Taxing the Brazilian Interest of Italian Corporate Shareholders

by Marco Q. Rossi

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In this article, the author discusses a recent ruling by the Italian Tax Agency regarding the tax treatment of Brazilian interest on net equity payments to Italian corporate shareholders.

In Ruling No. 538 of December 30, 2019, the Italian Tax Agency explains that payments made to an Italian company out of the current or accumulated earnings of a Brazilian subsidiary that are deductible for Brazilian corporate income tax purposes under the country's interest on net equity tax regime are not tax exempt for the Italian company under Italy's participation exemption regime. Instead, the payments should be classified as interest under the Brazil-Italy tax treaty (signed in Rome on October 3, 1978 ("the treaty")),[1] to apply the treaty's article 23 foreign tax credit provisions.

Facts of the Case and the JCP

Under the facts of the ruling, an Italian company owning a 99.6 percent share of the capital of a Brazilian company received several distributions from the Brazilian company in the tax years 2012 to 2016, 2018, and 2019. For accounting purposes, the distributions, coming out of the Brazilian company's retainer earnings or profit reserves, were classified as dividends on the Brazilian company's accounting books. However, for Brazilian corporate income tax purposes, a portion of the distribution was deducted from the Brazilian company's taxable profits subject to that tax, under a special tax regime known as Juros sobre Capital Próprio (JCP). The deductible payments were also subject to a 15 percent withholding tax, which is allowed under article 10 (dividends) or 11 (interest) of the treaty.

Brazil's JCP regime was established by Law 9249 (1995). Under JCP rules, the amount a Brazilian company may pay to its shareholders and then deduct in Brazil from its taxable profits as an operating expense is equal to the balance of its equity accounts multiplied by the prorated daily applicable long-term interest rate. The amount of the deduction is limited to either 50 percent of net income in the period for which JCP is to be paid or credited, or 50 percent of the balance of retained earnings and profit reserves from previous periods, whichever is greater. The payment of JCP is subject to a 15 percent withholding tax.

In the ruling, the Italian company asked the Italian Tax Agency to clarify the proper tax classification of the JCP payment in Italy in order to determine the correct application of the treaty's article 23 FTC provisions. The relevant issue raised by the taxpayer is whether the JCP payment should be classified as dividends under paragraph 3 of article 23 of the treaty (which is consistent with the domestic participation exemption regime of article 89 of the Italian corporate income tax code) and be tax exempt, or classified as interest and become eligible for the 25 percent tax matching credit provided under paragraph 4 of article 23.

Italy's TUIR

Italy operates a territorial regime under which foreign corporate profits are exempt from corporate tax in Italy. Under the participation exemption regime of article 89(3) of the Italian income tax code (Testo Unico delle Imposte sui Redditi (TUIR)), profits earned through foreign subsidiaries are subject to local tax and, when distributed as dividends, a share equal to 95 percent of the dividend is exempt from Italian

[1] The treaty was ratified in Italy as Law No. 844 of Nov. 29, 1980, and entered into force on Apr. 24, 1981.

corporate income tax. A share equal to 5 percent of the dividend is taxable at the 24 percent corporate tax rate (as a proxy for the deductibility of expenses incurred from participation in the foreign subsidiary), resulting in a 1.2 percent effective tax rate. Notably, the participation exemption regime also applies to foreign portfolio dividends from portfolio holdings in foreign noncontrolled companies. Upon taxpayer's election, profits earned through foreign branches (permanent establishments) are exempt from Italian corporate tax.

Dividends from profits of foreign companies established in low-tax countries (defined as an effective tax rate less than 50 percent of the equivalent Italian corporate tax rate) are fully taxable, unless the foreign company is engaged in real activities in the local jurisdiction through an organization (offices, employees, depreciable property or goods) commensurate with its business. Similarly, profits attributable to a foreign branch established in a low-tax country are taxed in Italy unless the branch is engaged in the active conduct of a business with sufficient organization in the jurisdiction.

To exempt foreign dividends, the general classification rule of TUIR article 44(2)(a) provides that a participation to the capital or equity of (or a financial instruments issued by) a foreign corporate entity is treated as equity. A payment related to the participation or instrument is classified as a dividend, solely in the event that the payment is wholly nondeductible for the purpose of computing the taxable income of that entity in its own jurisdiction. The nondeductibility of the payment in the foreign jurisdiction must be certified by the foreign entity or otherwise proved by the taxpayer through clear and detailed evidence.

