TAX HAVENS IN BRAZILIAN LAW:

THE LEADING CASE

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I - Introduction

Since the creation of the Committee on Fiscal Affairs (CFA) in 1998, the Organization for Economic Co-operation and Development (OECD) has been instructing its member countries to adopt measures controlling transactions with countries that have favorable taxation systems, or so-called tax havens[2]. This concern aims to avoid harmful tax practices arising from the natural demand of entities that operate in the world market to reduce the costs of their operations[3]. In the global context, the use of tax havens has been, over the years, a satisfactory, viable alternative to minimize tax costs[4].

Although Brazil is not an OECD member, many policies adopted by the organization are implemented internally via specific laws, which seek to treat appropriately tax avoidance measures with an international impact.

This is the case for controlling transactions with companies based in tax havens. Brazilian law properly and specifically treats business transactions with companies located in countries that are considered tax-

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[2] Interestingly, the translation of the term "tax haven" into the portuguese “paraísos fiscais” got the meaning of “tax heaven”.

[3] OECD, Organization for Economic Co-Operation and Development. HARMFUL TAX COMPETITION – A EMERGING GLOBAL ISSUE. 1998; and expressed more recently in the OECD report, The Global Fórum on Transparency and Exchange of Information For Tax Purposes. OWENS, Jeffrey, SDAINT-AMANS, Pascal. 1st apr., 2011.

[4] According to a report produced by the Boston Consulting Group, McKinsey's, Merrill Lynch / Cap Gemini and the Bank for International Settlements, it is estimated that are not paid approximately $ 11.5 trillion and are not taxed per year in income taxes due to investments held in tax havens. MURPHY, Richard. *The direct tax cost of tax havens to the UK*. http://www.taxresearch.org.uk/Documents/TaxHavenCostTRLLP.pdf

favorable. Brazilian law equates such operations, in the case of commercial transactions, to the system controlling transfer pricing, and in case of interest payments, the thin capitalization rules.

Thus, Brazilian law seeks to prevent abusive income tax avoidance[5] by monitoring import and export prices for goods and services as well as interest paid.

However, a decision by the Brazilian federal administrative court of tax appeals, named Conselho Administrativo de Recursos Fiscais – CARF, in the Brazilian Ministry of Finance further restricted tax haven use by companies located in Brazil.

II - The Legal Concept of Tax Havens in Brazil

The OECD does not objectively define the criteria classifying tax havens. The "*1987 Report by the OECD recognized the difficulties involved in providing an objective definition of a tax haven*" and even stated that "*a good indicator that the country is playing the role of a tax haven is where the country or territory offers itself or is generally recognized as a tax haven*"[6].

However, there are some general common elements among all tax havens recognized by the international community[7]. They have (i) low or no income taxation; (ii) lack of effective tax information exchange via tax, financial and corporate confidentiality; (iii) lack of fiscal transparency; and (iv) lack of effective economic activity in the country by the entity enjoying the benefit.

These four elements are essential for the survival of a country wishing to attract a concentration of wealth by offering tax advantages.

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[5] The taxation of income in Brazil is accomplished by two tributes: the income tax and social contribution on net income. Social contribution (contribuição social sobre o lucro líquido – CSLL) is nothing more than a tax whose revenue is for social security expenditures.

[6] OECD. "HARMFUL TAX COMPETITION: AN EMERGING GLOBAL ISSUE." 1998. P. 22.

[7] Id.

In addition to these requirements, we should consider the demand for political and economic stability of the country, as no investor wants to risk maintaining its international investments in an unstable state.

In the case of Brazilian legislation, Federal Law No. 9430/1996 defines a country with a favorable taxation regime as having the following conditions:

1) does not tax income or taxes at a maximum rate below 20%;
2) provides secrecy regarding corporations structure or ownership; and
3) does not allow the identification of the beneficial owner of income earned by non-residents.

However, although Brazilian law prescribes objective criteria for identifying the countries with favorable taxation, the Internal Revenue Service of Brazil issued a list of countries that Brazil considers tax havens[8].

