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BRAZILIAN FEDERAL REVENUE INSTRUCTION 1154/2011 – THIN CAPITALIZATION RULES AND REMITTANCES IN GENERAL

Brazilian Federal Revenue Instruction 1154 (*Instrução Normativa RFB n° 1.154*), issued on May 12, 2011, deals with the thin capitalization rules introduced by Provisional Measure 472 of December 15, 2009, which was later converted into Law 12,249 of June 11, 2010. Our reports on Provisional Measure 472/2009 and Law 12,249/2010 can be found in BM&A Tax Newsletters nos. 37 and 42.

In general terms, the purpose of the thin capitalization rules is to limit the deductibility of interest on loans contracted by a Brazilian company from (i) a related individual or legal entity that is resident or domiciled outside Brazil, or (ii) any individual or legal entity that is resident or domiciled in a “favorable tax regime” or that is under a “privileged tax regime”, as defined in tax rules and regulations¹.

In large part, BFR Instruction 1154/2011 reproduces the rules set out in Law 12,249/2010, but it also introduces some important provisions, which we examine in this newsletter.

1. THIN CAPITALIZATION RULES

1.1. Debt owed to related parties

In the case of loans from a related individual or legal entity that is not resident or domiciled in a favourable tax regime or under a privileged tax regime, BFR Instruction 1154/2011 essentially repeats the requirements and limits established by Law 12,249/2010: the Brazilian borrower is not entitled to deduct, for income tax purposes, interest on debt that exceeds (i) two times the equity interest held by the foreign related party in the Brazilian company or (ii) two times the net equity value of the Brazilian company, where the foreign related party does not hold an equity interest in the Brazilian borrower.

¹ The Netherlands and Switzerland were removed from the “privileged tax regime” list and “favorable tax regime” list, respectively, in mid-2010. Spain was removed from the “privileged tax regime” list in December/2010 whereas Luxembourg was definitely excluded from the same list in March of this year.

The Instruction reiterates that the sum of the debts owed by the Brazilian company cannot exceed two times the sum of the equity interests held by all related parties in the Brazilian borrower. If the related parties do not hold an equity interest in the Brazilian borrower, the sum of the debts cannot exceed two times the net equity value of the Brazilian company.

In addition to the rules described above, interest will only be deductible if it complies with the limits imposed under transfer pricing rules, and constitutes a necessary expense for the Brazilian borrower's business.

BFR Instruction 1154/2011 follows earlier rules and regulations on transfer pricing in defining the concept of "related parties".

1.2. Debt owed to individuals or legal entities domiciled in a favorable tax regime or under a privileged tax regime

In the case of loans from a party resident or domiciled in a favorable tax regime or under a privileged tax regime, the Brazilian company is not entitled to deduct, for income tax purposes, interest on debt that exceeds 30% of its net equity.

1.3. Intervening Parties

One important new provision relates to "intervening" parties. Under BFR Instruction 1154/2011, even if the foreign creditor is not related to the Brazilian borrower, and is not domiciled in a favorable tax regime or subject to a privileged tax regime, the thin capitalization limits will apply if another, "intervening", party to the contract meets either of these requirements and assumes liability for payment of the debt, even if the liability is only secondary.

If the creditor is related to the Brazilian borrower, the thin capitalization rules for related parties will apply, even if the intervening party is domiciled in a favorable tax regime or subject to a privileged tax regime. In the opposite situation, where the intervening party is related to the Brazilian borrower and the creditor is located in the favorable tax regime or is subject to a privileged tax regime, the thin capitalization rules for residents of favorable tax jurisdictions apply.

When the creditor is Brazilian and the intervening party is either a foreign party related to the Brazilian borrower, or a party resident in a favorable tax regime or benefits from a privileged tax regime, the thin capitalization rules will apply only if the intervening party remits funds to Brazil in payment of the debt.

1.4. Mere intermediary and interposed party

BFR Instruction 1154/2011 also addresses the use of "mere intermediaries" and "interposed parties" in loan transactions that would normally be subject to the limits under the thin capitalization rules. The limits apply, despite the presence of a mere intermediary or interposed party.

1.5. Onlending Transactions

Another new provision deals with onlending transactions, in which the credit made available to the borrower is linked to funds sourced in the international market. In these cases, the limits on deductibility of interest will not apply if the onlending institution simply transfers to the Brazilian borrower the currency exchange risk associated with the funds obtained outside Brazil, and does not charge any amount for financial agency services except the onlending fee.

1.6. Calculating the level of indebtedness

Under Law 12,249/2010, the amount of debt and the borrower's net equity under the thin capitalization rules are calculated as a monthly weighted average. BFR Instruction 1154/2011 clarifies certain aspects of the calculation:

- (i) The monthly weighted average is calculated by dividing the sum of the daily amounts of indebtedness by the number of days in the relevant month. The reason for this rule may be to ensure that any payments made over the course of a month are reflected in the outstanding balance of the debt;
- (ii) In calculating the amount of indebtedness, the amount of accrued interest outstanding on the last day of the month is added to the principal amount of the debt;
- (iii) The borrower's net equity is the amount shown on its most recent balance sheet, or, optionally, the net equity determined as of the month prior to month of the interest payment, based only on results to the end of the prior month. The Instruction does not take into account the effects of other changes to the borrower's net equity, such as increases and reductions of capital.
- (iv) Events such as mergers, spin-offs, dissolution and liquidation are taken into account in calculating the borrower's net equity.

2. DEDUCTIBILITY OF AMOUNTS PAID TO A PARTY DOMICILED IN A FAVORABLE TAX REGIME OR UNDER A PRIVILEGED TAX REGIME

In addition to the provisions dealing specifically with payment of interest, Law 12,249/2010 establishes certain requirements for the deduction, for income tax and Social Contribution on Net Profit (CSLL) purposes, of amounts paid, credited, remitted or otherwise made available to parties domiciled in a favourable tax regime or under a privileged tax regime.

Briefly, in order for such amounts to be deductible, the Brazilian taxpayer must:

- (i) identify the effective beneficiary of the party domiciled outside Brazil;
- (ii) provide proof of the operational capacity of the non-Brazilian party to carry out the transaction; and
- (iii) provide documentation to prove that the price was paid and that the goods or services were delivered.

BFR Instruction 1154/2011 adds that collective investment entities, including investment funds, are considered to be effective beneficiaries for the purposes of item (i) above.

The Instruction also provides that the deductibility rules do not apply to financial transactions carried out by individual or collective foreign investors under the rules and regulations established by the National Monetary Council (*Conselho Monetário Nacional*).

3. GENERAL RULES ON THE DEDUCTIBILITY OF PAYMENTS MADE TO A PARTY DOMICILED IN A FAVORABLE TAX REGIME OR UNDER A PRIVILEGED TAX REGIME

Lastly, BFR Instruction 1154/2011 creates a new exception from the rules on deductibility of amounts (including interest) paid to parties domiciled in a favorable tax regime or under a privileged tax regime for funds raised outside Brazil through an issue of bonds or other debt instruments, provided the following requirements are met:

- (i) The securities must be taken up by at least 40 investors;
- (ii) No single investor (including its related parties) may acquire more than 20% of the issue; and
- (iii) No single investor (including its related parties) may receive more than 20% of the total interest or other revenue paid on the securities.

This newsletter is merely informative, presenting only a general overview of the subjects. Thus, it is not a legal opinion.

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