The Use of Tax Loss Carry-Forwards in Brazil: Look, but Don’t Touch

1. Introduction

In a famous scene from “The Devil’s Advocate”, the Devil, played by Al Pacino, makes a speech to a beleaguered Kevin Lomax (Keanu Reeves) conveying some inside information about God. Allegedly, God has set rules in opposition for His own amusement: “Look, but don’t touch. Touch, but don’t taste. Taste, don’t swallow”.

It can be said that the provisions of Brazilian tax law on the use of tax loss carry-forwards are imbued with some of that wisdom. Currently, the recognition of tax loss carry-forwards is broad and free from time limitations. However, several other limitations on their use make an aggressive tax planning strategy a pyrrhic victory at best, given the time it should take to effectively utilize the tax loss carry-forwards.

This does not mean that the Brazilian rules are completely logical and unbiased. The limitations on the use of tax loss carry-forwards from controlled foreign companies in the Brazilian controlling company’s tax base, for example, do not follow the same logic of tax loss carry-forwards of the Brazilian controlling company itself in previous years. Nonetheless, one can reasonably say that these rules are effective in fulfilling the aim of the Brazilian tax authorities to reduce tax avoidance.

This article will shed some light on the Brazilian tax rules regarding the utilization of tax loss carry-forwards. First, the underpinnings of the current model will be explained, with remarks provided on the practical problems associated with the model. Furthermore, rules on the use of tax loss carry-forwards in special cases, such as business combinations, will be discussed. Finally, the authors will comment upon the ill-anticipated consequences of the model.

The purpose of this article is not only to describe the current set of tax rules concerning the utilization of tax loss carry-forwards in Brazil, showing their effects on tax planning, but also to criticize the consequences of such rules when appropriate. It is the expectation of the authors that new solutions, less disadvantageous to investment, may be provided in the future.

2. From an Expiration Model to a Cap Model

Like many other tax systems, the Brazilian tax model has long relied on rules providing a time frame during which tax loss carry-forwards may be enjoyed. In 1947, a three-year term for the use of tax losses was first established, later expanded to four years in 1976. There was no limit on the amount of tax losses that could be carried forward to a given year in that time frame.

Two consequences can be attributed to that model. The first is that enterprises from industries which expected a positive return after a longer period had to bear some sunken costs. The second is that a market for the sale of shell companies with tax losses began to flourish. While the first consequence had an impact only in the industry concerned, and for certain industries and activities the time limits could be relaxed (agricultural activities were exempt from the expiration rule), the second consequence had a direct fiscal impact.

The reaction from tax authorities was to provide rules denying the use of tax losses in cases where tax avoidance was more obvious, some of which still apply today. The most common practice was the sale of a shell company with tax losses to a new controlling company with profits. The new controlling company would merge with the shell company, absorbing the tax loss carry-forwards in the process. Decree-Law 2.341 thus negated the effects of tax losses from absorptions through mergers, fusions and split-offs.

Another common practice was to sell the control of a shell company with tax losses, change its line of business and then engage in new profit-making operations. Decree-Law 2.341 also negated the effects of such tax losses. Both rules will be further considered below.

During the last years of hyperinflation in Brazil (1989-1994), rules on tax loss carry-forwards varied wildly. Until 1991, a four-year term for tax loss expiration still applied; in 1992, there was no limit, but in 1993 the four-year term was reinstated, with different rules for purposes of counting the term. Finally, from 1995 onwards the time limit was abolished and the current model, based on caps, was first established.

Under the current model, tax losses may be carried forward to any year. However, in a given year only 30% of the year’s taxable profits may be offset against tax losses from previous years. This means that, in practice, taxable
profit will have to be more than three times higher than the tax losses to allow for their full use in one year.

An example can illustrate the procedure. Suppose that the SELIC interest rate is 9.75% per year, one of the lowest in history (given a current inflation rate of 5.85% per year, this means that the current real interest rate is 3.9% per year – a record low, but very high by international standards). It is no wonder, therefore, that the new model may cause considerable financial aggravation to corporations.

In the example above, the tax losses were less than the 30% offset cap, which allowed their full utilization. However, if tax losses were 500 instead:

- taxable profit: 1,000 + 100 – 50 = 1,050
- offset cap: 1,050 × 30% = 315
- profit taxed in the given year: 1,050 – 315 = 735

As a transitional rule, the time limits on tax losses from previous years were also abolished, so that they could also be accrued and carried forward to later years. Nonetheless, the mere fact that the losses could not be fully enjoyed leads to challenges against the new rules.

