

## Part Two

### Chapter 7: Controlled Foreign Company Legislation in Brazil

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#### 7.1. Characteristics of Brazilian CFC legislation

Whether or not Brazil has CFC legislation depends on what should be deemed to be the main features of such legislation. Accordingly, if a CFC is considered as a specific anti-avoidance rule (SAAR), i.e. aiming at specific situations whereby resident companies would be able to choose low-tax jurisdictions, then it would immediately be concluded that there is no need for such in Brazil. Accordingly, already in the adoption of worldwide taxation in Brazil, a full transparency regime was adopted. In such circumstances, there was no need for a SAAR since profits earned abroad were immediately taxed in Brazil irrespective of their effective distribution. In other words, it was irrelevant whether the controlled company was situated in a low-tax jurisdiction or whether its main income derived from passive investments; transparency would apply even in the case of an operative company situated in a high-tax jurisdiction.

On the other hand, should a broader concept be adopted for CFC legislation that would not consider only abusive situations (SAAR), then Brazil has CFC rules. However, as the authors adopt the strict concept of CFC legislation, the unrestricted Brazilian regime is hereinafter referred to as the “worldwide income taxation” legislation (WWIT legislation).

##### 7.1.1. Four phases of Brazilian WWIT legislation

Since the adoption of the worldwide taxation for the corporate income tax (CIT), four different phases of Brazilian WWIT legislation can be seen.

The first phase was marked by the complete shift to a worldwide basis<sup>[1]</sup> that allegedly aimed to address abusive situations but presented a wider scope. Accordingly, in 1995, Law 9,249 changed the Brazilian system from territorial to a worldwide basis with respect to companies. As per the explanatory reasons attached to the bill presented to Congress, besides the intent to harmonize the taxation of companies with individuals – whose foreign income was already subject to tax – the main concern was to address tax evasion that was mainly related to tax arrangements involving tax havens. In other words, the target was not foreign profits but Brazilian profits that would be hidden in low-tax jurisdictions. This reasoning sounds correct as, at that time, only a few Brazilian companies carried out business elsewhere.

However, under Law 9,249/1995, profits earned by and attributed to the foreign companies were to be taxed in Brazil regardless of the involvement of a tax haven or the nature of the income. As stated in Article 25 of Law 9,249/1995, profits earned by foreign controlled and associated companies should be added to the profits of the parent in proportion to its shareholding for the purpose of calculating the taxable profit as of 31 December of each and every year. Profits directly or indirectly produced abroad<sup>[2]</sup> by Brazilian companies were taxed on an annual term. The presence of an abusive situation was irrelevant. No distinction was made whatsoever as to the jurisdiction where the subsidiary was located (the “designated jurisdiction approach”) nor to the nature of the income derived by the company (the “tainted income approach”).<sup>[3]</sup>

The second phase arose as the search to fix the legal regime in order to prevent the violation of the realization principle that guides income taxation in Brazil. In this context, the Brazilian Federal Revenue Service enacted Normative Ruling 38/1996, which set forth that the taxation of foreign profits depended upon its actual availability to the Brazilian resident company (Article 2).

However, the Normative Ruling was not the correct instrument to determine the tax event; it was in clear contradiction to Law 9,249/1995; accordingly, while the latter had stated that tax was due on 31 December irrespective of its actual distribution, the ruling stated that a tax event would only occur upon the actual availability. Almost 1 year after the Normative Ruling had been enacted, the contradiction was finally resolved since Law 9,532/1997 changed the previous Law 9,249/1995 and, as already foreseen by the Normative Ruling, defined the tax event as per the availability. Only in specified situations would Law 9,532/1997 deem foreign profits available to the Brazilian parent company which, despite some contention from taxpayers, largely met the

1. For an in-depth historical background, see L. Schoueri & M.C. Barbosa, *Territorial and Worldwide Taxation in Brazil*, in *Territorialität und Personalität – Festschrift für Moris Lehner* pp. 95-110 (R. Ismer et al. eds., Otto Schmidt 2019).
2. See A. Martins de Andrade, *A Tributação Universal da Renda Empresarial* pp. 202-203 (Fórum 2008).
3. See G. Maisto & P. Pistone, *A European Model for Member States' Legislation on the Taxation of Controlled Foreign Subsidiaries (CFCs) – Part 1*, 48 Eur. Taxn. (2008), Journal Articles & Papers IBFD; and L. De Broe et al., *Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions*, 65 Bull. Intl. Taxn. 7 (2011), Journal Articles & Papers IBFD.

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requirements of the realization doctrine.<sup>[4]</sup> Therefore, Law 9,532/1997 assured the alignment between the Brazilian worldwide basis with the realization principle.

Nevertheless, the third phase appeared with the amendment of the Brazilian National Tax Code by Complementary Law 104/2001 in order to establish that foreign profits shall be deemed available under the conditions and in the moment defined by ordinary law. The tax authorities understood that this would be enough to allow taxation of foreign income to occur irrespective of its availability to the Brazilian shareholder (thus not observing the realization principle). In the same year, Provisional Measure 2,158 was enacted,<sup>[5]</sup> setting forth that “profits earned by a foreign controlled or associated entity shall be deemed available to the Brazilian controlling or associated entity on the date of the balance sheet in which they have been assessed” irrespective of the existence of an abusive situation (Article 74). The Federal Revenue Service enacted Normative Ruling 213/2002, providing that, in order to comply with the new legislation, taxpayers should include any positive results from equity accounting adjustments of relevant investments abroad in their tax base. As a pendulum swing, all foreign profits were made automatically taxable in Brazil even if they were not distributed.

