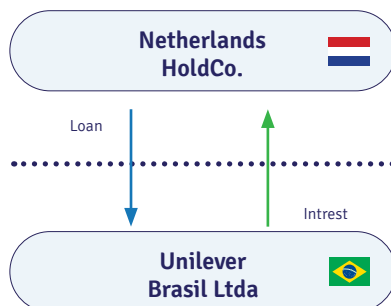


Brazilian Court rules on interpretation of substantial economic activity of Dutch holding companies for application of thin-capitalization rules

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On December 31, 2019, the Brazilian Administrative Council of Tax Appeals' published its decision involving the substance of "economic activity" of a Dutch holding company, lending to its related entity in Brazil. The case involved the application of the Brazilian thin-capitalization rules. The Brazilian court ruled that the lender, a Netherlands holding company, had insufficient economic activities. Hence, the thin-capitalization rules applied and part of the interest was not-deductible in Brazil. Consequentially, it resulted in (a partial) double taxation for the Group.

Background of the case



The Netherlands HoldCo. (the lender) and Unilever Brasil Ltda (the borrower) signed a loan agreement. Universal Brasil Ltda made interest payment to the Netherlands Holdco.

Under Brazil's thin-capitalization rules, outbound interest payments made by a Brazilian entity to its foreign related lender, through loan agreements, are deductible for income tax purpose. If, however the foreign related lender is a resident either of a tax haven or subject to a privileged tax regime, additional requirements (debt-to-equity ratio and the interest expenses are business related) must be satisfied in order to safeguard the deduction of interest. The Brazilian Tax Authorities challenged the economic activity of the lender.

Decision

The Brazilian Court stated that unless a holding company exercised a "substantial economic activity" in the year of assessment, it is considered that a company is subject to a tax haven or a privileged tax regime. In this context Brazil's stricter thin capitalization rule will apply. The Dutch holding company was not able to satisfy the substantial economic activity requirements even though it had business premises in the Netherlands and concluded other loan agreements with its group companies in China and Sweden. The Brazilian Court emphasised that mere existence of premises and concluding other loan agreements was not sufficient to demonstrate a substantial economic activity in the Netherlands. Hence, the Brazilian thin capitalization rules were applied.

Takeaway

- The case involved substance of economic activities relating to the financing transactions. In this respect, the owning or mere renting of an office in the Netherlands, in combination with the execution of other group loan agreements, was insufficient to safeguard the interest deduction at the level of the Brazilian company. As a result, MNEs may consider checking the appropriate substance and rationale of their financing structures (vis-à-vis Brazilian borrowers) to avoid the potential application of the (stricter) Brazilian thin capitalization provisions.

- o Although the information available in respect of this case is limited, we expect that the Netherlands lender was not able to substantiate that it performed the decision-making functions and controlled the risks associated with investing in the loan. It could be that the lender only performed agency or intermediary functions, making it difficult to substantiate sufficient economic rationale.
- o In this context reference is made to the Danish cases of the ECJ (C-118/16 and C-119/16) involving, among other elements, the beneficial ownership of intra-group loans as well as the February 11 OECD report 'Transfer Pricing Guidance on Financial Transactions: Inclusive Framework on BEPS: Actions 4, 8-10.'. As a result, intermediate financing companies that merely perform agency functions may be at risk of triggering application of the Brazilian thin capitalization provisions.
- o The case does not clarify if and to what extent the similar economic activity/substance requirements may materialize in determining interest WHT provisions. The interest WHT is (for instance) generally 25% if a recipient is resident in a tax haven.

In general, we are monitoring the Brazil-Netherlands income tax treaty (DTAA) developments and its' interplay with the Multilateral Instrument implementing tax treaty related BEPS measures (MLI). The Netherlands has signed the MLI but Brazil has not signed it yet. Therefore, the MLI does not have any impact on the existing DTAA between the Netherlands and Brazil. Interest paid to a non-resident generally is subject to a 15% interest WHT under the Brazil – Netherlands DTAA.

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