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## LEGAL MEMORANDUM

### Foreign Loans—Interest and other Charges— Liability for Payment of Withholding Income Tax

This study is an analysis of the question of liability, under Brazilian tax law, for the payment of the income tax which is withheld at the source and assessed on interest and other charges in cases of foreign loans.

#### SOME BASIC CONCEPTS OF BRAZILIAN TAX LAW

Under the law, the taxpayer of the withholding tax levied on interest, commissions, expenses and other charges that are remitted, credited, paid or delivered to parties resident or domiciled outside Brazil and which result from foreign currency loans is the foreign creditor (i.e., the individual or company resident or domiciled abroad who/which earned income from a source located in Brazil). Nevertheless, it is up to the Brazilian borrower (i.e., the payor source in Brazil) to withhold the tax, and this must be done on the date of payment, credit, delivery or remittance of the earnings, according to applicable provisions of the current Income Tax Regulations (RIR) approved by Decree No. 85.450 of December 4, 1980.

The case concerning import financing is different. Under article 11 of Decree-Law No. 401 of December 30, 1968, the value of interest remitted abroad in payment for purchases of goods on installment is subject to withholding of income tax at the source, even when the beneficiary of the income is the seller itself. For the purposes of that article, the remittance abroad is considered to be the “event generating the tax liability” and the “taxpayer” is considered to be the remitting party. That same provision is found in consolidated form in the RIR. Therefore, in import financing transactions, it is always the Brazilian importer who pays the tax.

The usual procedure in foreign loans is for the foreign creditor to transfer contractually to the Brazilian borrower the burden of paying the income tax. This means that the Brazilian borrower must remit to the creditor abroad the net amount of interest, commissions, expenses and other charges on the loan, without making any deduction, and that he also provided for payment of the corresponding income tax.

At present, the withholding tax rate which applies to this kind of transaction is twenty-five percent, except when the foreign loan is granted to Brazilian borrowers by residents or domiciliaries of a country with which Brazil has signed a treaty to avoid double-taxation, in

which case the rate is reduced to fifteen percent (for Sweden, Norway, Portugal, France, Belgium, Finland, Denmark, Austria, Germany, Spain, Italy and Luxembourg) or to twelve and one-half percent (in the case of Japan).<sup>1</sup>

#### VOLUNTARY DEPOSITS

Resolution No. 432 of June 23, 1977 issued by the Central Bank of Brazil permits the borrowers of foreign loans, within limits and conditions set by the Central Bank, to deposit cruzeiros in an amount that is equal, on the date of the deposit, to part or all of the foreign currency sum owed. These deposits must be made with banks that are authorized to operate in exchange (commercial banks) which then repossess the deposits to the Central Bank. The purpose is to offer borrowers domiciled in Brazil the advantage of safeguarding themselves against exchange fluctuations that occur between the date of the deposit and the date the foreign currency debt matures. In other words, the Central Bank guarantees the depositor exchange parity during the life of the deposit and returns to the borrower, via the commercial bank, on the date when the remittance is to be made, as many cruzeiros as are necessary so that the borrower can remit abroad the payments due the foreign bank. It is for that reason that the regulations applicable to these deposits, refer to them, erroneously, as "deposits in foreign currency." These deposits are also known as "voluntary deposits."

The change in the exchange rate which takes place between the date of the voluntary deposit and the date the foreign currency is due constitutes an earning for the borrower. From the accounting standpoint, such earning represents a reduction in the financial expense that is incurred due to the exchange fluctuation which results from the payment of the foreign currency loan taken out by the borrower. That earning may or may not have an effect in determining the borrower's taxable profit, depending on the length of time between the date of the deposit and the date the foreign currency obligation is actually paid off. It is only the net value, corresponding to the difference between the earning and the financial expense, that is taken into consideration for the purposes of calculating the corporate income tax owed by the borrower.