In this new round, a bigger wave of criticisms challenged the regime established by Provisional Measure 2,158/2001. Taxpayers and the major literature claimed that it was not correct to state that the National Tax Code had dismissed the realization principle with the modifications of Complementary Law 104/2001. As in the past, the availability criterion remained crucial for income taxation. Complementary Law 104/2001 only clarified that ordinary law would define the conditions and the moment when income should be considered available but, in no case, could the availability criterion itself be discarded. That is why it could be argued that Provisional Measure 2,158/2001 violated the National Tax Code<sup>[6]</sup> since every single foreign profit would never be deemed unavailable.<sup>[7]</sup> In addition, taxpayers claimed that the regime set in 2001 should be considered unconstitutional because, besides its disproportional and unreflective measures,<sup>[8]</sup> it violated the ability to pay requirement when demanding “income tax payment with any concrete sign of economic capacity”.<sup>[9]</sup>

The embryonic conception of the fourth phase started with the litigation raged at federal courts between taxpayers and authorities. Although the matter reached the Supreme Court in 2002, the Court came with a most inconclusive and controversial decision only in 2013 with the Direct Action of Unconstitutionality no. 2,588.<sup>[10]</sup> Despite (or maybe because of) this long period of time, the diversity of opinions among the Justices formed a puzzle. The way out was by average vote, taking into account more the outcome (constitutional or not) than the reasons underlying each vote.<sup>[11]</sup> At the end of the day, the outcome was: the constitutionality of the taxation of profits earned by controlled companies located in tax havens and the unconstitutionality of the rule to associate companies located outside tax havens. The decision was inconclusive with respect to situations involving controlled companies located outside tax havens and associated companies located in tax havens. The outcome can be illustrated by the chart below:

Investee	Location	Article 74 of Provisional Measure 2,158/2001	<i>Erga omnes</i> effectiveness and binding effect
Associated companies	not a tax haven	unconstitutional	yes
Associated companies	tax haven	not decided (the majority was not reached)	no
Controlled companies	not a tax haven	not decided (the majority was not reached)	no
Controlled companies	tax haven	constitutional	yes

On the same day of the final decision of the Direct Action of Unconstitutionality no. 2,588, the Supreme Court decided two other cases. According to the Court, the taxation of profits earned by controlled companies located outside tax havens<sup>[12]</sup> and by

- See L.R. Galhardo & J.N.F. (Jr.) Lopes, *Brazilian CFC Rules: Current Trends, Government Overreaching*, 18 *Journal of International Taxation* 3, p. 41 (2007).
- A provisional measure is a feature of the 1988 Constitution by means of which the president is authorized to unilaterally enact measures invested with “force of law” in cases of “relevance and urgency”. Once it has been enacted by the executive branch, a provisional measure is sent to Congress which may convert it into law within no more than 120 days. If it is not approved before this deadline, the provisional measure loses its enforceability *ex tunc*, and it is up to Congress to “regulate, by means of a legislative decree, the juridical relations deriving from it”.
- See R. Mariz de Oliveira, *A Disponibilidade Econômica ou Jurídica de Rendas e Proventos Auferidos no Exterior*, 4 *Revista Fórum de Direito Tributário*, Fórum, 2003, p. 33.
- See P. A. Barreto, *Imposto sobre a Renda e os Lucros Auferidos no Exterior*, in *Grandes Questões Atuais do Direito Tributário* (V. O. Rocha eds., Dialética, vol. 6, 2002), p. 341.
- See M. Seabra de Godoi, *O Imposto de Renda e os Lucros Auferidos no Exterior*, in *Grandes Questões Atuais do Direito Tributário* (V. O. Rocha eds., Dialética, vol. 6, 2002), p. 284.
- See H. Ávila, *O Imposto de Renda, a Contribuição Social sobre o Lucro e os Lucros Auferidos no Exterior*, in *Grandes Questões Atuais do Direito Tributário* (V. O. Rocha eds., Dialética, vol. 7, 2003), p. 239.
- See BR: Supreme Court, Direct Action of Unconstitutionality no. 2,588/DF, 10 April 2013.
- Considering the outcome of the Supreme Court decision on the issue, see E. Peixoto Orsini & D.G. Peixoto Orsini Marcondes, *New Brazilian Supreme Court Decision on CFC rules*, 20 *Intl. Transfer Pricing J.* 5, pp. 336-338 (2013), *Journal Articles & Papers IBFD*.
- BR: Supreme Court, Extraordinary Appeal no. 541,090/SC, 10 April 2013.

associate companies located in tax havens is constitutional.<sup>[13]</sup> Nevertheless, these last two decisions did not have *erga omnes* effectiveness.

Besides constitutional issues (see section 7.5.), the decisions were strongly deceptive for two main reasons.

First, with respect to controlled companies, the Supreme Court allowed the taxation regardless of the existence of an abusive situation (e.g. the location in a tax haven). Taking into account that no other industrial and exporting economy establishes similar taxation, the additional burden imposed by the Brazilian regime may eventually put Brazilian players out of the global competitive market. Therefore, from a political perspective, the regime set in 2001 was questionable.

Second, associated companies (for which there is no control by the Brazilian investor) should be taxed upon distribution. As the assumption of CFC-type legislation relies on the parent company's power to decide when the profits will be distributed, it is surprisingly odd to tax foreign profits of associated companies regardless of the distribution since there is only significant influence to participate in the financial and operating policy decisions of the investee. Even regarding associated companies located in tax havens, no power to defer the foreign profits is verified.

Given the decision of the Supreme Court, part of Provisional Measure 2,158/2001 was deemed unconstitutional, namely, the taxation on associate companies located outside tax havens. In 2014, inspired by the decision of the Supreme Court, Law 12,973 was enacted, raising the fourth phase. Basically, the previous legislation was adapted to conform to the Supreme Court decision, relieving the profits from associated companies in regular tax jurisdictions from taxation on a current basis in Brazil. On the other hand, not only the immediate taxation of controlled companies in tax havens (which constitutionality had been confirmed) but also situations that remained inconclusive in that decision (namely, immediate taxation of controlled companies not situated in tax havens and of associated companies in tax havens) were foreseen by the legislation enacted in 2014.

### **7.1.2. The current taxation on worldwide basis under Law 12,973/2014**

Law 12,973/2014 created four subgroups of taxation on a worldwide basis: (i) companies subject to regular taxation that are directly or indirectly controlled by a Brazilian parent company and associated companies treated as controlled companies given a constructive ownership clause; (ii) associated companies subject to regular taxation abroad; (iii) companies *legally differentiated* that are directly or indirectly controlled by a Brazilian parent company; and (iv) associated companies *legally differentiated*.

Given such division, it may be understood what Law 12,973/2014 considers as controlled and associated companies as well as what is *legally differentiated* in order to address the taxation imposed by such law.

