

What's new! In M&A TAX Brazil

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By Rodrigo Bastos, M&A Tax Partner and Private Equity Tax Leader in Brazil

An important set of new tax rules including Provisional Measures and Normative Instructions launched during the last days of 2009 brought changes to be observed by local companies. Among these changes, it is worth mentioning the New Tax Inspection Regime; the introduction of the e-LALUR (Income Tax electronic book); the new rules for PIS/COFINS offsetting; the changes in the applicable local transfer pricing (TP) methods and - most importantly - the introduction of Thin Cap rules in Brazil. Some of these changes are in line with the best practices adopted abroad.

At the same time, Brazil, despite all its problems, after a short economic crisis, is back on track with excellent future prospects. Considering the improvement of the tax environment (necessarily still to be substantially increased) and the favorable economic momentum, should we manage to establish long term tax policies and goals, rather than taking decisions based on short term needs, we shall certainly be able to attract more long term investments to fund our sustainable growth efficiently.

In this context of tax changes and economic recovery, this third Edition of **What's New! in M&A Tax Brazil** highlights the new Thin Cap Brazilian rules mentioned above; and make an Analysis of the M&A market recovery in Brazil. Finally, considering the increasing interest of Brazilian companies in assets located in other South American countries, we have included in this Newsletter an article on tax risks and opportunities when investing in Argentina.

Now we have thin cap rules

By Fábio Dantas, M&A Tax Senior Manager

The Brazilian Government introduced thin capital rules through Provisional Measure 472/09 (articles 24 and 25). This is billed as one additional move towards reducing tax deductions of what local tax authorities consider as excessive amounts of interest expenses arising from debts push down to Brazilian companies and another effort to avoid, the Government says, the unreasonable appreciation of the Brazilian Real.

As a general rule, a 2:1 debt/equity ratio must be observed in order to entitle interest due to related companies overseas to be treated as deductible for Brazilian tax purposes (Corporate Income Tax and Social Contribution on Net Income). In this regard, it is necessary to compare the total debt (at both stand alone and consolidated basis) with the respective equity participation on the Brazilian company. If such debt exceeds two times the equity participation, the difference is considered as unnecessary expense and, therefore, not deductible for local income tax purposes (article 24).

A harder limit has been created whenever interest is due to individuals or entities resident, domiciled or incorporated at tax havens. Would the total debt with such tax haven based lender exceeds 30% of the total net equity of the Brazilian company (also calculated at both stand alone and consolidated basis), the respective excess is considered as unnecessary expense and, therefore, not deductible for tax purposes in Brazil.

The new thin cap rules also apply when the related person is not the creditor, but simply acts as a guarantor, surety, representative or intervening party.

The introduction of thin cap rules in Brazil without previous notice, per se, is not a surprise as a quite relevant number of countries worldwide has equivalent thin cap rules. What in fact has raised concerns among the foreign investors is the Provisional Measure wording which left important gaps to be further discussed, such as: starting date for application of such rules; universe of related companies encompassed by the rules; threshold calculations; interest on net equity implications (if any); and consequences for pre-existing debts. In other words, there are several aspects which are still unclear and dependent of thorough discussions among the local market players (government, relevant tax authorities, accountants, legal/tax advisors and, of course, the taxpayers themselves). It is, however, quite clear that it produces anyway paramount effects on past, present and future M&A transactions, as investment and business plans.

Funding and tax strategies may need to be quickly reviewed, as well as country, exchange and financial risks would need to be reevaluated. Under this context, many alternatives to mitigate the consequences created by the new Brazilian thin cap rules are right now been discussed and implemented.

Finally, in addition to the above thin cap rules, PM 472 also established relevant restrictions on payments (e.g. service fees, royalties, etc.) made to beneficiaries resident or incorporated at tax havens (article 26). In this regard, any payments directly or indirectly made from Brazil to those individuals or entities are not tax deductible (Corporate Income Tax and Social Contribution on Net Income), except when the following requirements are cumulatively observed: (i) identified beneficiaries; (ii) operational capacity of the non resident to perform the transaction; and (iii) payments, receipt of goods, rights an use of services are evidenced with proper documentation.

Note that PM 472 was issued on Dec 15, 2009 but needs to be approved by the Brazilian Congress (and converted into Law) within an initial 60-day period. In other words, PM 472 can still be rejected or amended. Nevertheless, according to its command, the above referred articles are in force, producing its legal effects since the date it has been published (Dec16). We are keeping track of this subject and we will revisit this topic in our forthcoming editions if any relevant changes occur.

Brazil: economy and M&A activity bouncing back

By Alexandre Pierantoni, Corporate Finance Partner



Brazil has overcome the turbulent international 2008/2009 economic scenario and international crisis to become stronger and more attractive. Brazil is the first Latin American country, and probably one of the first countries worldwide, to emerge from the international recession. Brazil's internal demand (60% of a 2009 estimated GDP at US\$1.6 trillion), a high degree of diversification of its economy and trading partners, as well as a solid financial system (leveraged by active regulators and the Central Bank) have also helped to mitigate the effect of the crisis in Brazil.