Before the courts, the argument of taxpayers was that they had acquired the right to offset tax losses under the previous rules, which meant they could be fully used within the time frame set by the revoked legislation. This subject was hotly debated, and in 2009 the Brazilian Supreme Federal Court finally ruled there were no acquired rights to enjoy tax losses to allow for their full use in one year.

Furthermore, until 1995 tax losses could be adjusted for inflation to retain their value. In that same year, the adjustment rule was abolished as well, as part of the Plano Real for inflation control. It was possible, however, to carry tax losses forward to 1996, for example with the inflation adjustments prior to 1995. In 1995 alone, the official consumer price index (IPCA) recorded a 22.41% annual accrued rate, a relief in comparison with 916.46% in 1994 and 2,477.15% in 1993.

Even if Brazil were to have no inflation, real interest rates in Brazil have for many years been among the highest in the world. Currently (March 2012), the nominal interest rate paid for Brazilian treasuries and between banks (SELIC interest rate) is 9.75% per year, one of the lowest in history (given a current inflation rate of 3.85% per year, this means that the current real interest rate is 3.9% per year – a record low, but very high by international standards). It is no wonder, therefore, that the new model may cause considerable financial aggravation to corporations.

Agricultural activities were exempt from the offset cap (based on the same rule that exempted them from time limits before), but this exemption applied only to agricultural activities themselves. Therefore, a vineyard could carry forward tax losses from the production and sale of whole grapes, but not from the sale of wine.

As stated above, the current model makes tax avoidance much harder to achieve, as generated tax losses (including contestable, artificial ones) would not be easily carried forward to offset future taxable profit. On the other hand, companies with huge tax losses that arose for legitimate reasons may pay corporate tax on profit during the recovery of those previous losses.

### 3. Special Rules for Non-Operating Losses

The new model did not restrict itself to cap tax loss carry-forwards from normal sources, but also capped non-operating losses, i.e. losses stemming from the sale of real assets or fixed assets (as opposed to capital gains). From 1996, non-operating losses from previous years may be carried forward only to offset non-operating profits (capital gains from the sale of assets of the same kind). Furthermore, the sum of non-operating tax losses and “normal” tax losses is subject to the 30% offset cap.

This special limitation does not apply to losses due to robbery, obsolescence, fire or other disasters, and the like, even if there is scrap that can be sold. In such cases, tax losses are deemed to be part of the “normal” tax losses.

Although the purpose of the rule may be to prevent the artificial generation of tax loss carry-forwards, the rule is objective, encompassing legitimate and artificial transactions as well. Therefore, if, for example a company is strapped for cash and needs to raise cash from the sale of its assets at a less than book value, the tax loss may not be offset in future years except by the sale of another asset with a capital gain.

These limitations apply only to tax losses carried forward to future years, but not to tax losses in the same year of assessment. Consequently, if two companies have non-operating tax losses in a given year, the company operating at a profit (measured on a tax basis, not based on accounting books) may offset them completely in the same year, while the other company, in a loss position, will only offset the same losses much later.

It is obvious, therefore, that Brazilian tax rules on tax loss carry-forwards discriminate between companies operating at a loss and more profitable companies, making the former, in relative terms, much more tax burdened than the latter. The consequence is that these rules may make it much more difficult for companies operating at a loss to recover.

Naturally, not all companies with tax losses may be so burdened. If a company operates at a loss in a given year but manages to quickly recover to a profitable position, it may carry forward all tax losses even with the 30% offset cap.
However, if the company takes a much harder hit, taxation may make it slouch in terms of cash flow while attempting to recover.

4. Special Rules for Business Combinations: Mergers, Fusions and Split-Offs

As mentioned, in 1987 two rules were implemented to deny tax loss carry-forwards in cases involving business combinations. The first rule negates tax losses from companies absorbed during a business combination, i.e. by merger, fusion or split-off.11 The change from the previous model to the current one did not revoke the application of this rule.

The purpose underlying the denial of the utilization of tax losses from absorbed companies was to eliminate the market for shell companies with tax losses. It was common at the time to maintain companies with tax losses (e.g. companies that were once operational, but due to losses from their operations were deactivated) and sell them to profitable companies interested in taking advantage of some tax savings.