#### **7.1.2.1. Definitions of controlled and associated companies**

Regarding the definitions of *controlled* and *associated* companies, Law 12,973/2014 adopts the concepts of Brazilian corporate legislation (Law 6,404/1976).

On the one hand, controlled companies are companies in which the parent company, directly or through other companies, holds the rights to assure, permanently, preponderance in the corporate decisions and the power to elect the majority of the executives. Four aspects of this definition can be noted. First, the parent company must hold the rights to ensure preponderance in the decisions of the company. Second, these rights must ensure the power to elect the administrators. Third, these rights have to sustain such powers in a lasting manner.<sup>[14]</sup> Fourth, the control may be direct or indirect depending on whether the ownership of the rights belongs to the parent company (direct) or to other controlled companies (indirect). The last aspect is important because profits derived from indirect controlled companies are taxed individually ("*per saltum*")<sup>[15]</sup> no matter how indirect it is from the Brazilian parent company.

On the other hand, associated companies are companies over which the investor company, directly or through other companies, has significant influence. Significant influence shall occur if the investor company holds or exercises the power to participate in the financial or operational policy decisions of the associated company without controlling it. Significant influence is assumed when the investor company holds 20% or more of the voting capital of the investee without controlling it.

Although Law 12,973/2014 adopts the concepts of controlled and associated companies from the Brazilian corporate legislation (Law 6,404/1976), it includes a constructive ownership clause. According to Article 83 of Law 12,973/2014, an associated company will be deemed as a controlled company if the Brazilian investor company holds more than 50% of the voting capital of the associated company abroad jointly with individuals or other legal entities resident or domiciled in Brazil or abroad that are considered to be *related* thereto. As stated by Law 12,973/2014, the concept of *related* persons to the Brazilian investing company is broad. It includes, for example, individuals or legal entities that hold enough rights to be characterized as the direct or indirect

13. BR: Supreme Court, Extraordinary Appeal no. 611,586/PR, 10 April 2013.

14. See N. Eizirik, *A Lei das S/A Comentada*, 2ª ed., v. 4, Quartier Latin, 2015, pp. 232-233.

15. See R. Tomazela Santos, *O Regime de Tributação dos Lucros Auferidos no Exterior na Lei n. 12,973/2014* (Lumen Juris 2017), pp. 39-44.

parent company of the Brazilian investor company. One may also consider as related persons legal entities that are characterized as controlled, directly or indirectly, or associated with the Brazilian investing company. In addition, the concept of related persons encompasses individuals who are relatives up to the third degree, a spouse or companion of any of its directors, administrators, partners or controlling shareholders in direct or indirect participation of the Brazilian investor company.

Besides the division based on the relation between the investing and the invested companies, Law 12,973/2014 treats invested companies differently under criteria following a mix between designated jurisdiction and tainted income approach.

### **7.1.2.2. Legally differentiated companies**

Both controlled and associated companies are taxed differently if they are *legally differentiated*.

Associated companies are legally differentiated if they: (i) are located in a jurisdiction or dependency with favoured taxation or are beneficiaries of privileged tax regime under the terms of Articles 24 and 24-A of Law 9,430/1996; (ii) are subject to an *under-taxation* regime; or (iii) are controlled, directly or indirectly, by a legal entity subject to an *under-taxation* regime.

As per Law 9,430/1996, jurisdictions or dependencies with favoured taxation are those with a maximum tax rate lower than 20% or whose domestic legislation provides for the secrecy of corporate ownership. These jurisdictions are listed by the Brazilian tax authorities,<sup>[16]</sup> along with privileged tax regimes,<sup>[17]</sup> in which the definition relies on the concession of tax benefits to non-residents without the existence of a substantive economic activity in that jurisdiction.

According to Article 84 of Law 12,973/2014, an *under-taxation* regime is characterized by the taxation on profits of the legal entity domiciled abroad at a nominal rate of less than 20%. Given the similarity of this requirement in relation to the condition described above, its role may not be understood. On the one hand, it can be argued that the difference relies on the requirement of *effective* tax rate (Law 9,430/1996) versus *nominal* tax rate (Article 84 of Law 12,973/2014). Despite the inexistence of the expression “effective tax rate” on Law 9,430/1996, Normative Ruling 1,312/2012 expressly demands such a condition in order to deem a country to be a favoured taxation jurisdiction. On the other hand, it can also be argued that the creation of the *under-taxation* regime concept aims to set aside the need for a blacklist elaborated by Brazilian tax authorities.<sup>[18]</sup> Thus, it would be justified to be an independent concept.

Besides the three conditions imposed on associated companies, controlled companies are also legally differentiated if they: (i) are located in a jurisdiction with which Brazil does not maintain a treaty or an act with a specific clause for the exchange of information for tax purposes; (ii) are controlled, directly or indirectly, by a legal entity located in a jurisdiction or dependency with favoured taxation or beneficiary of privileged tax regime under the terms of Articles 24 and 24-A of Law 9,430/1996; or (iii) have their own *active* income as less than 80% of the total income.

As stated by Article 84 of Law 12,973/2014, every single income obtained directly by the legal entity through the exploration of its own economic activity is considered active income excluding the revenues derived from royalties, interests, dividends, corporate equities, rents, financial investments, financial intermediations and capital gains (except for the sale of corporate equities or permanent assets acquired for more than 2 years). Revenues from interests, financial investments and intermediations are considered active income for financial institutions that are recognized and authorized to operate by the monetary authority of the country in which they are located.