At first, the voluntary deposits were freely negotiable by the depositor, providing that there was movement in the account no more

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1. The reduced tax rate of the double taxation treaties should be applied to all foreign currency loans regardless of whether the liability for the withholding tax is borne by the payment source (the Brazilian borrower). Normative Ruling 092 of April 12, 1982.

frequently than every thirty days, and within the following limits: (i) minimum—US\$20,000 (or its equivalent in other currency) for each foreign loan transaction (that is, for each Certificate of Registration); and (ii) maximum—the total amount of the foreign loan.

However, when Central Bank Resolution No. 588 of December 7, 1979 took effect, the rules changed so that these deposits could only be released under certain circumstances, and can only take place now:

(i) on the maturity dates of the installments of the principal, interest and commissions provided for on the Certificate of Registration covering the transaction which gave rise to the deposit;

(ii) for simultaneous conversion of the loan into a direct capital investment, with 30 days advance notice being given; and

(iii) in special instances, at the discretion of the Central Bank, also with 30 days advance notice.

The subject of income tax is specifically dealt with in item 12 of Central Bank Circular No. 349 of June 23, 1977 which establishes the regulations governing deposits foreseen under the provisions of Resolution No. 432/77. This item reads as follows:

12. Subject to the system agreed upon between the borrower (depositor) and the creditor of the foreign loan, the Central Bank of Brazil will assume the liability for the income tax levied on the interest accrued in accordance with item 9 above, in the cases in which this burden is the liability of the borrower of the foreign loan or when it has been implicitly agreed that the same will be added to the interest rate, as foreseen in the Certificate of Registration of the foreign loan.

Item 9 of Circular No. 349/77 provides that interest will be paid to the depositor on the balances shown in the Resolution No. 432 deposit accounts, during the time the sums are on deposit, at the same rate as approved for the corresponding foreign loan transaction and which is in force during the life of the deposit.

#### OPERATION OF THE VOLUNTARY DEPOSIT

Let us see now how the voluntary deposit works in practice. The borrower deposits, with a commercial bank, an amount equal to all or part of the foreign currency loan. The commercial bank, in turn, transfers that deposit to the Central Bank of Brazil. We see, therefore, that the commercial bank acts as an intermediary between the borrower and the Central Bank.

The commercial banks and the Central Bank have already agreed on a procedure for releasing the deposited funds for payment of installments on the principal, interest and other charges related to the

loan on the dates they are due. In payment of the principal, the Central Bank and the commercial bank enter into a symbolic exchange transaction and the borrower receives the cruzeiro equivalent of the foreign currency sum that is to be sent overseas.

This symbolic exchange transaction is not necessary when interest and other charges are to be paid. In the specific case where interest is paid with funds deposited in the Central Bank, the borrower signs a special form, similar to the model provided as Exhibit XIII to Decam Communiqué No. 146 of January 11, 1980 issued by the Central Bank, requesting release of the funds necessary to make the payment. The commercial bank delivers that form to the Central Bank observing the requirement for advance notice. Subsequently, the Central Bank credits to the borrower's account with the commercial bank the cruzeiro equivalent of the net amount in foreign currency that is actually to be remitted abroad.

If the borrower has assumed the liability for paying the withholding (income) tax which is levied on this transaction, no payment of tax occurs. We have been told that the Central Bank takes the position that in such instances no withholding tax is owed because the responsibility for paying it was transferred by the borrower to the Central Bank at the time the voluntary deposit was made. Since the Central Bank is a federal autarchy, it enjoys immunity from taxes by virtue of a constitutional provision (art. 19, § 1 of the federal constitution) and is not subject to payment of the withholding tax. Furthermore, from an economic point of view, it would make no sense for the government (the Central Bank) to pay taxes to itself (the Union). This argument would seem to us to be debatable from a legal standpoint, but that is the procedure which is being employed in practice.

On the other hand, if the withholding tax has been determined to be for the account of the foreign creditor, the Central Bank pays the tax. In such an instance, the borrower, besides receiving the cruzeiro equivalent of the net amount of the foreign currency interest actually to be remitted abroad, will obtain a voucher (copy of the DARF form) for payment of the tax which was levied on that interest, and he will submit that voucher to the foreign creditor.