The prohibition on the use of such losses was implemented under the former rule, which did not cap the utilization of tax losses, but set a time frame during which tax losses could be carried forward. Under that model, the negation of the effects of tax losses made some sense, as there was no other deterrent to the utilization of such benefits.

After the current model was set, the two rules became somewhat redundant. Even if a company with huge tax losses was absorbed, the time it would take to offset all tax losses against future taxable profit would make the benefit from the transaction minor (especially due to opportunity costs, or during high inflation periods).

Furthermore, as with the rule on non-operating losses, the rule negating effects from tax losses of absorbed companies does not discriminate between legitimate or artificial business combinations. Therefore, if a fully operational company with tax losses is acquired and later merged with a new controlling company, the controlling company would not be able to carry forward the tax losses from the absorbed company, even if the absorption has a clear business purpose.

This is rather odd under current standards. In 1987, the tax authorities relied mostly on objective, clear-cut rules to combat tax avoidance. As interpretation did not allow for broader standards to deny the effects of such practices, hard law mechanisms were justifiable.

Presently, however, the tax authorities have pushed more and more for the use of the business purpose doctrine. This doctrine, as understood by the Brazilian tax authorities, allows them to disregard the tax effects of transactions for which only a tax reduction purpose can be seen, not a broader business or economic purpose. There are no express legal grounds to apply this doctrine,12 but the tax authorities usually base its application on legal principles of other types of law, as simulation or abuse of legal form.

Therefore, if this rule on business combinations were not applicable, the tax authorities would seek to deny the use of tax losses from absorbed companies only if they could not be explained under the business purpose doctrine (e.g. acquisition of shell companies). Legitimate transactions would not be affected by this treatment.

However, the market for shell companies continued to persist under the new rule. As a company is (normally) able to carry forward its own tax losses, the fact that it has profits from the operations of an absorbed company does not affect the utilization of its own tax losses. Under the new rule, transactions in which a company with tax losses merged with its profit-making parent company became widespread. It was also common for the controlled company that survived the merger to assume the name and identity of its former parent.

Reverse mergers, as these transactions have come to be known, were subject to scrutiny by administrative bodies with jurisdiction to evaluate tax assessments. However, it was soon confirmed that reverse mergers were outside the scope of the prohibition, except for the most obvious cases of tax avoidance (e.g. by the surviving company assuming its parent’s identity after merger). Otherwise, tax losses could be carried forward normally.13

A more sophisticated approach, given the business purpose doctrine, would be to have the controlling company with tax losses first acquire the profit-making business of its parent and change its name to closely resemble the parent’s. Only later (one year or more) would it perform the reverse merger itself. In that way, at the moment of the merger a business purpose would be more evident (both companies will perform similar activities) and lessen the risk of tax assessment, even if the subsidiary assumes its parent’s identity afterwards.

5. Special Rules for Business Combinations: Change of Control and Line of Business

As mentioned, normally a company may carry forward its own tax losses, even after absorbing a parent company with taxable profit. An exception to this rule applies if the company has experienced a change in control and line of business.14 This exception applies only if (1) control of the company in question is acquired by a new controlling entity and (2) the company changes its line of business. If only one of these facts occurs between the year the tax loss

12. Art. 116 of the National Tax Code (Código Tributário Nacional) is claimed to allow the use of this doctrine, but it demands the enactment of a statute regulating it, which was never enacted (Law 5.172 of 25 October 1966, Official Gazette of 31 October 1966).
arises and its offset against taxable profit, tax losses may be carried forward normally. When both facts are present between these two dates, however, all tax loss carry-forwards existing before both facts occurred are negated.

Both requirements need not be fulfilled at the same time. For example, if the company changes its line of business after the tax loss arises but only a few years later, before the offset, also suffers a change in control, the tax losses may not be used entirely. Between these two moments (when the tax loss arose and the tax loss was used), the two requirements (change of control and line of business) were met.

On the other hand, if the same company changes its line of business after the tax losses arise and, after the offset, has its control transferred, tax losses may be used normally. However, if tax losses are only partially enjoyed, the excess may not be used again in the future, as by then both requirements will have been met.