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16. See Normative Ruling 1,037/2010. The listed jurisdictions are: Andorra; Anguilla; Antigua and Barbuda; Aruba; Ascension Island; the Commonwealth of the Bahamas; Bahrain; Barbados; Belize; Bermuda; Brunei; Campione D' Italia; Channel Islands (Alderney, Guernsey, Jersey and Sark); Cayman Islands; Cyprus; Cook Islands; Djibouti; the Commonwealth of Dominica; United Arab Emirates; Gibraltar; Grenada; Hong Kong; Kiribati; Labuan; Lebanon; Liberia; Liechtenstein; Macau; Maldives; Isle of Man; Marshall Islands; Mauritius Island; Monaco; Montserrat Island; Nauru; Niue Island; Norfolk Island; Panama; Pitcairn Islands; French Polynesia; Qeshm Island; American Samoa; Western Samoa; San Marino; Saint Helena Island; Saint Lucia; Federation of Saint Kitts and Nevis; Saint-Pierre and Miquelon Islands; Saint Vincent and the Grenadines; Seychelles; Solomon Islands; Swaziland; Sultanate of Oman; Tonga; Tristan da Cunha; Turks and Caicos Islands; Vanuatu; the US Virgin Islands; British Virgin Islands; Curaçao; Saint Martin; and Ireland.
17. IN 1,037/2010 also includes the following as privileged tax regimes: Uruguay's regime regarding legal entities incorporated in the form of “Financial Companies Investment (Safis)” until 31 December 2010; Denmark's regime applicable to legal entities incorporated as a holding company that do not carry out substantive economic businesses; the Netherlands' regime applicable to legal entities incorporated as a holding company that do not carry out substantive economic businesses; Iceland's regime applicable to legal entities incorporated as the International Trading Company (ITC); the United States' regime applicable to legal entities incorporated as a Limited Liability Company (LLC) in which membership is made up of non-residents that are not subject to federal income tax; Spain's regime applicable to legal entities incorporated in the form of “*Entidad de Tenencia de Valores Extranjeros* (E.T.V.Es.)”; Malta's regime applicable to legal entities incorporated as International Trading Company (ITC) and International Holding Company (IHC); Switzerland's regimes applicable to legal entities incorporated as a holding company, domiciliary company, auxiliary company, mixed company and administrative company for which tax treatment results in an incidence of Corporate Income Tax (“IRPJ”) in a combined way less than 20% according to the federal, cantonal and municipal legislation as well as the arrangements applicable to other legal forms of incorporation of legal entities by rulings issued by tax authorities resulting in an incidence of IRPJ, in combination, less than 20% (twenty per cent) according to the federal, cantonal, and municipal legislation; Austria's regimes applicable to legal entities as a holding company that do not carry out substantive economic businesses; Costa Rica's Free Zone System; Portugal's regime applicable to the International Business Center of Madeira (CINM); and several specific Singapore regimes with differentiated tax rates.
18. See S.A. Rocha, *Tributação de Lucros Auferidos por Controladas e Coligadas no Exterior* (2nd edn, Quartier Latin 2016), pp. 194-196; and Tomazela Santos, *supra* n. 15, at pp. 146-149.

Given such considerations, it can be noted that controlled companies and associated companies have different regimes under Law 12,973/2014. For associated companies, there is no requirement regarding the nature of the income and the existence of a treaty or an act with a specific clause for the exchange of information for tax purposes. Also, associated companies are not legally differentiated if they are controlled by a legal entity located in a jurisdiction or dependency with favoured taxation or beneficiary of a privileged tax regime, under the terms of Articles 24 and 24-A of Law 9,430/1996.

### **7.1.2.3. The taxation imposed by Law 12,973/2014**

Controlled companies (legally differentiated) and associated companies that are legally differentiated are taxed on “adjustments in the investment value” on an annual term irrespective of distribution that shall be computed by the Brazilian company. As one may see, Law 12,973/2014 does not adopt the “full transparency” regime with the taxation of local profits computed by reference to the investment abroad. Despite its misleading language, Law 12,973/2014 follows the separate entity approach since it only sets forth the disclosure of investments in the financial statements of the parent company and likewise adds the profits of affiliated companies in the calculation of the taxable income. Thus, tax neutrality of equity adjustments remains untouched. In addition, perhaps because of transitional issues to this new law, the tax on “adjustments in the investment value” is also deferrable for up to 8 years (but provided that 12.5% of the amount due is immediately collected).

Despite being taxed on “adjustments in the investment value”, the amount of profits of associated companies that are legally differentiated to be added to the taxable profit of the parent company can be wider than the amount of profits earned through controlled companies as a whole. According to Article 82(1) of Law 12,973/2014, any (positive or negative) result obtained through another legal entity in which the associated company maintains any type of corporate equity, albeit indirectly, will comprise its “adjustments in the investment value”. As profits derived from controlled companies are taxed individually, regardless if they are direct or indirectly controlled by the Brazilian parent company, such a provision would be controversial. However, with respect to associated companies (legally differentiated), it is relevant to highlight that only the first tier of an associated company is taxed. Since the concept of an associated company is based on the significant influence criterion, it could be argued that the individual taxation of profits derived from the “associated company of the *associated* company” of the Brazilian company. Although profits derived from the “associated company of the *controlled* company” of the Brazilian company are taxed individually, the results of the “associated company of the *associated* company” of the Brazilian company are consolidated on the results of the first tier of an associated company.

On the other side, profits obtained through foreign associated companies subject to regular taxation abroad are only taxed upon distribution following the Supreme Court decision. As they shall be taxed solely when their profits are available to the Brazilian associated company, the object taxable is different from the other cases. Accordingly, profits that are distributed are usually calculated after tax is paid in the foreign jurisdiction (net profit) while, in the former cases, the amount to be taxed in Brazil is before taxation in the foreign country. Correspondingly, while the Brazilian taxation on profits obtained through regular associated companies can only be offset against the tax on dividends imposed abroad (direct credit), the taxation on “adjustments in the investment value” can be offset against direct and indirect credit.<sup>[19]</sup> Given that “adjustments in the investment value” are computed before the foreign CIT, Law 12,973/2014 provides for the credit with the CIT imposed abroad (indirect credit) in order to avoid double taxation.

As the indirect credit is not available for profits derived from the regular associated companies’ regime, in 2016, Law 13,259 included Article 82-A of Law 12,973/2014 providing for the option for those associated companies to be taxed under the regime designated to associated companies that are legally differentiated. Thus, regular associated companies have the choice between taxation upon distribution without indirect credit or taxation regardless of distribution with indirect credit.

