VGL NEWS

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"Law No. 12,249/10 – Articles 24 to 26: New Restrictions on Corporate Tax Deductibility Rules"

On June 14, 2010, Law No. 12,249 was issued as the result of the conversion of Provisional Measure No. 472, of December 16, 2009, which introduced the so-called "thin capitalization" rules, as well as other "anti-abusive" rules aiming to limit the amount which can be deducted from the tax base of Corporate Income Tax ("**IRPJ**") and Social Contribution on Net Profits ("**CSLL**") in connection with interest and other amounts paid or credited by a Brazilian source either to (i) related individuals or legal entities resident or domiciled abroad, as defined by Brazilian transfer pricing rules under Law No. 9,430, dated December 27, 1996 ("**Foreign Related Parties**"); or (ii) beneficiaries located in Tax Favorable Jurisdictions ("**TFJ**") or that are under a Privileged Tax Regime ("**PTR**"), as defined under Law No. 9,430/96. In general, Law No. 12,249/10 corrected some lack of precision in the wording of Provisional Measure No. 472/09 as well as furnished some additional provisions to clarify issues that were either not clearly explained by the original wording or completely absent therefrom.
In broad terms, the rules of Articles 24, 25 and 26 of Law No. 12,249/10 determine the following:

Article 24 – Thin capitalization rules: Article 24 of Law No. 12,249/10 sets forth that interest paid or credited by a Brazilian source (borrower) to a Foreign Related Party (lender) not located in a TFJ or under a PTR will only be deductible for purposes of IRPJ and CSLL if they constitute necessary expenses to the Brazilian borrower's activities and fulfill the following requirements: **(i)** in case of debt with a Foreign Related Party that holds equity interest in the Brazilian borrower, the indebtedness amount, on the date of the interest's accrual, does not exceed 2 (two) times the amount of the corporate equity interest held by the Foreign Related Party in the net worth of the Brazilian borrower; **(ii)** in case of debt with a Foreign Related Party that does not hold equity interest in the Brazilian borrower, the indebtedness amount, on the date of the interest's accrual, does not exceed 2 (two) times the amount of the net worth of the Brazilian borrower; **(iii)** in both cases (whether or not the Foreign Related Party holds equity interest in the Brazilian company), the sum of all debts held with Foreign Related Parties, on the date of the interest's accrual, does not exceed 2 (two) times the sum of the equity interest held by all Foreign Related Parties on the net worth of the Brazilian borrower, except if the Brazilian borrower only has debt transactions with Foreign Related Parties that do not hold any equity interest in the Brazilian borrower. In the latter case, the sum of all debts held by all Foreign Related Parties without any equity interest in the Brazilian borrower can not exceed 2 (two) times the net worth of the Brazilian borrower.

Please note that Law No. 12,249/10 improved the original wording of Article 24 of Provisional Measure No. 472/09, establishing different criteria to evaluate the deductibility of interest paid to Foreign Related Parties that hold equity interest in the Brazilian borrower and to Foreign Related Parties that do not hold equity interest in the Brazilian borrower. Since the latter situation was not dealt with by Provisional Measure No. 472/09 it was very difficult to determine if and how the original wording of Article 24 would apply to these situations.

Article 25 – Anti-abusive rules for deductibility of interest paid to beneficiaries located in a TFJ or under a PTR: While Article 24 of Law No. 12,249/10 is applicable to debt transactions entered into with Foreign Related Parties, Article 25 establishes anti-abusive rules regarding interest paid or credited to beneficiaries resident, domiciled or incorporated in a TFJ or under a PTR. According to such provision the interest expense will only be deductible from the tax base of IRPJ and CSLL if (i) such expense is necessary to the Brazilian borrower's activities and (ii) the sum of all debt held with entities located in a TFJ or under a PTR does not exceed 30% (thirty percent) of the net worth of the Brazilian borrower. Please note that Normative Ruling of the Brazilian Revenue Office No. 1,037, dated June 4, 2010 sets forth which countries and dependencies are considered by the Brazilian tax authorities as TFJ. The same Normative Ruling also establishes which specific situations are

considered by the tax authorities as PTR.

Law No. 12,249/10 also removed the requirement of Provisional Measure No. 472/09 according to which the debt amount held with each specific beneficiary located in a TFJ or under a PTR should not exceed 30% (thirty percent) of the net worth of the Brazilian borrower, since such requirement is irrelevant in light of the current requirement described in item (ii) of the previous paragraph.

General rules applicable to articles 24 and 25: Regarding the concept of indebtedness (debt transactions) in Articles 24 and 25 of Law No. 12,249/10, all types of debt transactions should be considered, e.g. any loan or financing transaction, including all terms, conditions and length of financing transactions, regardless of whether the transactions are registered before the Brazilian Central Bank. Those rules will also apply to debt transactions undertaken by Brazilian borrowers in case a Foreign Related Party (Article 24) or a beneficiary located in a TFJ or under a PTR (Article 25) assumes the position of co-signer (*avalista*), guarantor (*fiador*), legal representative/attorney-in-fact (*procurador*) or intervenient (*interveniente*). Law No. 12,249/10 also elucidates that the amount of indebtedness and net worth shall be verified for purposes of these rules by the weighted monthly average.

Clarifying another issue that was absent from the original wording of Provisional Measure No. 472/09, Law No. 12,249/10 sets forth that the rules of Articles 24 and 25 do not apply to international funding transactions entered into by Brazilian financial institutions with the sole purpose of transferring the resources obtained abroad to third parties in Brazil.

Article 26 – Anti-abusive rules for deductibility of amounts of any nature: Notwithstanding other applicable rules for purposes of calculating IRPJ, Article 26 of Law No. 12,249/10 sets forth, as a general rule, that the amounts of any nature paid, credited, delivered, used or remitted directly or indirectly by a Brazilian source to beneficiaries resident or incorporated in a TFJ or subject to a PTR are not deductible from the tax base of IRPJ and CSLL. However, these expenses may be deducted if the following cumulative requirements are complied with: **(i)** identification of the beneficial owner of the foreign entity to whom those amounts are remitted; **(ii)** evidence of the operational capacity of the foreign individual or legal entity to perform the transaction at hand; and **(iii)** documentary evidence of the payment of the respective price and of the receipt of the relevant goods, rights or services.

Law No. 12,249/10 brings forth an exception to item (ii) of the previous paragraph, which no longer applies if (a) the transaction was not carried out with the sole or primary purpose of saving taxes or (b) the foreign beneficiary is a wholly owned subsidiary, branch or main branch of the Brazilian company and the profits of such beneficiary are taxed in Brazil in accordance with article 74 of Provisional Measure No. 2,158-35, dated August 24, 2001.

Relying on the same wording of Provisional Measure No. 472/09, for purposes of Article 26 of Law No. 12,249/10 beneficial owner is defined as the individual or legal entity that was not incorporated with the sole or primary purpose of saving taxes and that earns these amounts on its own behalf and not as an agent, fiduciary administrator (such as trusts) or legal representative of a third-party.

Clarifying another issue of Provisional Measure No. 472/09, Law No. 12,249/10 sets forth that the rules of Article 26 do not apply to the payment of interest on net equity (*juros sobre capital próprio*), which is an alternative to the payment of dividends allowed by the Brazilian legislation.

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