As can be seen, there is a possibility that in the structure mentioned in the previous section (absorption of parent company by subsidiary company with tax losses), this rule may be applied to impede the utilization of tax loss carry-forwards. Even though the rule itself is simple, the question of what the terms “change of control” and “change of line of business” mean is more difficult to answer.

The term “control” is taken from Brazilian Business Law and, in this context, control can be exercised directly or indirectly, i.e. through control of enough direct parent companies. Under this approach, if control is reallocated from a parent company to another group company, keeping indirect control intact, tax losses could still be enjoyed.

There is no legal definition of the term “line of business” (ramo de atividade). In the absence of a legal definition, there are wide-ranging possibilities of interpretation. This is even more true because the norm provides for a “change” of line of business, which does not mean that the previous business may be abandoned.

Decisions of administrative bodies with jurisdiction to evaluate tax assessments and judicial authorities have associated the concept of “line of business” with the corporate object of the company, as defined in its bylaws. However, this solution is not always sound. If, for example, a “pure” holding company has in its portfolio only participation in telecom companies, and decides to perform telecom activities as well, a change in the company bylaws would be necessary to add that activity. It sounds unreasonable that this fact alone would lead to a deemed change in line of business.

The same line of questioning can be followed for the suppression of an activity instead of an addition. If a company produces machines and sells machines, but later stops producing them to remain engaged only in the selling of such products, should it be considered a change in the line of business?

It is plausible that a change in the company bylaws would point to evidence of a change in the line of business, but evidence must not be confused with the fact it intends to prove. It does not seem possible, however, to establish a criterion that does not lead to a tautology or allow for a high degree of subjectivity in the definition.

The authors understand that the content of the term “change in line of business” is broad only because it must be construed based on the provision’s purpose. The opposite would mean the concept to be blind, affecting artificial and legitimate transactions alike and even leaving some artificial transactions intact. For example, if a shell company is shrewdly designed to contain many different corporate objects, so that no change in its bylaws is necessary to engage in a new activity, no “change in line of business” would be confirmed.

In the authors’ opinion, the rule was designed to prevent the use of shell companies with no economic activity only for their tax losses. This situation does not cover, in most situations, rearrangements within a group, like a holding company that begins to perform activities of other companies of the group. Nor does it cover a change in the performance of activities (e.g. from wholesale to retail sales of the same product) if that is consistent with a market strategy. Therefore, many facts other than a change in bylaws should be taken into account when determining whether to deny the right to carry forward tax losses. Unfortunately, this has not always been the case.

6. Tax Loss Carry-Forwards of Controlled Foreign Companies

Before 1996, Brazil did not tax profit that was not produced in Brazilian territory. Under the territoriality principle, foreign-source profit of Brazilian companies was not taxed, as tax losses from the same sources should not be used to offset Brazilian corporate taxes.

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income is first mostly derived from a given activity, like dividends from portfolio companies, and later from another activity, like operational activities of the portfolio companies."

19. Some authors defend that a change in the line of business should be ‘substantial’. See Tilbery, supra n. 17, at 163 (Resenha Tributária ed., 1987). See also Mariz de Oliveira, supra n. 16, at 878.


21. One author affirms that offers of shell companies for sale were publicized even in newspapers. See Ricardo Marz de Oliveira, supra n. 16, at 869.
However, Brazil later adopted the universality principle, thus taxing profit of resident companies regardless of source.22 The new model for taxation of foreign profit covered not only income directly attributable to a Brazilian company, but also the profit of its subsidiaries abroad. Unlike other countries that apply controlled foreign company (CFC) tax rules, this taxation was applicable to any controlled company, not only companies resident in tax havens. Later on, such profit was taxed regardless of whether it had been distributed.23

Unlike the treatment described above, foreign-source losses may not be offset against taxable profit in Brazil. Brazilian tax rules allow losses to be offset only against future profits from the same sources.

For instance, if a Brazilian company has two subsidiaries, one in Colombia (with profit) and another in Venezuela (with losses), the Columbian profits should be added to the Brazilian corporate tax base (although corporate taxes paid in Colombia may be offset against the tax due on the same profit in Brazil). However, losses in Venezuela may not be used to offset Colombian profit, only to offset future profit in Colombia. This would be the case even if the subsidiaries were in the same country.

This rule applies even to foreign branches of Brazilian companies. Each branch should account for its profits as if it were a different company. The only difference is that different branches in the same country may consolidate their positions (i.e. offset one’s loss with the other’s profit) to add their sum to the Brazilian company’s tax base.

