

TAX NEWSLETTER

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PROVISIONAL MEASURE NO. 472/09 IS CONVERTED INTO LAW NO. 12,249/10 (THIN CAPITALIZATION RULES AND OTHER IMPORTANT PROVISIONS)

Provisional Measure ("*Medida Provisória*") No. 472, of December 15, 2009, addressed in our Newsletter No. 37, was converted into Law No. 12,249, of June 11, 2010, published in the Brazilian Official Gazette on June 14, 2010. Law No. 12,249/10 maintained most of the rules provided for under Provisional Measure No. 472/09, but also changed and added a number of important provisions.

Based on the comments already made in our Newsletter No. 37 (attached hereto for ease of reference), the main provisions which were changed and/or included by Law No. 12,249/10 are addressed below. The provisions of Law No. 12,249/10 addressed in this newsletter entered into force on the date of publication of said law, but became effective as from December 16, 2009.

1. THIN CAPITALIZATION RULES – ARTICLES 24 AND 25 OF LAW NO. 12,249/10

As mentioned in our Newsletter No. 37, before the enacting of Provisional Measure No. 472/09, there were no legal provisions, in Brazil, imposing maximum ratios of debt to equity of Brazilian legal entities (so-called "thin capitalization rules").

With the enacting of Provisional Measure No. 472/09, and considering the new provisions introduced by Law No. 12,249/10, Brazilian legal entities are now required to comply with thin capitalization rules for the purpose of deduction, from the taxable basis of the Corporate Income Tax (IRPJ) and Social Contribution on Net Profits (CSLL), of interest on loans entered into with:



- (i) non-Brazilian parties that are related to the Brazilian company, according to the definition provided under Brazilian tax law for the purpose of transfer pricing (Article 23 of Law No. 9,430/96), and that are not resident or domiciled in a "tax favorable jurisdiction" (Article 24 of Law No. 9,430/96) or "privileged tax regime" (Article 24-A of Law No. 9,430/96), or
- (ii) individuals or legal entities that are resident or domiciled in a "tax favorable jurisdiction" (Article 24 of Law No. 9,430/96) or "privileged tax regime" (Article 24-A of Law No. 9,430/96).

With respect to item (i) above, Provisional Measure No. 472/09 required that debt of the Brazilian company with a related non-Brazilian party could not exceed two times the net worth value of the equity interest held by such related party in the Brazilian entity, without addressing the situation where the related party did not directly hold a stake in the Brazilian company (what could be the case, for instance, of a subsidiary or branch of the Brazilian company). Law No. 12,249/10 maintained this limit for situations where the creditor is a related non-Brazilian party that directly holds a stake in the Brazilian company, but also addressed the situation where the non-Brazilian related party does not directly hold a stake in the Brazilian company. In this latter case, the interest on the respective loan can only be regarded as deductible from the taxable basis of the IRPJ and CSLL when the amount of the respective debt, when the interest accrues, does not exceed two times the total net worth value of the Brazilian legal entity.

In both situations mentioned in the previous paragraph, total debt with non-Brazilian related parties cannot exceed two times the net worth value of all of the equity interests directly held by such non-Brazilian related parties in the Brazilian entity.

If the Brazilian company only has debt with non-Brazilian parties that do not hold directly a stake in the Brazilian legal entity, total debt with such non-Brazilian related parties is limited to two times the total net worth value of the Brazilian legal entity.

With respect to situation (ii) above, Law No. 12,249/10 no longer requires that each transaction is analyzed individually. Rather, Law No. 12,249/10 requires that all debt of the Brazilian company with individuals and legal entities resident or domiciled in "tax favorable jurisdictions" or "privileged tax regimes" cannot exceed 30% of the total net worth value of the Brazilian legal entity. In this respect, one should recall the recent enacting of Normative Ruling No. 1,037/10, whereby the Brazilian Federal Revenue Service (RFB) addressed these two different concepts ("tax favorable jurisdiction" and "privileged tax regime"). Normative Ruling No. 1.037/10 was addressed in our Newsletter No. 41.

In both situations (i) and (ii) above, the debt and the net worth value of the Brazilian legal entity shall be calculated considering weighted monthly averages.

Finally, Law No. 12,249/10 provided that thin capitalization rules do not apply to transactions relating to the raising of funds abroad that are later transferred within Brazil ("*operações de repasse*") by commercial banks, investment banks, development banks, savings banks, credit companies, and other certain financial institutions. The RFB will enact regulations dealing with this exception.

