therefore any further requirement in relation to double taxation, such as that mentioned in this case by the TEAC, is not imposed by the legislation in force, is unnecessary, and falls outside the scope of its powers under the laws governing its conduct.

We believe the arguments outlined above are strong enough to prompt an adjustment to the Spanish TEAC’s view in the event of a claim to the National Appellate Court, which would be the court responsible for deciding on an appeal of this type.

### **3. Potential practical implications**

As we have already mentioned, from a Brazilian perspective, the payment of IoNE could be a very attractive option, especially if the country of residence of the investor characterizes IoNE as dividends / shares in profits and a participation exemption regime applies to that type of income.



Despite the above, from the Spanish perspective, the TEAC's view could, depending on various factors and scenarios, and whether it is ultimately confirmed, have an impact on the financial structures of Spanish (and international investments channeled through Spain) investments in Brazil.

As we have said, however, we believe there are strong arguments against the TEAC's reasoning, and therefore in our view it is still early days to analyze its final implications.

One thing we can say is that among the potential effects that future acceptance of the TEAC's reasoning could have, the one that gives the greatest cause for concern would be an acceptance of no independence of the Spanish tax and legal system to characterize income from a non Spanish source, which could be translated, as in the case under analysis, into a type of "importation" of elements of the tax obligation from other jurisdictions that would override Spain's own, which, we must not forget, arise from the legislative power conferred by the Spanish people on their parliament.

That said, it should be noted that, if according to the abovementioned decision, IoNE is characterized as interest for Spanish domestic tax purposes, the matching credit at a 20% rate stated in article 23.2 of the tax treaty for interest would still be applicable to the income obtained by the Spanish investor. This means that, whatever the actual withholding rate in Brazil, the credit in Spain would always be granted as if 20% tax had been levied, therefore this instrument may still be more advantageous than simply paying dividends.