Brazilian tax law in this regard is not systematic. If all profit from abroad should be taxed as if directly earned by the Brazilian company, it would be logical, considering the current tax loss carry-forward model, that losses abroad would offset taxable profit in Brazil. Their excess would be offset based on the 30% cap.

Another model, that sounds more reasonable, would tax profit of the Brazilian company abroad as well as profit from controlled foreign companies in tax havens or under regimes that provide for treatment similar to that in a tax haven, as seen in other jurisdictions. As profits are subject to very low taxation in such jurisdictions, it would be more logical to have them taxed in Brazil.

Instead, tax law has opted to treat each source separately, so as not to reduce – only increase – the Brazilian tax base. The result is that controlled foreign companies are deemed to be “foreign” when they have losses, but are deemed to be part of the Brazilian parent if they are profitable.

It is advisable, therefore, that Brazilian companies avoid having subsidiary companies abroad entirely, but rather should consider maintaining parent companies abroad or sister companies under a holding company also abroad.


7. Conclusion

Aggressive tax planning involving tax loss carry-forwards is not very effective in Brazil today. Previously, when Brazil still adopted a time frame to allow tax losses to be carried forward before they expired, a market for shell companies with tax losses flourished, which in turn led to initiatives limiting their use.

Some of these initiatives in the 1980s which are still valid today tried to set objective rules to cover the most aggressive tax avoidance practices. The first was to deny tax losses from business combinations involving the absorption of companies carrying tax losses. The second was to negate the effect of a company’s own tax losses if the company underwent a change in both its control and its line of business between the date when the tax losses arose and the date when such losses were carried forward.

Both rules have the disadvantage of affecting artificial and legitimate transactions alike, while leaving other tax-saving possibilities available. In the case of business combinations involving the absorption of companies, it has been accepted that reverse mergers (i.e. a controlled company with tax losses merges with its profit-making parent) allow the utilization of tax losses if there is no evidence of simulation (e.g. the controlled company assuming the name and identity of its parent after merger).

Given the position of tax authorities on the issue, a more advisable procedure would be to have the company with tax losses absorb first some of the profitable parent’s business, to only at a later date provide for a reverse merger. The procedure would allow more economic substance to be seen so as to avoid claims of simulation by the tax authorities.

The rule negating the use of a company’s own tax losses is too broad, encompassing situations beyond its original purpose. Administrative and judicial rulings construed “change of line of business” to mean a change in the company’s corporate object as provided in its bylaws. This standard catches transactions that do not relate to trading in shell companies, e.g. the change of object of a holding company to assume also the operations of its subsidiaries.

The authors advocate for a more constructive interpretation approach, construing the meaning of “change of line of business” based on the purpose of the provision. Therefore, not only changes in a company’s bylaws, but also in the operation of the company itself against a business strategy should be borne in mind.

The logic that guided these two provisions anticipates the more sophisticated business purpose doctrine, currently often used by the tax authorities. Even though the way it is applied by the
tax authorities deserves criticism, it is much more meaningful to address transactions based on their significance in market terms, rather than classifying tax avoidance practices and approving rules without reference to their context.

However, those rules are still valid and coexist with the current model of utilization of tax loss carry-forwards. By granting the possibility of offsetting tax losses without time constraints, Brazilian tax law imposes quantitative caps instead, taking longer to allow full enjoyment of the losses. This model is effective against tax avoidance practices, but may also burden companies recovering from large deductible losses.

In financial terms, the possibility to carry forward to a given year only 30% of that year’s taxable profit makes the excess vulnerable to inflation and opportunity costs. Furthermore, companies with larger past tax losses relative to their current profit may see their initiatives of recovery hindered.

Furthermore, a rule allowing non-operating tax losses (i.e. losses from the sale of real assets or fixed assets) limits their use only to offset similar gains (besides respecting the 30% cap). This limitation may also financially affect companies with cash constraints that need to raise cash by selling some assets.

Finally, losses from activities from sources abroad or of controlled foreign companies may not be offset against taxable profit of the controlling company in Brazil, even if the foreign-source profit is taxed as Brazilian income. This treatment is in contradiction with the rules for tax loss carry-forwards in general. The fact that such treatment is given makes it unadvisable to have companies being controlled by a Brazilian company.