Article 19, § 1 of the federal constitution provides as follows:

Art. 19. The Union, the States, the Federal District and the Municipalities are forbidden to:

III. create a tax on:

(a) each other's assets, income or services;

§ 1 The provision in letter (a) of item III extends to the autarchies in respect of assets, income and services connected with

their essential purposes or resulting from them; but does not, however, extend to the public services granted to them, neither does it exempt the option buyer from the obligation of paying the tax on the immovable property that is the object of the option.

As we pointed out above, under the law the taxpayer of the withholding (income) tax levied on interest resulting from foreign loans continues to be the foreign creditor, even when the burden of that tax has been specifically assumed by the borrower. It would be appropriate to determine whether or not that tax constitutes a "tax on the assets, income and services connected with the essential purposes" of the Central Bank of Brazil, "or resulting from them," due to the fact that the borrower has made the voluntary deposit under the provisions of Resolution No. 432/77. This point is still the subject of considerable controversy, but we believe that, even in such an instance, the foreign creditor continues to be the legal taxpayer of the withholding tax, and it would be the duty of the Central Bank to pay that tax in its capacity as payor. If we accept this interpretation as true, the withholding tax would not fall within the tax immunity which has been extended to the Central Bank under § 1 of art. 19 of the constitution. However, the Central Bank's understanding of the matter is different; in practice it does not pay the tax when the burden was assumed contractually by the borrower.

#### RECENT DECISIONS REGARDING THE WITHHOLDING TAX

Let us now proceed to analyze two decisions on this subject, namely:

(a) an administrative decision handed down by the Regional Superintendent of the Federal Revenue in São Paulo on April 29, 1981 and which is of great relevance for Brazilian borrowers that contract foreign loans and make deposit of foreign currency funds under the system permitted by Central Bank Resolution No. 432/77; and

(b) a court decision handed down by the Federal Supreme Court on August 6, 1981, upholding an earlier decision of the Federal Appeals Court dated April 14, 1980. That decision is of interest to both Brazilian borrowers and to foreign creditors that are resident of countries with which Brazil has signed a treaty to avoid double taxation, in instances where those creditors repress to the borrowers the burden of paying the withholding tax that is levied on interest and other charges owed on foreign loans.

The first decision concerns an application made for refund of the withholding tax, erroneously paid by the Brazilian borrower on inter-

est remitted abroad under a foreign loan contracted with The Bank of Tokyo (Panama) S.A.. Part of the amount of the loan had been deposited under Resolution No. 432/77. The Regional Superintendent of the Federal Revenue in São Paulo denied the voluntary appeal filed by the Brazilian borrower. We state that this tax should not have been paid because, due to the voluntary deposit, the liability for the tax had been transferred to the Central Bank under the terms of item 12 of Circular No. 349/77, and the borrower ought not to have paid the withholding tax levied on the interest of the foreign loan during the life of the voluntary deposit. Therefore, we do not agree with the grounds cited to justify this decision.

The summary of that decision reads as follows:

Income tax—Withholding. Refund.

The deposits of foreign currency that are made under Resolution No. 432/77 of the Central Bank of Brazil are financial investments which have nothing to do with the foreign loan transactions which gave rise to such deposits; therefore, the interest on those deposits is not to be confused with the interest due on those transactions. The tax on the latter was well and duly paid by the defendant. Voluntary appeal denied.

In this case, the borrower made the voluntary deposit of part of the loan under the terms of Resolution No. 432/77, but inadvertently paid the withholding tax on the interest of the loan that was paid to the foreign creditor (The Bank of Tokyo (Panama) S.A.) during the life of the deposit. Later, the borrower discovered that he ought not to have paid the tax and so he applied for a refund, which the Federal Revenue authorities denied.

