Brazil and the Netherlands agree on the qualification of Brazilian ‘interest on net equity’ under the bilateral tax treaty

By way of a Mutual Agreement Procedure (“**MAP**”), the Netherlands and Brazilian Competent Authorities have reached consensus on the qualification of Brazilian ‘interest on net equity (Juros sobre o Capital Própio, “**JCP**”) within the meaning of the Netherlands-Brazil tax treaty (“Treaty”). The Competent Authorities have agreed that for the purpose of applying the Treaty, and in accordance with Brazilian tax law, JCP should be considered interest. This is in line with an earlier Decree of 27 August 2020 (“**Decree**”), where the Dutch State Secretary of Finance had already unilaterally taken the position that JCP qualifies as interest under the Treaty. This means that Dutch taxpayers receiving JCP from their Brazilian subsidiaries should be eligible for a 20% tax sparing credit on interest payments under the Treaty instead of the 25% tax sparing credit on dividends.

Whilst one may think that this marks the end of a long-lasting uncertainty, we do not rule out that Dutch taxpayers might still be able to effectively challenge the agreement reached by the Netherlands and Brazilian Competent Authorities on the Dutch qualification of JCP for tax treaty purposes through a Dutch court.

Background

JCP is a statutory remuneration paid by a subsidiary to its shareholders, based on the net equity amount of the subsidiary. Whilst from a legal point of view, JCP has significant similarities to a payment of a dividend, for Brazilian tax purposes it is treated as interest. In addition, Brazil levies a 15% withholding tax on payments of JCP.

BeforeJanuary 1, 2016, JCP received by a Dutch resident entity was considered a benefit derived from a shareholding from a Dutch tax perspective. Consequently, if the participation exemption conditions with respect to the Brazilian subsidiary were satisfied, the JCP benefits were exempt from Dutch corporate income tax. As fromJanuary 1, 2016, a legislative change was introduced, pursuant to which the participation exemption no longer applies to benefits derived from a subsidiary, where the corresponding payment is tax deductible.

Because of this legislative change, JCP received by a Dutch recipient shareholder is no longer exempt and is subject to Dutch corporate income tax at the ordinary rates (15% on the first EUR 395,000 of profits and 25,8% on the excess profits –2022 rates). However, the Treaty provides for a tax sparing credit, which credit can be set off by the Dutch recipient against the Dutch corporate income tax due on its JCP income. The question arose which tax sparing credit rate should be provided by the Netherlands under article 23 of the Treaty. A 25% tax sparing credit applies for qualifying dividends and a 20% tax sparing credit applies for interest.

To resolve this unclarity, the Dutch unilateral Decree of 2020 stated that the treatment of an item of income for Treaty purposes should be determined by its tax treatment in the source state. Because Brazil treats JCP as interest for its domestic tax purposes, the Decree therefore provides that the 20% tax sparing credit applies. This is contrary to the earlier long-term Dutch practice that JCP should be considered a benefit derived from a shareholding from a Dutch tax perspective.

The Competent Authorities have now agreed that for the purpose of applying the Convention,
in accordance with Brazilian tax law, JCP is considered interest within the meaning of paragraph 4 of Article 11 of the Treaty. This agreement was reached under a MAP within the meaning of article 25, paragraph 3 of the Treaty, which provides that the competent authorities of the Contracting States shall endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention.

Done deal?

Although the uncertainty regarding the qualification of JCP is seemingly taken away by the agreement reached between the Competent Authorities, there might still be a possibility for Dutch taxpayers to challenge the agreement with a Dutch court of law. Under Dutch law, it is questionable whether the Competent Authorities in the case at hand have the power to agree on a meaning of a term that would prevent recourse to the domestic law meaning of that term. Paragraph 32 of the OECD Model Tax Convention Commentary also explicitly states that:

"(…) it is important not to lose sight of the fact that, depending on the domestic law of Contracting States, other authorities (Ministry of Foreign Affairs, courts) have the right to interpret international treaties and agreements as well as the "competent authority" designated in the Convention, and that this is sometimes the exclusive right of such other authorities."

It would also not be the first time where the legality of a Competent Authority agreement was questioned. In BNB 2000/16 and BNB 2000/17, the Competent Authorities of the Netherlands and Germany had also agreed through a MAP on the meaning of a specific treaty term. The Dutch taxpayer challenged the meaning of the term as agreed by the Competent

Authorities, and the Dutch Supreme Court ruled:

"The Decree contains no more than a statement that the Dutch and German Competent Authorities have reached agreement on several points on the basis of article 25 of the Convention. It cannot be seen how such a statement of agreement reached (…) can relieve the [Dutch] court from its obligation to interpret the treaty, if a provision of the treaty is invoked."

To our knowledge, the prevailing doctrine in the Netherlands remains that courts and taxpayers are not strictly bound by the outcome of such MAP. With the aforementioned in mind, a Dutch taxpayer may still be able to effectively challenge the agreement reached by the Netherlands and Brazilian Competent Authorities on the Dutch qualification of JCP for tax treaty purposes.

If you have any questions or comments, we are happy to assist.

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