With respect to foreign controlled companies, until 2022, the Brazilian parent is allowed by Law 12,973/2014 to use a deemed-paid foreign tax credit equivalent to 9% of the foreign profit in addition to ordinary foreign tax credit. Considering the Brazilian tax burden (34%), this tax benefit is able to fully neutralize whenever CFCs are located in jurisdictions with an income tax rate above 25%. Thus, it can be argued that, somehow, Law 12,973/2014 contemplated the importance of competitiveness.

Other treatment restricted to investments in foreign controlled companies is related to the offset of losses. Until 2022, Law 12,973/2014 allows the Brazilian parent company to put all foreign results in one basket, allowing profits and losses to be offset against each other (and thus only the net positive amount shall be taxed in Brazil). This treatment does not encompass controlled and associated companies that are legally differentiated. As can be noted, Law 12,973/2014 deemed this regime as a tax benefit because it may end in 2022, and it is limited to certain situations. In all other cases, profits and losses can be offset limited to each foreign company. In other words, every single foreign company turns out to be one different basket.

As can be noted, the Brazilian WWIT legislation is complex since it presents four different regimes, each one having their own peculiarities that can be illustrated by the chart below:

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19. For indirect credit to associated companies legally differentiated, see Article 26 of Normative Ruling 1,520/2014.

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	Controlled Companies (regular)	Controlled Companies (legally differentiated)	Associated Companies (legally differentiated)	Associated Companies (regular)
Tax object	"adjustments in the investment value"	"adjustments in the investment value"	"adjustments in the investment value"	"profits obtained upon distribution" (equivalent to dividends)
Participation on other tiers	-	-	inclusion of results obtained through another legal entity	-
Consolidation	possibility to put foreign results in one basket	-	-	-
Tax benefit	deemed-paid foreign tax credit (2022)	-	-	-
Tax credit	direct and indirect credits	direct and indirect credits	direct and indirect credits	direct credit
Tax base shift	-	-	-	option to be taxed as associated companies legally differentiated

From a policy perspective, Brazil continues to adopt capital export neutrality. As a rule, Brazil taxes undistributed dividends not following a piercing the veil or a deemed dividend approach; it taxes the profits of the foreign entity. In addition, the deemed-paid foreign tax credit cannot be overstated. Not only is this tax benefit time-limited (2022), but it can also be selective. Law 12,973/2014 itself mentions the sectors entitled to it (construction, manufacture of foods, and beverages), but it was amended in 2014 by Law 13,043 which included the expression "other industries in general". Moreover, the government can include any other sector but only when the inclusion "does not result in prejudice to investments in the country".

Besides complexity and discretionary power to the government, it is important to highlight that Brazilian WWIT legislation does not follow typical CFC legislation.

### 7.1.3. Brazilian WWIT legislation: Not a typical CFC legislation

Considering the current Brazilian WWIT legislation on companies, it can be concluded that Brazil does not have a typical CFC legislation.

As explained above, the purpose of the Brazilian regime goes beyond tackling so-called *tax deferral*. Different from typical CFC rules, the Brazilian WWIT regime has a wide scope. Besides *controlled* foreign corporations, in some situations, retained profits of *associated* companies are taxable irrespective of distribution.

Also, it has a wide scope because, for controlled companies, it is irrelevant where they are located or the nature of their income. The only consequence in establishing a controlled company in a tax haven (or not complying with some other conditions) is the impossibility of consolidation (i.e. of offsetting profits of one foreign company against losses of the other foreign company). In any case, all profits of controlled corporations are taxed regardless their distribution to the parent company.

Taking this into in consideration, the Brazilian WWIT legislation differs from CFC-type rules because it is not designed as a SAAR. The main rule is to tax retained profits and only in specific situations are they taxable only upon distribution. Therefore, what would be the exception is, in fact, the rule.

Moreover, even the exceptions are related solely to associated companies (subject to regular taxation) that are not typically taxed under CFC regimes. That is why it can be concluded that Brazilian WWIT legislation on corporations is not a typical CFC regime.

## 7.2. Special CFC rules

Brazilian WWIT legislation does not impose a special CFC rule. In 2013, right after the Supreme Court decisions on the previous Brazilian WWIT regime, Provisional Measure 627 was enacted on which Law 12,973/2014 was based. Along with the (current) four subgroups of worldwide taxation, Article 89 of Provisional Measure 627/2013 had established taxation on foreign profits obtained through controlled companies by individuals as shareholders irrespective of distribution.

This treatment would have depended on the following conditions. Such controlled foreign companies should be: located in a jurisdiction, dependency with favoured taxation or beneficiary of privileged tax regime under the terms of Articles 24 and 24-A of Law 9,430/1996; or subject to an *under-taxation* regime. Also, Article 89 of Provisional Measure 627/2013 would be applied whether the Brazilian individual resident had not had the documents related to the foreign company that would identify the other partners.

Furthermore, Article 90 of Provisional Measure 627/2013 created a constructive ownership clause in order to address Brazilian individual residents who owned more than 50% of the voting capital of the controlled company abroad jointly with other individuals

or legal entities resident or domiciled in Brazil or abroad and thereto considered to be related. The concept of related persons was similar to those enacted by article 83 of Law 12,973/2014 described at section 7.1.2.1.

However, Law 12,973/2014 was enacted without this regime being applicable to individuals. Currently, there are only the four groups of worldwide taxation under the terms of Law 12,973/2014. Besides these four regimes, Brazilian WWIT legislation does not have specific rules for other structures.

In fact, given the wide scope in the Brazilian WWIT legislation, it can be argued that there is no need for specific rules. As the Brazilian WWIT rules encompass associated companies and taxes profits from controlled companies regardless of distribution, it is difficult to circumvent them.

### 7.3. CFC legislation and other anti-abuse provisions

Not only is the Brazilian WWIT legislation not a SAAR, Brazil also does not have a general anti-avoidance rule (GAAR). In 2001, the government intended to enact a GAAR. Complementary Law 104/2001 added the following provision as a paragraph of article 116 of the Brazilian National Tax Code:

The administrative authority may disregard acts or legal transactions carried out with the aim of dissimulating the occurrence of the tax event or the nature of the elements which constitute a tax obligation, as per a procedure to be established by ordinary law [authors' translation].