In the ruling, the Italian Tax Agency refers to article 44(2)(e) and takes the position that the JCP payment should be classified as taxable interest for Italian corporate income tax purposes and is not eligible for the participation exemption of TUIR article 89(3). Instead, the remaining distributed Brazilian company earnings not deductible in Brazil should be treated as a dividend eligible for the participation exemption.

TUIR article 44(2)(a) predates both the anti-hybrid rules proposed by the OECD in action 2 of the base erosion and profit-shifting project and the provisions in the EU antiavoidance directives (the ATADs) on hybrid mismatches.

BEPS and the ATADs

In general, application of the BEPS project's action 2 anti-hybrid rules requires a link between the tax treatment applicable to the remuneration derived from hybrid financial instruments in different jurisdictions and meeting these four conditions:

- taxpayer use of a financial instrument;
- an actual payment;
- an effective mismatch in the tax treatment of that payment, characterized by the tax deduction of the payment in the source state without corresponding taxable income inclusion in the residence state; and
- a hybrid element as the cause for the conflict in the characterization of the payment under two different tax systems.

Council Directive 2017/952/EU (ATAD 2), approved on May 29, 2017, amended Council Directive 2016/1164 of July 12, 2016 (ATAD 1). ATAD 2 amends article 9 of ATAD 1, which covered some hybrid mismatches between EU member states. The scope of article 9 has been extended to include hybrid mismatches between EU member states and third countries. In addition, ATAD 2 provides rules consistent with those recommended by the OECD in the 2015 final BEPS report on action 2. Italy transposed the EU ATADs by way of Legislative Decree No. 142 of November 29, 2018.

ATAD 2 says a financial instrument mismatch arises when a payment made or accrued by an instrument is deducted by the payer in one country, but does not lead to a corresponding income inclusion at the level of the payee in the other country. This is because of a different classification of the instrument under the internal law of the two jurisdictions. Noninclusion covers situations in which the payment qualifies for double tax relief, as well as situations in which the payment is not included in income within a reasonable time, as defined by the directive. The mismatch must be the result of differences in instrument characterization or the payments made under it.

It is debatable whether the interest on net equity should be included within the scope of BEPS action 2 or ATAD 2, despite the right to deduct payments from the Brazilian companies' taxable profits. In fact, Brazilian interest on net equity is not a financial instrument scheme to achieve base erosion and profit shifting. Instead, it is a tax mechanism created by the Brazilian legislature to achieve several tax policy objectives:

- mitigate the effects of the distinction between equity and debt to reduce the debt bias;
- encourage the capitalization of Brazilian companies through formal capital contribution to prevent leveraging and excessive level of indebtedness;
- integrate corporate and individual income taxes to eliminate double taxation of corporate profits; and
- alleviate the undesirable effects of the prohibition on monetary adjustment of financial statements in the context of high inflation.

Also, article 9 of Law No. 9249/1995, which introduced the interest on net equity in the Brazilian tax system, already restricts the possibility of BEPS by establishing a maximum amount to be deducted from the taxable profits.

First, interest on net equity is calculated based on the application of long-term interest rates on the adjusted equity of the Brazilian company, considering all variations during the calendar year, subject to the limits of either 50 percent of the current profits or 50 percent of the retained earnings. Second, the payment of interest on net equity is subject to 15 percent withholding, increased to 25 percent in the case of payments made to beneficiaries domiciled in low-tax jurisdictions. Moreover, interest on net equity targets mitigating economic double taxation of profits earned through legal entities: once in the hands of the company, and a second time in the hands of the shareholders.

Indeed, Brazilian interest on net equity is deductible from the tax base of the corporate income tax and taxed at the level of individual shareholders at a 15 percent flat rate, which is lower than the 27.5 percent top individual income tax rate. It follows that the leeway available for using interest on net equity as an aggressive tax planning mechanism to achieve BEPS is severely restricted by Brazilian tax law. This requires caution in the introduction of tax measures based on BEPS action 2, because interest on net equity represents an important mechanism to address the debt bias caused by the tax deductibility of interest expenses and to offset the effects of Brazil's relatively high inflation.

