

What's new! In M&A Tax



A publication by PwC Brazil
4th Edition - September 2010

What's new in this edition?

Page 2

Updated Tax Havens' "blacklist"

Brazilian IRS reviewed the existing tax havens' blacklist and created a privileged tax regimes' list

Page 3

Banking Agents: when should they be used?

Risks and advantages of banking agents

Page 4

Tax war: installment program for tax credits related to tax incentives

The State of São Paulo enacted a law for the payment in installment of tax credits related to tax incentives that are disputed by the authorities.

Privileged tax regimes, Banking agents and Installment program issued by São Paulo State

In this edition we call M&A players attention to the updated "blacklist" of jurisdictions considered as "tax havens" by the Brazilian Tax Authorities. There is also a newly issued "blacklist" of the so-called "privileged tax regimes" such as Delaware LLCs and Dutch HoldCos. The idea of privileged tax regimes exists since 2008 but there was not a blacklist of the regimes considered as privileged. Despite still not clear in the Brazilian Tax Legislation, there are some important tax effects to consider due to the issuance of such privileged tax regimes' list and headquartering of investment companies subject to privileged tax regimes should be viewed with care.

There is also an article from our M&A Financial Services Team regarding the opportunity of investing and operating in Brazil through banking agents and the main issues and concerns to the companies which envisages setting up such type of business.

Finally, we revisit to the "tax war" among the Brazilian States issue with some comments regarding the most recent installment program issued by the State of São Paulo, applicable to companies which benefited, directly or indirectly from past tax incentives in other States. Although there are some risks that should be observed when companies decide to enroll to the program, it may represent a good way to mitigate some risks in M&A transactions involving targets subject to tax incentives or companies which acquire goods from suppliers under this situation.

By Rodrigo Bastos – M&A Tax Partner and PE Tax Leader in Brazil

Updated Tax Havens' "blacklist"

On June 4, 2010 the Brazilian IRS issued an updated version of the so called Brazilian Tax Havens' "blacklist" (Normative Instruction 1,037). Amongst several small jurisdictions such as Kiribati and Norfolk Islands, Switzerland has been included in the list.

Normative Instruction (IN) 1,037 also listed what the Brazilian Tax Legislation considers as "privileged tax regimes", i.e., regimes granted for certain companies established in jurisdictions which cannot be considered as tax havens by the Brazilian tax legislation. The list of privileged tax regimes encompassed, amongst others, Dutch Holding companies, Luxembourger Holding companies, Spanish "ETVEs" and Uruguayan "SAFIs".

Considering that the use of Dutch HoldCos are quite common in Brazil and that there are many Swiss' multinational corporations here installed, the local tax authorities decided to suspend the effects of the blacklist in those cases (according to the Declaratory Act 11, issued in June 24, 2010).

Before the IN 1,037 there was not such a black list of privileged tax regimes (only a list of Countries, not a list of tax regimes). Actually, privileged tax regimes have already been included in the Brazilian Tax Legislation since 2008 and, accordingly, some tax consequences were established. However, there was not an updated formal list and or more evidenced rules establishing in what circumstances or to whom such tax consequences should be imposed.

We may say that, considering this new list, some adverse tax effects regarding the non-deductibility of payments (interest, services, royalties, etc) for the calculation basis of the Brazilian income

taxes, transfer pricing and thin cap rules would be applicable where transactions are performed between Brazilian companies and foreign entities or non resident individuals benefiting from the privileged tax regimes there listed. These tougher rules were already valid to companies or persons located in the blacklisted jurisdictions (countries), but were not applicable to those parties subject to privileged tax regimes.

The potential adverse tax consequences to be considered for parties subject to the foreign privileged tax regimes consist of the ones listed below:

- Transfer pricing - whether a local company performs any transactions involving the sale and/or purchase of goods and rights (including financial transactions) with foreign parties located in tax havens or with foreign parties subject to privileged tax regimes, TP effects, if any, must be considered for the purpose of calculating the Brazilian income taxes. This rule is applicable even if the foreign party domiciled in a tax haven (or the foreign party subject to a privileged tax regime) is not a related company or person.
- Thin cap - The recent thin cap rules should be observed in case of any interest paid or by all means credited to entities or persons domiciled, resident or incorporated in tax havens or subject to privileged tax regimes, even if referred entities or persons are not related to the Brazilian entity.