As can be seen, this provision intends to address sham transactions and not to establish broad standards in order to address tax avoidance.<sup>[20]</sup> Despite the discussion on the self-applicability of such a rule given the requirement of a procedure to be established by ordinary law, the Brazilian Administrative Council of Tax Appeals (*Conselho Administrativo de Recursos Fiscais*, CARF)<sup>[21]</sup> began to adopt a substance-over-form approach. CARFs decisions on tax planning cases are controversial not only because Brazilian legislation does not have a GAAR but also because there seems to be no uniformity among such decisions.<sup>[22]</sup>

Even considering that Brazilian legislation would have a GAAR and that this rule should be applied in a certain way, as explained at section 7.1.3., Brazilian WWIT rules are not a SAAR. Thus, one cannot conclude which would be the relation between a GAAR and the Brazilian WWIT regime.

In any case, the authors believe that a SAAR prevails over a GAAR following the *lex specialis* approach provided that they are at the same hierarchical level.<sup>[23]</sup> Considering that GAARs adopt general standards to counter abusive practices, SAARs establish special conditions to certain operations, materializing the general standards in a more targeted form (*sniper approach* <sup>[24]</sup>). Therefore, if Brazilian legislation had both GAARs and CFC-type rules, the latter would prevail over the former.

### 7.4. CFC legislation and tax treaties

With respect to the previous Brazilian WWIT regime, after a long road of discussion, the relationship between such rules and tax treaties was settled in the leading *Vale* case.<sup>[25]</sup> According to the Superior Court of Justice, the scope of Article 74 of Provisional Measure 2,158/2001 comprehended profits earned by and attributed to foreign companies. Therefore, Article 7 of the Brazilian tax treaties precluded the application of the previous Brazilian WWIT legislation.<sup>[26]</sup>

The majority of the Superior Court did not accept the position of the tax authorities which sustained that Article 74 of Provisional Measure 2,158/2001 would impose tax on equity method adjustments recorded by the Brazilian parent company instead of on

20. See L.E. Schoueri, *Planejamento Tributário e Garantias dos Contribuintes: Entre a Norma Geral Antielisão Portuguesa e Seus Paralelos Brasileiros*, in *Garantias dos Contribuintes no Sistema Tributário*, (D. Freire e Almeida et al. eds., Saraiva, 2012), p. 400.

21. The court is a body within the Ministry of Finance comprising a specialized group of experts that are chosen among both tax authorities and taxpayers and is supposed to review tax assessments. The review body within CARF is composed equally of tax agents and taxpayers who are all appointed by the Minister of Finance, and the chair of the body – to whom the casting vote is granted – is always a member of the tax authority. The review procedure at the court is similar to its judicial counterpart and, when the appeal is not granted by the CARF, the taxpayer is always allowed to resort to the judicial courts where the examination will be restarted regardless of any opinions previously handed down within the administrative review. Moreover, should the court grant the taxpayer's request, the Brazilian Federal Revenue Service cannot bring its claim to the judiciary since the former's decision extinguishes the tax assessment.

22. See L.E. Schoueri, *Legal Interpretation of Tax Law: Brazil*, in *Legal Interpretation of Tax Law* (R.F. van Brederode & R. Krever eds., Series on International Taxation, vol. 46, Wolters Kluwer 2014), pp. 47-74; L.E. Schoueri & M. Calicchio Barbosa, *Chapter 6: Brazil in GAARs – A Key Element of Tax Systems in the Post-BEPS Tax World* (M. Lang et al. eds., IBFD 2016), Books IBFD; and L.E. Schoueri & R.A. (Jr.) Galendi, *Chapter 9: Brazil in Tax Avoidance Revisited in the EU BEPS Context* (A.P. Dourado ed., IBFD 2017), Books IBFD.

23. See F. Debelva & J. Luts, *The General Anti-Abuse Rule of the Parent-Subsidiary Directive*, 55 Eur. Taxn. 6, p. 232 (2015), Journal Articles & Papers IBFD; A. Perdelwitz, *Chapter 15: Developing a Common Framework against Tax Avoidance in the European Union in The Implementation of Anti-BEPS Rules in the EU: A Comprehensive Study* p. 11 (P. Pistone & D. (Dennis) Weber eds., IBFD 2018), Books IBFD; R.J. Danon, *Treaty Abuse in the Post-BEPS World: Analysis of the Policy Shift and Impact of the Principal Purpose Test for MNE Groups*, 72 Bull. Intl. Taxn. 1, p. 38 (2018), Journal Articles & Papers IBFD.

24. See M. Seiler, *GAARs and Judicial Anti-Avoidance in Germany, the UK and the EU – Series on International Tax Law*, vol. 98, p. 5 (M. Lang ed., Linde 2016).

25. See BR: Superior Court of Justice, Appeal no. 1.325.709/RJ, 24 April 2014.

26. For further analysis, see L.E. Schoueri & M. Calicchio Barbosa, *Brazil: CFC Rules and Tax Treaties in Brazil: A Case for Article 7 in Tax Treaty Case Law around the Globe 2015* (M. Lang et al. eds., IBFD 2016), Books IBFD.

profits earned by the investee itself. As decided by the Superior Court, under Decree 1,598/1977, accounting adjustments in equity would be tax neutral. Not only would the foreign investee have “its own legal personality” under Brazilian law, but also the profits of the foreign company would be calculated outside Brazil following the local applicable legislation and then included in the tax base of the Brazilian parent company. Thus, the Superior Court states that the previous Brazilian WWIT rules would encompass profits both earned by and attributed to the foreign company. Also, this conclusion would comprehend investees located in tax havens under the Brazilian blacklist.

In this sense, the Superior Court recognized the application of Article 7 of tax treaties. Otherwise, the previous Brazilian WWIT regime would override tax treaties, violating the good faith in foreign relations. However, this consequence would also be impossible since provisions of tax treaties would prevail over Brazilian domestic legislation due to the specialty criterion (*lex specialis derogat generalis*) under the terms of Article 98 of the Brazilian National Tax Code.<sup>[27]</sup>

Although the general outcome of this decision is praiseworthy, it is too soon to conclude that the same reasoning will remain under the current Brazilian WWIT legislation because there has not yet been one decision in this regard.