It is important to note that the Brazilian Internal Revenue Service considers this list complete[9]. Thus, even if a country, for example, taxes income at a maximum rate below 20%, it is not considered a tax haven if its name is not included in the list edited by the federal agency. Therefore, according to Brazilian law, tax havens are, in fact, those countries whose name appears on the list issued by the Internal Revenue Service of Brazil[10].

However, since 2008, legislation concerning tax havens has begun to recognize a second situation susceptible to regulation: countries that, despite having apparently normal taxation, grant a preferential tax regime in specific situations, which operates similarly to tax havens.

Thus, Brazilian legislation treats these favored taxation regimes in the same manner as transfer pricing and thin capitalization.

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[8] Same technique used by the OECD, which publishes the so-called black list.

[9] Solution from consultation No. 37 of February 3, 2003.

[10] IN 1037/2010, Internal Revenue Service of Brazil (Receita Federal do Brasil).

To identify preferential tax regimes, Brazilian legislation sets forth the following requirements:

1) income is not taxed or is taxed at a maximum rate lower than 20%;

2) tax relief is provided without requiring the exercise of a relevant economic activity in the country;

3) tax benefit conditioning the absence of the exercise of relevant economic activity is offered in the country;

4) income earned abroad is not taxed or taxed at a maximum rate of less than 20%; or

5) access to information regarding corporate structure, ownership of property or rights, or to the economic transactions carried out is not allowed.

It is important to highlight that, in this context, it does not matter that a country enjoys a normal taxation regime or implements an income taxation scheme recognized by the international community. The control criteria apply whenever either the business relationship or interest payment receives privileged treatment as defined by Brazilian law. The criteria apply, for example, to legal entities in in the United States of America, more specifically, from the state of Delaware, defined as a Limited Liability Company (LLC), whose members are non-residents and not subject to U.S. federal income tax.

It should be noted again, for a regime to be classified as a privileged tax regime, the list published by the Internal Revenue Service of Brazil should be consulted, as it includes regimes regulated by the Brazilian authorities[11].

III - Brazilian Legislation Regulating Tax Havens Control

[11] IN 1037/2010, Internal Revenue Service of Brazil (Receita Federal do Brasil).

According to Brazilian legislation, the Internal Revenue Service of Brazil can regulate an operation once an entity is identified as a Brazilian resident and either transacts business with or pays interest to entities located in tax haves or that are subject to a preferential tax regime.

3.1. Control Paying Interests

When interest is paid abroad, the transaction is controlled by limiting the interest that is deductible from income tax in Brazil, when the interest arises from contracts not registered with the Central Bank of Brazil.

According to Brazilian rules, a bank that finances an agreement in which money is received from abroad through interest payments must be registered with the Central Bank of Brazil, in compliance with the rules and limitations of the domestic financial system.

In Brazil, nothing prevents individuals, without financial institutions, from contracting for amounts paid in interest due to trade agreements signed with persons located overseas. Under this hypothetical, as Brazilian legislation limiting domestic interest at 1% per month[12] does not apply, it is possible that other indices are defined, given *a priori*, the free negotiations between parties.

However, to restrict the practice of so-called thin-capitalization, Brazil has enacted an anti-evasion rule stating that, if the party receiving the interest abroad is connected to a party residing in Brazil, then the payment is limited to the LIBOR rate for US dollar deposits through six months plus a 3% *spread*.

This rule also applies to interest payments from Brazilian parties to residents in tax havens or under a privileged tax regime. Thus,

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[12] Under Brazilian law, only financial institutions can condone the collection, as creditors, of loans or financing with interest rates exceeding either 1% per month or 12% per annum. In contracts between individuals, absent the financial institution, any stipulation above this legal limit is null and is, in theory, the crime of usury.

under Brazilian law, when the recipient of interest payments from Brazil is a resident in a tax haven or subject to a favorable tax regime, the only interest deductible as an expense to the Brazilian payer is the LIBOR rate limit plus a 3% *spread* .

3.2. Control of Tax Havens

In contrast, when a Brazilian resident transacts, as a business, with persons residing in tax havens or under a preferential tax regime, the amounts paid or received are regulated by the transfer pricing rules.

