

## BRAZIL

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## Brazil income tax reform: Interest on equity extinction

**Paulo Vieira da Rocha, Murilo Jakuk and Marina Fernandes of VRBF Advogados discuss the advantages of the current interest on equity payment possibility, its usual qualification on double tax treaties and the consequent impact of its proposed abolition.**

In September 2021, the Brazilian House of Representatives approved the Income Tax Reform Law Project (Projeto de Lei 'PL' No. 2.337/2021) that is being discussed in the Brazilian Parliament. It is not a definitive version, since it still depends on the Senate approval and on the presidential ratification or veto for coming into force.

It should be remarked that the tax rate on dividends has been defined at 15% (currently Brazil system taxes only income as profits, at the corporate level; participation exemption is in force, as general rule, since 1996), but the legislative proposal includes many different other modifications in the Brazilian income taxation system (individual's income tax and corporate tax).

The focus of this article is to analyse one of these other modifications: the extinction of the so-called 'interest on equity' fiscal regime (IOE). This article provides a short overview of the origins of this fiscal category, as well as the implications that its extinction may have to domestic and international taxation, impacting companies' tax strategies that may need to be reassessed.

### IOE payment rules and its history

The fiscal regime of the IOE has appeared in the Brazilian legal system through the Law No. 9.249/1995 (a federal statute) as an alternative of capital remuneration compared to dividends; thus it somehow a 'profits distribution'.

In short, it granted the possibility for companies operating on the Lucro Real tax regime (taxation of actual profits, based on accounting books) to pay interest over the companies' equity at a given rate (TJLP). This payment is deductible from the tax assessment base of corporate

tax, the taxable profit (taxed altogether at 34% rate), at one side, but such payment is subject to tax withholding at the rate of 15%, considered a tax on the beneficiary of the interest (the shareholder).

This possibility enabled a greater return on the capital invested in Brazilian companies and induced the capitalisation of companies by its shareholders. In other words, such regime induced the companies being financed by equity instead of the shareholders instead of third parties' debit.

It is out of the question that this financial instrument was created to encourage the expansion of business activity through equity increase, rather than through debt.

The strategy was then to match opportunity cost in line with the company's other creditors. In other words, the tool has a very simple goal: to discourage companies from seeking resources in the financial market, being able to count on capital from their owners. This could improve the financial health of Brazilian companies. Moreover, the aim of neutrality regarding the source of the funding is the another hallmark this regime, since interests in Brazil are usually taxed at a 15% rate at source.

### Qualification of IOE on DTTs

From a legal perspective, this instrument has a hybrid nature, since the IOE holds, at the same time, rights and obligations typical of equity and third-parties' capital. This point, by itself, already brings a multitude of complexities to the treatments given by domestic tax legislation, but the difficulty is even greater in the international scenario, including its qualification for the purposes of interpretation and application of the double tax treaties (DTTs) signed by Brazil.

It should be remarked that DTTs use a schedular structure. They divide items of income into categories, according to an autonomous qualification, in order to distribute taxing rights among the contracting states. For this reason, they do not adopt a general and comprehensive consideration for income. And then the question arises: in which category does IOE fit?

In a preliminary analysis, two possibilities arise for qualifying IOE considering categories of income adopted in the OECD Model for tax treaties:

- Interest, provided for on Article 11 of the Model, if typical aspects of third-party capital are considered, or;
- Dividends, provided for on Article 10 of the Model, if typical aspects of equity prevails.

The difference in categorising entails the application of different rules for the taxation this type of income in interna-

tional transactions: either by mechanisms adopted by the state of residence to avoid double taxation, or by the form of taxation by source state.

It is important to mention that, different from what is adopted in the current OECD Model, Brazil, in general, uses in its DTTs, for the definitions of dividends and interest, clauses of integrative remission to domestic law. In other words, for the construction of both concepts, one must observe that the income should be treated by the treaty in the same way it is under the tax legislation of the state where the company that pays them is a resident for tax purposes.

However, in some cases, the IOE can be qualified in one or another category depending on the phrasing adopted in the concerned DTT. Although, after the publication of Law No. 9.249/1995, Brazil adopted in its treaties an explicit provision to qualify the JCP as interest.

It was made by means of protocols concerning almost all of the DTTs signed afterwards. The only exceptions were the protocols annexed to the DTTs with Finland and Uruguay. It is important to mention that this type of protocol was not attached to the treaties signed before the publication of Law No. 9.249/1995.

### IOE extinction

Even though this qualification discussion is relevant for determining the applicable tax rules to the cross-border outbound payment of IOE from Brazilian companies, it represents a kind of tax benefit in most cases. For this reason, this form of capital remuneration has become very common in domestic and international business structures.

The extinction of the possibility of paying IOE in Brazil foreseen in the tax reform in debate, if confirmed, would demand the reassessment of general tax strategies regarding the income distribution from Brazilian companies in many cases. For this reason, we highlight this possible law modification which will have a significant impact on business practices related to Brazil.

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