The Regional Superintendent denied the voluntary appeal filed by the borrower against the decision of the Federal Revenue office in São Paulo “for lack of a basis in law,” sustaining, basically, the following:

(a) The Central Bank of Brazil could not have assumed, as it is alleged to have assumed, the legal liability for the payment referred to on page 2, since it does not fit into any of the hypotheses provided for in the National Tax Code. Neither Resolution No. 432/77 nor Circular No. 349/77 would have the force of law required to attribute to the Central Bank the condition of a passive party—liable for the tax obligation under discussion;

(b) At no time did the Central Bank *even assume* the liability, towards the creditor of the interest, to pay such interest. The liability that was assumed was toward the borrower of the foreign loan who

made the foreign currency deposit, to which Circular No. 349 refer, with the intent to compensate himself for the interest charges due under that loan. As grounds for this statement, the decision mentions three distinct transactions: (i) the foreign loan transaction; (ii) the voluntary deposit made by the borrower with a bank that is authorized to operate in exchange; and (iii) the transfer of the deposit from the bank to the Central Bank of Brazil. It is only the interest on the deposit, and not the interest on the foreign loan, which would constitute a charge assumed by the Central Bank, because the deposits of foreign currency that are made under Resolution No. 432/77 are financial investments which have nothing to do with the foreign loan transactions which gave rise to them.

The decision confuses two distinct questions:

(i) Does the Central Bank have the responsibility to pay the withholding income tax on the interest, considering that the borrower assumed that burden before the foreign creditor, and in view of the fact that the borrower made a voluntary deposit of part of the amount of the loan under the terms of Resolution No. 432/77? The response given by the Federal Revenue authorities is negative. In their opinion, the responsibility of the Central Bank in this case is that of a mere depositary;

(ii) If the borrower improperly paid the withholding income tax during the period in which he had made the voluntary deposit, is he or is he not entitled to a refund of the excess paid? The decision also seeks to respond negatively to this second question, but it uses, erroneously, may we say with all due respect, the same arguments on which the response to the first question was based.

We believe that the borrower is entitled to a full refund of the amount of the withholding income tax paid in error during the period in which he made the voluntary deposit, regardless of whether the Central Bank is or is not liable for that tax obligation. Consequently, we believe that the decision handed down in the administrative sphere could be modified in court.

In the second case, a borrower whose head office is in Rio de Janeiro (Companhia Brasileira de Participações—Cobrapar S.A.) contracted a foreign loan with a Japanese bank (The Sanwa Bank Limited), and it was established that the withholding income tax would be for the account of the borrower. As the creditor in the transaction was a financial institution based in Japan, the borrower was to pay the tax at the rate of twelve and one-half percent, as provided in article 10 of the tax treaty between Brazil and Japan intended to avoid the double taxation of income.

The pertinent provisions of article 10 of that treaty provide as follows:

Article 10.

- 1) Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other Contracting State.
- 2) However, such interest may be taxed in the Contracting State in which it arises, according to the laws of that Contracting State, but the tax so charged shall not exceed 12.5% of the gross amount of the interest.

Nevertheless, the borrower was apparently unaware of the content of those provisions of the Brazil-Japan Treaty and proceeded to pay the withholding income tax at the normal rate of twenty-five percent when he remitted interest to the creditor. Subsequently, basing its claim on the Treaty the borrower filed a petition in court to obtain a refund of part of the tax paid on the interest remitted to the Japanese bank, that is, to recover from the Brazilian government the excess amount paid.

The court action was found to be without grounds by the lower Federal Court of Rio de Janeiro, and the borrower then filed an appeal to the Federal Appeals Court (TFR). The Third Panel of the TFR, in a unanimous decision, also denied the appeal. The summary of the TFR's decision states that:

Income Tax—Remittance of interest relative to a cash loan obtained from a Japanese bank—If it was established that the tax on the interest was to be paid by the debtor, in Brazil, with the creditor abroad receiving the amount without any deduction, then it cannot be admitted that the Brazil-Japan Treaty to avoid double taxation applies. Judgment upheld.