A company residing in Brazil paying for goods and services to entities located in countries with a favorable taxation regime or subject to a favorable tax regime can only deduct as expenses a value defined by applying one of the three methods set out in the legislation, chosen by the taxpayer.

The first method, Independent Prices Compared (Preços Independentes Comparados – PIC), values the imported goods, taken abroad, as the arithmetic average in a free market, within the same time period and under the same payment conditions[13].

The second method, Resale Price Less Profit (Preço de Revenda Menos Lucro – PRL), is determined by the decomposition of the product's resale price in Brazil, with a margin at 20% (for resale of the imported product) or 60% (when the imported product is integrated or consumed to produce another product in the domestic market) [14].

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[13] Equivalent to CUP, Comparable Uncontrolled Price Method under the OECD model. See OECD TRANSFER PRICING BETTER GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS. OECD, Paris, 2010. p. 63.

[14] This is equivalent to the Resale Price method, OECD model. The OECD Guidelines on Transfer Pricing warns about the many variables that must be taken into consideration in setting the margin used in applying this method. However, Brazilian law only considers two margins: 20%, for the resale of imported goods, and 60%, when the imported good an input in the production of the final good. See OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS. OECD, Paris, 2010. p. 65/69

The third method, Production Cost Plus Profit (custo de Produção Mais Lucro – CPL), is composed of the production cost in the country of origin plus a 20% profit margin[15].

On the other hand, when a Brazilian company receive payments due the export of products to persons located in a tax haven or under a privileged tax regime, the Brazilian IRS will regulate the transaction when the value is less than 90% of the value for the same product in the domestic market[16]. If sub-evaluation for the price of goods exported is identified, then the sale value for these products can be adjusted according to Brazilian law, assuming the proceeds reach the level set by one of four methods. The method most beneficial to the taxpayer should be accepted.

The first method, Sales Price in Exports (Preço de Venda nas Exportações - PVEx), is determined by the arithmetic mean for the sale of the same or similar products in the free market, in the same time period and under the same payment conditions.

The second and third methods have mixed techniques and calculate the value descomposing the resale price of the exported good in the country of destination. If the sale in the country of destination is a bulk sale, then the law applies the Wholesale Sales Price Method by adding a 15% profit margin. If the sale in the destination country is a retail sale, the method applies the Retail Sales Price Method with a profit margin of 30%.

Finally, the fourth method, Production Cost Plus Profit Method finds the value as the production costs in Brazil plus a 15% profit margin[17].

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[15] This method is equivalent to the Cost Plus Method, note the criticisms regarding the use of discretion and the use of fixed margins of profit. See more on OECD TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS. OECD, Paris, 2010. p. 70/75

[16] The methods adopted by the Brazilian legislation regarding the control of payments for exports escape the OECD model.

[17] The method resembles the principle of the Transactional Net Margin Method, but its limitations under Brazilian law are so great that it is impossible to say it is equivalent to the OECD method.

It is important to note that the restrictions imposed by the Brazilian law are, in fact, anti-evasion rules. In this circumstance, the anti-evasion rules aim to regulate specific situations, taxing them specifically.

In accordance with this perspective, taxpayers in Brazil can plan their business activities with persons located abroad on the premise that, if such persons are in countries that are considered tax-favored or under a privileged tax regime, then the Brazilian tax administration will control within the regulatory requirements. Thus, the Brazilian norm limits the use of tax havens for tax planning, but simultaneously ensures that, if the transaction is conducted via the parameters established by legislation, then the Brazilian tax authority must accept the transaction.

However, a decision rendered by the CARF Tax Court in the Ministry of Finance in Brazil contradicted the security afforded under Brazilian law, as discussed below.

IV - A Brief Description of CARF Operation

The CARF is the body responsible for trying administrative appeals related to federal taxation in Brazil.

The Brazilian State is a federation, and each of the federated entities, Union, States and Municipalities, are empowered by the Constitution to collect taxes to finance their expenditures.

Within the Federal Government, the Brazilian Internal Revenue Service is the body competent to administer and recover federal taxes owed by taxpayers and, eventually, record uncollected taxes for the public coffers.