2. REMITTANCES TO INDIVIDUALS OR LEGAL ENTITIES IN "TAX FAVORABLE JURISDICTIONS" OR IN "PRIVILEGED TAX REGIMES" – CONDITIONS TO TAX DEDUCTION – ARTICLE 26 OF LAW NO. 12,249/10

As addressed in our Newsletter No. 37, as from the enacting of Provisional Measure No. 472/09, amounts of any nature that are paid, credited, delivered, remitted or used, directly or indirectly, by legal entities that are domiciled in Brazil to individuals or legal entities that are resident or domiciled abroad and submitted to the treatment of a "tax favorable jurisdiction" (Article 24

of Law No. 9,430/96) or "privileged tax regime" (Article 24-A of Law No. 9,430/96), shall be regarded, as a rule, to be non-deductible from the taxable basis of the IRPJ and CSLL of the Brazilian legal entity, except if the following conditions are cumulatively met:

- Identification of the beneficial owner of the non-Brazilian legal entity domiciled abroad, considering, as such, the individual or legal entity that has not been created with the sole or main purpose of tax saving and that earns the amounts on its own behalf, and not as an agent, trustee, or attorney-in-fact of a third party;
- Proof of the operational capacity of the individual or legal entity that is resident or domiciled outside Brazil and carries out the transactions; and
- Documentation proving that the price was paid and that the respective goods or rights were received, or that the respective services were used.

Law No. 12,249/10 provided that the non-deductibility mentioned above does not apply to interest on shareholders' equity ("*juros sobre capital próprio*")¹.

Furthermore, Law No. 12.249/10 provided that it is not required to prove the operational capacity mentioned above when (i) a particular transaction has not been carried out with the sole or main purpose of tax saving, or (ii) in the case of interest payments, the beneficiary of such interest is a wholly-owned subsidiary or branch of the Brazilian payor of the interest which has its profits subject to taxation in Brazil pursuant to Article 74 of Provisional Measure No. 2,158-35/01 (i.e., pursuant to Brazilian "controlled foreign corporation", or "CFC", rules).

3. TRANSFER PRICING – PROFIT MARGIN IN THE PRL METHOD

Provisional Measure No. 472/09, in its Article 61, Item II, revoked Article 2 of Law No. 9,959/00, which provided for profit margins of 20% and 60% applied to PRL method. Provisional Measure No. 476, of December 23, 2009, in its turn, revoked the aforementioned Article 61 of Provisional Measure No. 472/09 and expressly re-established the effects of Article 2 of Law No. 9,959/00. There is discussion as to transfer pricing rules which currently apply.

4. PENALTIES – INDIVIDUAL INCOME TAX

Pursuant to Law No. 12,249/10, if an individual requests a refund in his or her Individual Income Tax Return, and if this refund is not granted due to an evident breach of law, the individual will be subject to a penalty of 75% on the amount of the refund request. Law No. 12,249/10 no longer provides for the application of this 75% penalty in the case of amounts that are not deducted in the Individual Income Tax Return, like provided before in Provisional Measure No. 472/09.

5. FOREIGN EXCHANGE VARIATION – CRITERIA FOR RECOGNITION OF REVENUES OR EXPENSES FOR TAX PURPOSES

Before Law No. 12,249/10, revenues or expenses derived from foreign exchange (F/X) variation of credits or obligations of Brazilian companies were generally recognized, for the purpose of calculating the taxable basis of the IRPJ, CSLL, and Social Contributions on Gross Revenues (PIS and COFINS), on a cash basis (i.e., upon liquidation of the respective transaction). Notwithstanding this general rule, Brazilian legal entities were entitled to recognize such F/X variations on an accrual basis. Such option was valid for each entire calendar year.

¹Brazilian tax law allows Brazilian companies to make distributions to shareholders of interest on shareholders' equity as an alternative to making dividend distributions. Such payments of interest on shareholders' equity are generally treated as expenses that are deductible from the taxable basis of the IRPJ and CSLL, provided that certain legal requirements are complied with.

The manner for making the option mentioned in the previous paragraph, though, was not clearly provided for under Brazilian tax laws. Now, Law No. 12.249/10 provides that, from 2011 onwards, Brazilian entities can make the election to recognize F/X variation on an accrual basis only in January of the respective calendar-year. In addition, this option can only be modified throughout such calendar year if there is a "high fluctuation of the F/X rate". For this purpose, a "high fluctuation of the F/X rate" will be deemed to take place when such fluctuation exceeds a percentage to be established by the Brazilian Federal Government.