In contesting the court action, the government attorney said that:

The document on page 9, a certificate of registration, issued by the Central Bank of Brazil, establishes the following as characteristic of the loan as regards interest:

1½ % per annum, net, above the London interbank rate for six-month deposits in Eurodollars, readjustable semi-annually on the outstanding balance of the principal, beginning on September 18, 1973. Income tax for the account of the borrower.

It can be seen, therefore, that the amount of the interest on the loan is calculated on a rate of 1½ % net, such rate being the average London interbank rate, free of income tax as was stated in the clause itself when it provided "income tax for the account of the borrower."

Therefore, there is no deduction of income tax on the remittances of interest to the creditor overseas, which invalidates the enforcement of the Brazil-Japan Treaty on interest to be paid to the financial entity abroad.

The decision of the TFR denied the appeal, concluding as follows:

Now if the creditor, the Japanese bank, was to receive the sum relating to the interest, without any deduction for taxes, the treaty Brazil celebrated with Japan to avoid double taxation would never apply to this instance.

Not being satisfied with that decision, the borrower filed an extraordinary appeal seeking to have the question re-examined, this time by the Federal Supreme Court (STF), on the grounds of parts (a) and (d) of the permission given in article 19, III, of the constitution, and alleging that the decision violated art. 98 of the National Tax Code (CNT), and was inconsistent with rulings of the STF. The Chief Justice of the TFR did not permit that appeal to proceed, and the borrower resorted to another type of appeal in order to send the case to the STF. However, in ruling on this new appeal, the STF also declined to re-examine the question.

Article 98 of the CTN provides as follows:

Art. 98. The international treaties and conventions revoke or modify internal tax legislation and shall be observed by those that are subsequently enacted.

In the opinion of the Reporting Judge, Cunha Peixoto:

There was no denial of article 98 of the National Tax Code, since the Tribunal from which the case was sent, in interpreting the agreement between lender and borrower, limited itself to concluding that the mentioned Treaty did not apply to the case in dispute. The point is that the Treaty is intended to avoid double taxation, and the agreement being judged left all payment of income tax to the borrower.

Thus the appeal also finds no basis on part (d), since the appellant made reference to a decision which maintains that:

“A treaty revokes laws that are previous to it, however, it may be revoked by subsequent laws, even if the latter do not do so explicitly or if they do not denounce it.”

I deny the appeal and order that the case be shelved.

The position taken by the STF in this appeal should be interpreted as an isolated ruling by that court. If the treaty signed by Brazil

and Japan were interpreted in a restrictive manner, so that it would not apply to cases in which Brazilian borrowers assumed the burden of paying the withholding income tax, and if that interpretation were extended to the other countries which Brazil has celebrated double taxation treaties, the financial cost of the foreign loans borne by the borrowers themselves would be considerably higher.

#### CONCLUSION

As we have already mentioned in this study, in instances of foreign loans, the Brazilian borrower is a mere payor, but the taxpayer under the law is the foreign creditor. When the borrower assumes the liability, the tax authorities take the view that, the receipt by the foreign creditor is actually increased. For that reason, the borrower may make the corresponding "gross up" so as to pay the withholding income tax due and remit the full amount of the interest due the foreign creditor. Now, if we hold to this same principle, we must acknowledge that the treaty to avoid double taxation applies, because the funds are always received by the foreign bank. There cannot be two weights and two standards of measurement for the same situation.

In addition, if we also apply the trend embraced by this decision of the STF to import financing transactions, we would have a situation which is highly unfavorable to Brazilian companies. In cases of financed imports, the legal taxpayer of the withholding income tax which is levied on interest and other charges related to the transaction, is always the remitting party, that is, the Brazilian importer. By increasing the financial cost of imports financed with countries with which Brazil has signed a double taxation treaty, Brazilian companies themselves would be penalized.

In our opinion, the borrower could examine the feasibility of bringing a rescissory suit against this decision of the STF.

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