The potential problem under the regime established by Law 12,973/2014 involves the wording of the relevant provisions because it refers to “*profits obtained through* associated foreign companies” and to “*adjustments in the investment value*” for controlled companies and associated companies legally differentiated. Imprecisely, the tax authorities may affirm that Article 7 would not be applicable because the taxation would comprehend profits of the Brazilian company. To sustain this conclusion, they may also argue, incorrectly, that Law 12,973/2014 would inaugurate a “full transparency” regime – as decided in the *Gyo-Hi* case<sup>[28]</sup> – given the taxation of local profits calculated by reference to the investment abroad and thus disregarding the legal personality of the foreign investee.

Nevertheless, this argument is inaccurate despite the misleading language of Law 12,973/2014 that adopts the separate entity approach because it aims at profits earned by and attributed to foreign investees. What is different is the mere disclosure in the financial statements of the parent and the addition in the calculation of the taxable profit.

Not only Article 7 of tax treaties is objectively limited to profits of a resident of the other state – which is precisely the case – but it is also not clear-cut that tax treaties are not applicable if domestic law adopts “full transparency” or “look-through” approaches. The notion that tax treaties cannot attribute income<sup>[29]</sup> may be challenged by the fact that tax treaties seem to have adopted the separate entity approach (e.g. Article 5(7)).<sup>[30]</sup> Also, the idea that Article 10 would encompass deemed dividends can be questioned since it expressly states “dividends *paid*” by a company.<sup>[31]</sup>

In any case, it can be noted that the controversial discussion involving CFC rules and tax treaties is a bit different from the perspective of the Brazilian WWIT legislation. The Brazilian WWIT regime does not follow the transparency approach because it attributes income to the companies abroad, taxing it accordingly on a current basis. In addition, since the whole idea of CFC legislation, as seen in most jurisdictions, is to set aside the application of tax treaties given the existence of an abusive situation,<sup>[32]</sup> one may not import such reasoning into the Brazilian WWIT legislation. Although it can be argued that Brazilian WWIT rules also comprehend potentially abusive situations, the general rule is to tax regardless of the distribution and irrespective of the nature of the income or where the investee company is located. Therefore, it would be irrational to put different regimes with different purposes in the same (controversial) basket.

## 7.5. CFC legislation and constitutional law

The Brazilian Constitution establishes that the tax on income shall be based on the criteria of universality. According to scholars, the worldwide taxation would be a natural consequence in light of “the constitutional tax principle of universality” since the beneficiary of the income produce abroad is a Brazilian resident who is duly submitted to its laws and sovereignty.<sup>[33]</sup>

However, it is not clear-cut how worldwide taxation shall be established. If the constitutional ability-to-pay principle is taken into account,<sup>[34]</sup> the possibility to tax on an accrual basis cannot be argued given the adoption of the realization criterion. Thus, a taxation irrespective of distribution would be unequal and a compromise of the taxpayers’ property.<sup>[35]</sup>

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27. For a precise understanding of the relationship between domestic law and tax treaties, see L.E. Schoueri, *Tax Treaty Override: A Jurisdictional Approach*, 42 Intertax (2014).
  28. The Japanese *Saikō-Saibansho* decided that Article 7 would not be able to preclude the application of CFC rules based on a so-called “transparency” or “look-through approach”. See JP: Supreme Court, Case no. 2008 (*Gyo-Hi*) 91, 29 Oct. 2009.
  29. See M. Lang, *CFC Regulations and Double Taxation Treaties*, 57 Bull. Intl. Taxn. 2, pp. 53-55 (2003), Journal Articles & Papers IBFD.
  30. See K. Vogel, *Double Tax Treaties and Their Interpretation*, 4 Berkeley J. Int'l L. 1, p. 14 (1986).
  31. See L.E. Schoueri & R.A. (Jr.) Galendi, *Brazil: Taxation of Controlled Foreign Companies in Brazil – Still a Case for Article 7 in Tax Treaty Case Law around the Globe 2017* (M. Lang et al. eds., IBFD 2018), Books IBFD.
  32. See FI: Supreme Administrative Court, Case no. KHO:2002:26, 20 Mar. 2002.
  33. See H.B. Machado Segundo & R.C.R. Machado, *O Imposto de Renda das Pessoas Jurídicas e os Resultados Verificados no Exterior*, in *Imposto sobre a Renda e Proventos de Qualquer Natureza - Questões Pontuais do Curso da APET* p. 184 (I.G.S. Martins & M.M. Peixoto eds., MP Editora 2006).
  34. See V. Polizelli, *O Princípio da Realização da Renda* (IBDT/Quartier Latin, 2012).

That is why the Brazilian WWIT legislation is challenged among scholars. Automatic taxation in Brazil requires income tax payment even when the existence of a sign of economic capacity is not certain.<sup>[36]</sup> It is also not proportional to tax regardless of distribution in all situations involving controlled companies.<sup>[37]</sup>

The question here is not whether the adoption of the realization principle for the taxation of wholly owned foreign subsidiaries makes sense.<sup>[38]</sup> On the contrary, the question relies on whether the Brazilian legislation does or does not adopt the realization doctrine.

Even if it is claimed that the realization principle cannot be directly derived from the ability-to-pay principle, the Brazilian National Tax Code adopted it without any exception, for better and for worse. According to its Article 43, the taxation on income depends on the acquisition of economic or juridical availability of income. It is true that, considering the economic availability, the criterion does not necessarily demand foreign profits to be distributed to the parent company. However, positive “adjustments in the investment value” do not comply with the economic availability criterion. In order to meet the realization requirement, they should be distributed by the foreign company to the Brazilian parent company.

This understanding was not followed by part of the Supreme Court in 2013. Regarding the previous Brazilian WWIT legislation (Provisional Measure 2,158/2001), some justices sustained that the taxation of equity accounting adjustments by the Brazilian parent company would be in accordance with the constitutional and legal concepts of ability to pay and realization. However, under the very corporate legislation, equity adjustments accrued but not distributed are unrealized gains. Also, since Decree 1,598/1977, equity method adjustments are tax neutral for purposes of Brazilian income tax legislation. Otherwise, the taxation of equity adjustments could imply a clear confiscation considering multiple adjustments carried out in each and every tier of a holding structure after a single profit earned by the operating company as it could easily surpass the amount of the profit itself. That is why taxation of equity accounting adjustments or of “adjustments in the investment value” do not meet the realization requirement.