Tax courts have come to different conclusions at the international level. For instance, Spain's National Court (Audiencia Nacional), in a decision handed down on February 27, 2014, classified the interest on net equity as dividend under Spanish domestic law, based on its typical characterization of a corporate right.[2] Similarly, in Germany, the Federal Court of Finance (Bundesfinanzhof) characterized Brazilian interest on net equity as dividend both under German domestic law and the Brazil-Germany tax treaty, which was in force at the time of the facts of the case.[3]

Treaty Issues

Regarding treaty issues, the taxpayer asked the Tax Agency to provide clarification on the method that should be used to eliminate double taxation in Italy on Brazilian company payments. The two relevant treaty provisions are paragraphs 3 and 4 of article 23.

According to paragraph 3, payments characterized as Brazilian-source dividends are exempted from tax in Italy. No credit applies for income taxes paid in Brazil.[4] Under this scenario, the Italian company would be exempt from Italian corporate income tax on the payments received from the Brazilian company, but the 15 percent withholding tax applied in Brazil on those payments would be a final tax not creditable in Italy.

According to paragraph 4, payments characterized as Brazilian-source interest are included in taxable income in Italy, but Italy must

[2] Audiencia Nacional, Appeal No. 232/2011 (Feb. 27, 2014).

[3] Bundesfinanzhof, I R 6/11 (June 6, 2012).

[4] Article 23(3) reads: "Where a company which is a resident of Italy holds at least 25 percent of the capital of a company which is a resident of Brazil, Italy shall exempt from tax the dividends received by the company which is resident of Italy from the company which is resident of Brazil."

grant a matching credit equal to 25 percent of the amount of the interest. In this scenario, the Italian company would include the payments from the Brazilian company in its taxable profits subject to Italian corporate income tax but would receive a credit equal to 25 percent of the amount of those payments. This would entirely offset the 15 percent Brazilian withholding tax and some of the residual Italian tax, if there is any.[5]

The Italian Tax Agency stated that regarding the treaty, the tax classification of the JCP payment should be determined in accordance with Brazilian law. This position does not seem to be correct. Because the purpose of the treaty, in connection with the issue under consideration in the ruling, is to establish the method for eliminating double taxation under article 23 regarding the application of Italian taxes on Brazilian subsidiary payments, the tax classification of those payments should be done following Italian law.[6]

According to the Italian Tax Agency, the JCP payment should be characterized as interest under Brazilian tax laws. While it is included in the taxable income of the Italian company subject to Italian corporate income tax, it is eligible for the 25 percent matching credit under the treaty.

Other Things

Finally, on a separate issue that was not raised by the taxpayer and was not within the scope of the ruling, the Italian Tax Agency observed that the JCP should not be taken into consideration for the purpose of applying the interest deduction limitation rules of article 96 of the TUIR. As a result, the JCP payment does not enter into the formula that limits the Italian company's deduction of net interest expenses (equal to the excess of interest expenses over interest income for the tax year) to an amount not exceeding 30 percent of the company's earnings before interest, taxes, depreciation, and amortization.

It is worth pointing out that Italy, with Law No. 160 of December 27, 2019 (the Budget Law for 2020), brought back to the Italian corporate tax system an allowance for corporate equity (ACE) providing a notional interest deduction equal to 1.3 percent of a company's qualifying net equity. It will be interesting to see how countries that fall at the other end of the discussion will characterize Italy's ACE for their own internal tax law purposes, and whether any interpretation similar to the one advocated by the Italian Tax Agency regarding Brazil's version of ACE will jeopardize the intended objective of the regime, which has nothing to do with either base erosion or tax avoidance. ■

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[5] Article 23(4) reads:

> For the deduction mentioned in paragraph 2 of this Article Brazilian tax shall always be considered as having been paid at the rate of 25 percent of the gross amount:
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> (a) of the dividends as defined in paragraph 4 of Article 10;
> (b) of the interest as defined in paragraph 4 of Article 11, and
> (c) of the royalties as defined in paragraph 4 of Article 12.

The preceding paragraph 2, as referred to in paragraph 4, reads as follows:

> 2. If a resident of Italy owns items of income arising in Brazil, Italy in determining its income taxes specified in Article 2 of this Convention, may include in the basis upon which such taxes are imposed the said items of income, unless specific provisions otherwise provide. In such a case, Italy shall deduct from the taxes so calculated the tax on income paid in Brazil, but in an amount not exceeding that proportion of the aforesaid Italian tax which such items of income bear to the entire income. On the contrary no deduction will be granted if the item of income is subjected in Italy to a final withholding tax by request of the recipient of the said income.

[6] That would be the approach required under article 2(2) of the treaty, which says: "As regards the application of this Convention by a contracting State any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of this Convention."