- Payments – any payments (interest, royalties, service fees, etc., except interest on net equity payments) to foreign beneficiaries subject to privileged tax regimes (or foreign beneficiaries domiciled in tax havens) would be not deductible for the purpose of calculating the Brazilian income taxes.

Further to the Brazilian withholding income tax, only the legal entities or persons located in those jurisdictions considered "tax havens" would be affected. The current withholding income tax rules do not refer to privileged tax regimes. Accordingly, foreign entities or persons subject to privileged tax regimes would not be affected by the existing rules regarding the withholding taxation levied on capital gains, investments made through the Resolution 2,689 of the Brazilian Central Bank (foreign investments made via the Brazilian stock market by qualified investors - exempt from taxation on capital gains), investments made through a FIP (private equity fund), etc.

Since the revisited blacklist, M&A players must pay attention to where foreign vehicle companies are established and how such investment companies are treated for tax purposes in the foreign country where they are located. The tax advantages obtained via a tax haven or through a privileged tax regime must be viewed together with the potential adverse tax consequences arising from this new Brazilian tax rules.

The potential effects of IN 1,037/2010 are still under discussion. We are keeping track of this subject and shall revisit this topic in our forthcoming editions, if any relevant moves occur.

By Fábio Dantas – M&A Tax Senior Manager

Banking Agents: when should they be used?

The banking agent, originally regulated by the Brazilian Central Bank (“BACEN”) Resolution 2,640/99, can be defined as a non-financial legal entity, which carries out business on behalf of the bank and also as a subsidiary activity, acts as an intermediary between financial institutions authorized to operate by the BACEN and their customers.

The original intention of BACEN, when it established the banking agent entity, was to increase low income people’s access to the Brazilian Financial System. In this sense, banking agents should be seen as an operational alternative in places where it is not financially attractive for the financial institutions to keep an operating bank branch.

As part of this process, BACEN Resolutions 3,110 and 3,156, both enacted in 2003, established the services authorized to be provided by banking agents as follows: (i) proposals for opening accounts; (ii) receipt and payment of bills, (iii) payment orders; (iv) applications for loans and financing; (v) credit analysis; (vi) charging services; (vii) applications for credit cards; and (viii) data processing activities. These regulations require previous approval from BACEN before rendering some of these listed services, especially the first and the second items.

From a social and economic viewpoint, there is no doubt about the positive aspects arising from the activities of the banking agents, mainly in relation to the increased offering of banking services to lower income groups. After more than 10 years, it has become normal practice to offer financial products to a significant number of people who previously did not have access to the Brazilian banking market.

On the other hand, the growth of banking agents has resulted in increased judicial disputes related to labor liabilities. These disputes, in most cases involve the two issues commented on below.

The first situation relates to the subsidiary responsibility of the financial institutions. The social security legislation states that in the event of work being performed by any third-party as a service provider (including the banking agent) a risk of joint liability to the hirer (i.e. financial institution) may be triggered as a subsidiary responsible entity. Under this scenario, financial institutions could be considered liable for social security contributions in case of default by the banking agent (the entity).

The second situation relates to the judicial claims of banking agents employees’ who may argue that in fact they should be treated as bank workers and consequently benefit from all the rights granted to them, such as Labor Union membership, reduced work shifts (six hours), a night shift additional rate of 35%, and bonuses, among others things.

It is important to note that such judicial claims may have different risk profiles, dependent on the actual circumstances. In fact some important rulings have suggested that when it is possible for an employer to support the business motivation of hiring a banking agent (non-banking employee) the main risks of employment relationship and the bank workers’ Labor Union membership are mitigated. These rulings considered that the activity carried out by a non-financial entity (banking agent) is also regulated and authorized by the Brazilian Monetary Authority and requires in its essence, that a financial institution contracts other entities for the achievement of its purposes.

In cases where a financial institution intends to hire a banking employee, and utilize the banking agent structure with the exclusive intention of reducing or avoiding labor costs, and this intention can be proved, the risks set out above (employment relationship and agent labor rights) would increase. In this sense, it is important to emphasize that the choice of hiring a banking agent cannot be made for the wrong motives or by concealment of the facts that may trigger labor liabilities, which can result in forfeit of its legal status as an agent, allowing the workers to claim the rights they consider due. The employment relationship elements defined by the law and the judiciary, such as subordination, dependence on the employer, non-sporadic nature of the work, wages and individual suitability for the services rendered are crucial to evaluate this risk.