## 7.6. Improving the current rules

There are three main flaws in the Brazilian WWIT legislation.

First, the Brazilian WWIT regime constitutes an obstacle to encouraging Brazilian multinationals to expand overseas. The current rules, as the previous one, do not follow the global trend. The Brazilian WWIT legislation has only budgetary concerns despite being questionable how much the price is to tax regardless of distribution. It goes beyond the debate between capital import neutrality (territoriality) and capital export neutrality (worldwide taxation). For example, if a subsidiary of a Brazilian parent company had been carrying out business in any jurisdiction, it would be one step behind its competitors. If one compares this policy with that of most European countries, it may be argued that Brazilian multinational companies would be two steps behind their competitors. Given that many European countries adopt a participation exemption, subsidiaries of Brazilian parent companies shall still be subject to a higher burden even if dividends are distributed because the foreign tax credit is usually not enough to fully offset the taxation of that country on those dividends. Therefore, as the profits of such a subsidiary shall be taxed in Brazil on a yearly basis regardless of the effective distribution, the Brazilian parent company would think twice before carrying out activities elsewhere.

Second, as the current Brazilian WWIT legislation tried to adapt the previous rules according the Supreme Court decisions in 2013, it is too tangled. There are four different subgroups and it can be difficult to fit complex corporate structures into one of them. As each subgroup has its peculiarity, the costs of applying and complying with it may be high for taxpayers. For example, the uncertainty of the concept of “under-taxation regime” as well as the application of the significant influence criterion to deem an entity to be associated may lead to legal conflicts. Moreover, the effectiveness of the Brazilian WWIT regime can be too costly for tax authorities. Since the application of these rules encompasses the rules of different jurisdictions, tax treaties and complex corporate structures, administrative costs for tax enforcement may be too high for the income obtained.

Third, the Brazilian WWIT legislation may be vulnerable to inversions given the absence of an exit tax and CFC rules applicable to individual shareholders. For instance, according to the corporate governance charter of the InBev group, a major player in the beverage market, its control has been evenly split between the Brazilian and the Belgium stakeholders since the 2004 merger between Ambev and Interbrew. Nevertheless, the main entity of the group (where the free-float is allocated) is resident in Belgium, not in Brazil. The remaining corporate structure is also located outside Brazil where the main individual shareholders (Brazilians) would presumably reside. Despite the business reasons for the merger and reorganization in 2004, one likely consequence is the avoidance of the previous Brazilian WWIT rules. As the current regime still does not comprehend individual shareholders, the avoidance would remain in case the shareholders would again be Brazilian residents. Another example is the major meat producer

35. See F. Zilveti, *O Princípio da Realização da Renda*, in *Direito Tributário – Homenagem a Alcides Jorge Costa* (L.E. Schoueri ed. Quartier Latin 2003).

36. See Ávila, *supra* n. 9, at p. 239.

37. See J.F. Bianco, *Transparência Fiscal Internacional* pp. 82-83 (Dialética 2007).

38. For the opinion that this may be “silly”, see D. Shaviro, Columbia Law School/Davis Polk Panel on Corporate Inversions, in Start Making Sense Blog, available at <http://danshaviro.blogspot.com> (accessed 28 April 2019).

JBS that was originally created and controlled in Brazil. However, in 2017, JBS disclosed that it planned to create “JBS Foods International”, a holding in Ireland, to where it would move assets responsible for about 80% of its revenues.<sup>[39]</sup>

## **7.7. Outlook: The future of CFC legislation**

The pre-1990s Brazilian tax policy was marked by a capital-importing country standpoint. Since then, Brazil has adopted a source approach following the territoriality basis. For inbound investments, Brazil would almost disregard the right of the state of residence of foreign investors. For example, the combination of a source of payment nexus with rigid foreign exchange control exercised by the Central Bank was (and still is) the main Brazilian mechanism to tax services (on a gross basis).

Currently, it cannot be affirmed that the Brazilian position is totally in favour of territoriality. The choice between territoriality and worldwide basis is no longer clear-cut. Even considering that many Brazilian multinationals now fight to compete on equal footing with foreign companies, the capital-exporting mindset has still not been consistently reflected in Brazilian law.

If the creation of worldwide basis taxation in 1995 was allegedly aimed to address tax evasion, now the taste of the tax revenue obtained from foreign profits – although not so relevant – seems to drive the current tax policy. Taking into account the reaction of the Executive Branch to the Supreme Court’s decision, the weakening of the Brazilian WWIT legislation may not be seen. It seems that the Brazilian government has no intention of adopting CFC-type rules or turning back to territoriality basis in this regard.

As the current Brazilian WWIT regime imposes taxation on controlled companies, irrespective of the distribution of profits in both regular and abusive situations, it may not be sustained that it shall be strengthened under the terms of BEPS Action 3. Actually, the standardization proposed by the BEPS Project would demand the opposite, i.e. that Brazil would soften its regime. However, no evidence indicates that that the Brazilian government is willing to weaken its WWIT rules.

Furthermore, the need to expand the Brazilian WWIT legislation in order to set a minimum tax for digital companies may not be seen for two reasons. First, as every single profit obtained through subsidiaries is taxed regardless of distribution, the creation of a global intangible low tax income would not lead to a minimum effective tax rate but, rather, to higher taxation. Second, the source of payment approach seems to be the other Brazilian key to address digital business since it is very convenient for the tax administration.

In conclusion, one may not forecast the future of the Brazilian WWIT legislation. Although this policy seems odd in the light of other Brazilian tax policies, the Executive Branch has indicated that it has no intention to set it aside. The current Brazilian WWIT legislation regime may be “aggressive”, but it ensures tax revenue, although one may question if the cost benefit ratio is worthwhile.

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39. See <http://www.valor.com.br/agro/4558625/jbs-transfere-ativos-para-empresa-na-irlanda-que-abrira-capital-em-ny>; and <https://exame.abril.com.br/negocios/irlanda-o-quase-paraiso-fiscal> (accessed 28 April 2019).