The RFB must be notified of the option made by the taxpayer in January of each calendar-year and of any change to this option made during the rest of the calendar-year. The RFB will also enact regulations addressing the formalities related to making this election and how to change the option during the calendar-year.

6. INSTALLMENT PLAN FOR PAYMENT OF FEDERAL DEBTS IN LUMP-SUM OR INSTALLMENTS

Article 65 of Law No. 12,249/10 provides for a special program for payment of federal debts in a lump-sum or in installments, the latter in up to 180 months. The debts that may be included in this special program are the debts managed by federal agencies and foundations, as well as any type of debt that is collected by the Office of the Attorney-General ("*Procuradoria-Geral Federal*"). Such debts may be subject or not to tax assessments, and may be already enforced or not by tax authorities in the judicial level. These debts include, for example, debts related to fees and penalties charged by the Brazilian Central Bank, by the Brazilian Tourism Office (EMBRATUR), Brazilian Office of Applied Economic Research (IPEA), Brazilian Office of Geography and Statistics (IBGE), public universities, and federal regulatory agencies. Debts with the Brazilian Antitrust Agency (CADE) and with the Office of Meteorology and Industrial Quality (INMETRO) cannot be included in the installment plan.

This new installment plan provides for rules that are very similar to those applicable to the federal tax debt installment plan provided for under Law No. 11.941/09 (REFIS 4).

The debts mentioned above that accrued by no later than November 11, 2008 may be paid in a lump-sum or in installments, and no guarantees need to be offered, pursuant to Article 65, except for those already in place in tax enforcements.

The reductions to amounts of debt provided for under Law No. 12,249/10 are inversely proportional to the length of the installment plan, according to the table below:

NUMBER OF INSTALLMENTS	REDUCTION OF FINE FOR NON-PAYMENT OF DEBTS	REDUCTION OF FINE FOR NON-COMPLIANCE WITH DEBTS OTHER THAN NON-PAYMENT	REDUCTION OF DEFAULT INTEREST	REDUCTION OF LEGAL CHARGES (FEES)
Lump-sum	100%	40%	45%	100%
Up to 30	90%	35%	40%	100%
Up to 60	80%	30%	35%	100%
Up to 120	70%	25%	30%	100%
Up to 180	60%	20%	25%	100%

Law No. 12,249/10 expressly provides that attorney fees in tax proceedings may be canceled as a result of inclusion of the respective debt in the installment plan.

The taxpayer must submit its request to include debts in this installment plan by December 31, 2010, indicating precisely the debts to be included in the plan. This option implies irrevocable acknowledgment that the respective debt was due by the debtor.

The debt will be consolidated at the requesting date and must be divided in installments by the taxpayer, subject to the minimum monthly installments of R\$ 50.00 for individuals and R\$ 100.00 for institutions.

In case of a debt subject to judicial deposit, the corresponding amount will be converted into payment after applying the discount on the updated amount of the deposit for the payment in lump-sum or installment. Any outstanding amount will be released by the taxpayer, if there is no remaining debt (whether of a tax or non-tax nature).

In this installment plan, individuals can also become obligor under the debts, becoming jointly liable for payment of such debts together with the respective legal entity.

The lack of payment of any installment is confirmed 30 days after the due date. The lack of payment of three installments, consecutive or not, will result in the notification of the taxpayer and immediate termination of the installment plan previously authorized, with the collection of the outstanding debt, not including the benefits and the installments already paid.

Regulations related to this new installment will be enacted in up to 120 days.

7. FEDERAL TAX INSTALLMENT PLAN (REFIS 4) – IMPORTANT ASPECT

The procedures related to the REFIS 4 have still not been concluded. In the meantime, Article 127 of Law No. 12,249/10 assures that the tax debts to be included in the REFIS 4, for which a request has been accepted by tax authorities, will not be enforceable by Brazilian tax authorities.

This confirms that, until the aforesaid procedures of REFIS 4 are concluded, taxpayers will not be subject to improper collection acts by tax authorities and, in particular, will not be subject to judicial tax enforcements with respect to debts to be later paid under the REFIS 4.

This newsletter aims at commenting on the main changes recently occurred on the Tax Legislation. For further enlightenments, our professionals are at your disposal.

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