The economic impact of the global financial crisis and demand downturn has been less severe for Brazil than for the USA, Europe and Asia. This is a consequence of successful long term combined public and private efforts towards growth. A combination of factors, such as more than fifteen years of political stability, the search for fiscal discipline, strong international reserves, solid macroeconomic indicators (based on a strong focus on inflation control) and strengthening of the middle class consumption power, have led Brazil to this position.

Also, it needs to be said that the Government has reacted quite promptly to the economic crisis with the implementation of anti-cyclical measures to sustain the consumption level of durable goods and credit flow, particularly for the automotive and construction industries and for households. These measures contributed to a lower unemployment rate and economic recovery.

Financial and strategic investors are seeing these opportunities and know that they have to be in Brazil. Cross border mergers and acquisitions and strong capital markets will play an important role.

While the international financial crisis had a significant impact on world M&A activity, Brazil's experience was different. In Brazil, 2009 M&A activity achieved similar levels to those observed in 2008 with some 640 deals being announced. Mid market activity remains strong and is expected to drive M&A activity in 2010.

Foreign investors accounted for c.40% of the announced transactions, recovering to levels similar to the pre-crisis period. Private equity backed deals represented 29% of the announced transactions- a record level.

Majority stake (purchase of a controlling interest or up to 100% of voting rights) related transactions accounted for 52% of all announced transactions, while minority stakes accounted for 30%. Strategic and financial investors are participating aggressively in Brazil and bouncing back overall investments in the 'real' economy.

Monthly analysis of deal flows demonstrates that M&A activity in Brazil is at high levels. From July to October 2009 the average announced number of deals reached 63 per month, compared to a first and second quarter average in 2009 of 46 deals per month.

Some tax issues to be taken into account when acquiring a company in Argentina

By Daniel Santiago, Partner, PricewaterhouseCoopers Buenos Aires

Transfer of “shares” or of “going concern”?

The two methods in which companies are transferred are the sale of the shares in the company in question or the sale of the going concern. These two procedures have substantially different tax effects, both for the purchaser and seller.

Under a purchase and sale of shares, the Corporate Income Tax (CIT) treatment of the seller depends on the type of taxpayer concerned. If the seller is a local company, the sale shall be subject to CIT. Conversely, if the seller is an individual resident in Argentina no CIT shall be levied on the transaction.

If the seller of the shares, be it an individual or legal entity, is a foreign taxpayer, the sale shall not be assessable for local income tax. The purchaser of the shares assumes, as a new shareholder, all the tax debts and contingencies corresponding to the acquired company.

Transfers of going concerns are regulated by Law 11,867. A going concern is understood as the tangible and intangible property forming part of the “business”. A going concern includes “goodwill”, which consists of the clientele, prestige in the market and other incorporeal elements relating to the future expected profits.

In the sale of a going concern, the seller is the company owning the going concern, which shall be required to pay CIT for that sale. The purchaser of the going concern is, in principle, jointly and severally liable with the seller for the taxes owed attributable to the going concern at the transfer date. However, Argentinean tax legislation establishes a mechanism for limiting the purchaser’s liability for the undetermined tax debts corresponding to the transferred going concern. This mechanism consists of providing the Argentinean IRS (AFIP) with formal notice of the transfer in question at least 15 days in advance of the transfer date. Upon compliance with this requirement, the powers of the AFIP to claim from the purchaser any tax debt not determined for the period prior to the transfer shall elapse after three months have passed as from the date of the transfer.

Another important issue that the purchaser should take into account is that the portion of the price paid for the going concern attributable to “goodwill” is not deductible or amortizable for tax purposes.

In view of this, it has been found on several occasions that the seller’s and purchaser’s intentions as to how the transaction should be carried out are antagonistic. In fact, it is evident that while many sellers consider it appropriate to sell company shares to avoid paying CIT, purchasers frequently prefer acquiring the going concern to limit their liability when there are tax debts or contingencies incumbent on the company.

Structuring of the transaction

The incidence of tax issues relating to company acquisitions does not limit to the due diligence. All transactions require evaluation of the respective tax effects on the parties. But these effects will increase and a larger number of issues will be assessed as transactions become more complex.

Thus, in the cases of foreign purchasers, the choice of the jurisdiction of the corporate vehicle to be used for the acquisition is a sensitive issue, in view of the existence of double taxation treaties signed by Argentina with other countries. Those treaties allow for reducing and in some cases avoiding the tax burden on certain items. In this regard, Argentina and Brazil have entered into a treaty to avoid double taxation, the provisions of which prevail over local tax regulations.

Another issue to be taken into consideration is the “funding” of the transaction, in relation to which tax regulations (and exchange regulations in the last few years) are especially important.

Many times the parties agree that certain assets held by the company intended to be transferred are excluded from the transaction. In those cases, the best way of excluding these assets should be analyzed to minimize the tax impact.

These are just a few examples of the tax effects to be borne in mind, which require a careful planning.

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