When the Brazilian Internal Revenue Service identifies taxpayer noncompliance with the tax laws, it must enter a notice of infraction and collect the tax due plus interest, fines and monetary adjustments. The taxpayer facing this claim can dispute this notice of infraction, which is adjudicated by the Internal Revenue Service of Brazil.

If the taxpayer loses, then he may appeal to another body, the CARF[18].

The CARF is a federal trial board, and each chamber is composed of six judges[19], three appointed by the Federal Revenue Service and three appointed by the Minister of Finance, chosen by organized civil society, among tax experts. The CARF board judges are appointed for a three-year term, and they are guaranteed freedom and independence in their judgment.

However, the Brazilian Constitution guarantees, as a fundamental principle of the State, any harm or threat to the law may be reviewed by the Judiciary. Thus, even if taxpayers lose their claim in the administrative process, then they may renew their arguments before the Judiciary, which could revise the findings from the administrative proceedings and trial.

V - Control of Tax Havens under the CARF

As presented, the Brazilian legislation that addresses the tax havens is relatively recent (from 1996), and the leading case tried by the CARF on tax haven use was Case N. 11020.003966/2005-08, which took place June 25, 2008.

In that case, the taxpayer was a bus-making company based in Brazil, which exported products abroad via two wholly owned subsidiaries. One subsidiary was located in the British Virgin Islands, a country listed as tax-favored under the Federal Revenue Brazil, and the other in Uruguay as

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[18] There may be an appeal in favor of the Internal Revenue Service, referred to as an *ex officio* appeal, when the taxpayer is successful in cancellation of a notice of infraction exceeding R $ 1,000,000.00 (one million reais).

[19] In portuguese, the judge of this administrative board is named Counsellor. This term is not used, in Portuguese language, as the same of lawyer.

a *Sociedad Anonima Financiera de Inversion - SAFI*, as investment corporation regarded as a beneficiary of a privileged tax regime.

In both cases, the company exported Brazilian products to the overseas subsidiaries, with the subsequent export, from tax havens, to purchasers in various parts of the world. However, the merchandise was shipped from Brazil to the end buyers' destination, via sales documentation on behalf of and for third parties[20].

Brazilian exports were paid by wholly owned subsidiaries (importing) using remittances duly registered with the Central Bank of Brazil and addressed by the industry based in Brazil (exporter).

The Internal Revenue Service of Brazil established a review procedure that sought to check compliance with the tax haven regulations. To this end, they demanded submission of all documentation from Brazilian taxpayers and their wholly owned subsidiaries located abroad, and the taxpayers complied.

The company, in the course of inspection, proved that the export price fit within the control standards established by the Brazilian legislation. That is, the company in Brazil sold its products to another company located in countries with a favored taxation system and businesses under a more favorable tax regime. However, they used, for such exports, the values protected under the control methods established by Brazilian law.

However, the tax authority considered an alternative argument in support of the tax assessment. According to their findings, the wholly owned subsidiaries located in the tax havens did not have significant economic activity in the country where they were located, thus, they were only shams sales for those that were actually conducted from Brazil.

According to the Internal Revenue Service of Brazil, the Brazilian company established two overseas subsidiaries with the sole purpose of (re)selling products produced and exported by the company

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[20] As possible according to brazilian Law.

based in Brazil. Thus, the value considered for calculating income tax in Brazil should be the (re)sale value from the tax haven and not the price of the exports from Brazil. However, that price was bolstered by the valuation method provided under Brazilian law for sales to companies located in tax havens or under a privileged tax regime.

The CARF embraced the finding that maintained the tax assessment notice issued by the Internal Revenue Service of Brazil, considering correct the income tax allocated as revenue from exports, the price paid by purchasers to subsidiaries located in tax havens.

Given this opinion, we understand that, despite the objective rules under the Brazilian legislation to control business conducted with companies based in tax havens, the CARF may set aside these rules. The CARF will likely set them aside where the transaction is considered a business sham and absent a minimum effect on the business undertaken.

As Brazil has no general anti-evasion rules, no clear limits define the minimum effect in negotiation that the CARF would accept. This ambiguity may generate uncertainty in the brokerage of business from Brazil as to the use of companies based in countries with a favorable taxation regime or companies subject to a favorable tax regime.