Our experience in this area suggests that the labor risks, especially those related to reduced work shifts, under the scenario of employment characterization, should be carefully analyzed since the amounts involved can be material. Notwithstanding, it is crucial to carefully analyze the particular elements of each situation.

The scenario facing the financial industry when considering whether to use the banking agent structure is that this model may be adopted only when there is a business motivation to provide banking related services mainly in places where it is not financially attractive to keep a branch of the bank operating. If this is the genuine motivation, then there are good grounds to proceed.

By Luciana Aguiar, Tax Partner – Financial Services, Ana Luiza, Tax Senior Manager – Financial Services and Glaucia Martins M&A Tax Senior Manager

The most recent installment program for tax credits related to tax incentives

In the October 2009 edition of this newsletter, an article was published regarding the State tax incentives and the fiscal war between the Brazilian States. We discussed the granting of tax incentives by the States, particularly those related to State VAT (ICMS), which aimed to attract new taxpayers or increase the production of the existing ones in the beneficiary state, allowing them to increase their production capacity and create new jobs.

However, as mentioned on that occasion, the States grant such incentives without the agreement of the other States, which lead to discussions both at the judicial level (when the other States question the existence of the tax incentive) and the administrative level (when the other States adopt procedures to avoid the use of credits arising from companies benefited from the tax incentives).

In particular, the State of São Paulo has since 2004 been assessing and charging its taxpayers for using 100% of ICMS credits related to the acquisition of products acquired from taxpayers who benefit from tax incentives from other States. According to the tax authorities, taxpayers from São Paulo can only use ICMS credits in the proportion they are effectively paid at source.

In December 2009, the State of São Paulo enacted Law No. 13,918/09, which allowed the taxpayers from São Paulo to keep the credits related to goods that had benefited from tax incentives which were incorrectly recorded before 31 October 2009. This is conditional on the payment of the controversial ICMS credits recorded, which could be made by a single payment with a reduction of 75% of the penalties and of 60% of the interest; or in up to 11 installments with a reduction of 60% of the penalties and 50% of the interest. The election to do this should have been made by 26 March, 2010.

Considering the position adopted by the State of São Paulo since 2004, the possibility of installment payments of controversial ICMS credits arising from a tax incentive should reduce the potential exposure identified, for those taxpayers who opt for such installment program. However, it is necessary to note that the exclusion of each and every risk related to the tax credits mentioned above also depends on the taxpayer changing its procedures related to tax credits in the period subsequent to October 2009. If the taxpayers who adopted the installment payment programs do not change their procedures they will have only reduced the risk related to periods prior to October 2009.

The initiative of the State of São Paulo to provide for an installment program for the amounts that are constantly being disputed between the tax authorities and taxpayers helps mitigate some of the many risks that are frequently observed in transactions with targets that benefits from tax incentives or acquire goods from suppliers in this situation. It is also important to note that despite the installment program mentioned above tax incentives are still surrounded by uncertainties that continue to impact M&A transactions and should be considered in the financial and tax analysis of the business.

By Fabiana Schiavon, M&A Tax Senior Manager



Contacts

João Gândara

Tax M&A Leader Brazil
Telephone: [55](11) 3674-3899
joao.gandara@br.pwc.com

Rodrigo Bastos

Tax M&A Partner and PE Tax
Leader Brazil
Telephone: [55](11) 3674-3603
rodrigo.bastos@br.pwc.com

Álvaro Taiar

Tax M&A Financial Services
Partner Brazil
Telephone: [55](11) 3674-3833
alvaro.taiar@br.pwc.com

Marcela Carvalho

Tax M&A Director
Telephone: [55](11) 3674-3502
marcela.carvalho@br.pwc.com

Dimitri Faria

Tax M&A Director
Telephone: [55](11) 3674-2515
dimitri.faria@br.pwc.com

Fábio Dantas

Tax M&A Senior Manager
Telephone: [55](11) 3674-3493
fabio.dantas@br.pwc.com

Rita Canto

Tax M&A Manager
Telephone: [55](11) 3674-2470
rita.canto@br.pwc.com
