

Dutch State Secretary of Finance publishes Decree on Brazilian "Interest on Net Equity" qualification

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Executive summary

On 27 August 2020, the Dutch State Secretary of Finance published a decree on the qualification of Brazilian Interest on Net Equity (INE) payments (the Decree), for Dutch corporate income tax (CIT) purposes and for the application of the Tax Agreement between Brazil and the Netherlands (BR-NL tax treaty). By means of this Decree, the State Secretary of Finance has clarified the position of the Dutch Ministry of Finance regarding the classification of the INE payments as either dividends or interest under the BR-NL tax treaty, which should be adhered to by the Dutch Tax Authorities (DTA).

The Decree confirms the position that INE payments are considered income derived from a share investment to which the participation exemption was applicable prior to 1 January 2016. However, for purposes of the BR-NL tax treaty, the Dutch State Secretary of Finance takes the position that the treatment in the source country should be followed. This leads an INE payment to qualify as interest to which a lower foreign tax credit (FTC) - 20% tax sparing credit under the BR-NL tax treaty is available. This position implies an incremental 5% levy in the Netherlands over INE payments received by a Dutch BV against the 25% CIT due over the INE income.

Detailed discussion

Background

Under the Brazilian law, INE is a hybrid instrument with both characteristics of equity as well as debt. The hybrid characteristic of INE results from its nature of a payment to the shareholder which, differently from a dividend payment, can be deducted from the Brazilian CIT base.

Up to 2016, INE payments from Brazil to a Dutch shareholder were generally exempt from Dutch CIT by application of the Dutch participation exemption regime. As mandated by the changed European Union Parent Subsidiary Directive, effective 1 January 2016, the Dutch participation exemption no longer applies to exempt deductible INE payments as a result of the inclusion of the anti-hybrid rule in Article 13(7) *Dutch Corporate Income Tax Act 1969*.

However, the effective levy against the Dutch CIT headline rate of 25% could still generally be reduced by an FTC, increased to 20% or 25% by the tax sparing credit available under the BR-NL tax treaty. The available FTC on INE payments (among others) depended on the classification of the INE payments as either dividends or interest under the BR-NL tax treaty:

- ▶ 25% FTC if classified as a dividend and paid to a 10% or greater shareholder (Art. 23(4)(a) BR-NL tax treaty)
- ▶ 20% FTC if classified as interest (Art. 23(4)(b) BR-NL tax treaty)

In the past, the position was taken in practice (and confirmed by the DTA in various instances) that the INE payments are to be considered as dividends for purposes of the BR-NL tax treaty. Hence, a tax sparing credit of 25% was generally available.

"New" position of the DTA

Recent discussions with the DTA have triggered uncertainties on the treatment of the INE payments as dividends or interest under the BR-NL tax treaty. With the intention to clarify and confirm the position of the Dutch Ministry of Finance and the DTA, the Decree states that for the purpose of providing an FTC under Article 23 of the BR-NL tax treaty, the interpretation which is aligned with the qualification of the source country - Brazil - should prevail.

From the literature and case law, it is understood that INE payments are treated similarly to interest in Brazil, hence according to the State Secretary of Finance, the Netherlands also should take the position that INE payments are considered interest for purposes of the BR-NL tax treaty. As previously mentioned, for interest income, a lower FTC of 20% is generally available under the BR-NL tax treaty.

We note, however, that the Decree does not have the force of law and may therefore be challenged (e.g., in a court of law) by taxpayers taking a different position.

Next steps and timing

The Decree entered into force on the day after the date of the publishing of the *Staatscourant* - the *Official Gazette* - on 28 August 2020.

Taxpayers should review their current tax positions in relation to INE payments from Brazil and discuss restructuring alternatives to mitigate risks with their local tax professionals.

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