VI - Conclusion

As demonstrated, Brazilian law gives special treatment to business transacted with companies in tax havens and under preferential tax regimes. However, the administrative courts, in the leading case on the matter, recognized that the foreign company could not be a mere intermediary and that substantial business should be conducted with the Brazilian company in that context.

In this situation, and in each specific case, the agreement between the company in Brazil and the company in the tax haven or under a favorable tax regime may be disregarded. Rather, adjudicators should directly consider the economic outcome for the company located abroad under these tax regulations.

ANNEX I - Countries With Favorable Taxation Regimes:

I - Andorra; II - Anguilla; III - Antígua e Barbuda; IV - Antilhas Holandesas; V - Aruba; VI - Ilhas Ascensão; VII - Comunidade das Bahamas; VIII - Bahrein; IX - Barbados; X - Belize; XI - Ilhas Bermudas; XII - Brunei; XIII - Campione D'Italia; XIV - Ilhas do Canal (Alderney, Guernsey, Jersey e Sark); XV - Ilhas Cayman; XVI - Chipre; XVII - Cingapura; XVIII - Ilhas Cook; XIX - República da Costa Rica; XX - Djibouti; XXI - Dominica; XXII - Emirados Árabes Unidos; XXIII - Gibraltar; XXIV - Granada; XXV - Hong Kong; XXVI - Kiribati; XXVII - Lebuan; XXVIII - Líbano; XXIX - Libéria; XXX - Liechtenstein; XXXI - Macau; XXXII - Ilha da Madeira; XXXIII - Maldivas; XXXIV - Ilha de Man; XXXV - Ilhas Marshall; XXXVI - Ilhas Maurício; XXXVII - Mônaco; XXXVIII - Ilhas Montserrat; XXXIX - Nauru; XL - Ilha Niue; XLI - Ilha Norfolk; XLII - Panamá; XLIII - Ilha Pitcairn; XLIV - Polinésia Francesa; XLV - Ilha Queshm; XLVI - Samoa Americana; XLVII - Samoa Ocidental; XLVIII - San Marino; XLIX - Ilhas de Santa Helena; L - Santa Lúcia; LI - Federação de São Cristóvão e Nevis; LII - Ilha de São Pedro e Miguelão; LIII - São Vicente e Granadinas; LIV - Seychelles; LV - Ilhas Solomon; LVI - St. Kitts e Nevis; LVII - Suazilândia; LVIII - Suíça21; LIX - Sultanato de Omã; LX - Tonga; LXI - Tristão da Cunha; LXII - Ilhas Turks e Caicos; LXIII - Vanuatu; LXIV - Ilhas Virgens Americanas; LXV - Ilhas Virgens Britânicas.

ANNEX II - Privileged Tax Regimes:

I. With reference to the laws of Luxembourg, the regime applicable to legal persons constituted as the holding company;

[21] Suspended due to a request for review formulated by Switzerland.

II. With reference to the legislation of Uruguay, the regime applicable to legal entities established in the form of "Inversion financial companies (IFC)" until December 31, 2010;

III. With reference to the laws of Denmark, the regime applicable to legal persons constituted as the holding company that are not performing substantial economic activity;

IV. With reference to the laws of the Kingdom of the Netherlands, the regime applicable to legal persons constituted as the holding company are not performing substantial economic activity[22];

V. With reference to the legislation of Iceland, the regime applicable to legal entities constituted as International Trading Company (ITC);

VI. With reference to the laws of Hungary, the regime applicable to legal entities constituted as offshore KFT;

VII. With reference to the laws of the United States of America, the regime applicable to legal entities constituted as state Limited Liability Company (LLC), composed of non-residents, not subject to federal income tax;

VIII. With reference to the legislation of Spain, the regime applicable to legal entities constituted as foreign tenure entity (Entidad de Tenencia de Valores Extranjeros - E.T.V.Es.); and

IX. With reference to the legislation of Malta, the regime applicable to legal entities constituted as International Trading Company (ITC) and International Holding Company (IHC).

[22] Suspended due to a request for review formulated by the Netherlands.