M E M O R A N D U M T O C L I E N T S

REGULATION OF TRANSITION TAX REGIME - IN RFB NO. 1,397/13 Date **09/24/2013**

On September 17, 2013, the Brazilian Federal Revenue (*Receita Federal do Brasil - "RFB"*) issued the Normative Instruction (*Instrução Normativa - "IN"*) no. 1,397/13, which provides for the Transition Tax Regime (*Regime Tributário de Transição - "RTT"*) established by Articles 15 and following of Law no. 11,941/09. It is worth mentioning that such regime was instituted in order to neutralize, for taxation purposes, the effects of the profound changes in accounting methods and criteria introduced by Laws 11,638/07 and 11,941/09.

In general, the IN no. 1,397/13 aims to regulate many controversial issues involving the RTT, among which stand out the institution of Tax Bookkeeping (*Escrituração Contábil Fiscal – "ECF"*), statements and concepts of the Taxable Income system (*Lucro Real*), debentures premiums, subsidies to investments and donations, evaluation of investments by its net worth, presumed profit (*Lucro Presumido*) and Contributions to the Social Security Funding (*"COFINS"*) and to the Employee Profit Sharing Program (*"PIS"*), plus the rules related to dividends and interest on net equity (*Juros sobre o Capital Próprio – "JCP"*), which were analyzed by us in a specific Memorandum dated 09/19/2013[1].

I – TAX BOOKKEPING ("ECF")

At first, we emphasize that this IN establishes the Tax Bookkeping from the calendar year 2014, which is an accessory obligation contained in the entry of a new accounting, according to the accounting principles and rules that were effective on December 31, 2007. That is, starting from the calendar year 2014, corporations will have two accounting statements, one based on current accounting standards for corporate and accounting purposes, and another based on the accounting standards in force on December 31, 2007, for tax purposes.

[1] Available in our website: www.ssplaw.com.br.

We believe this new accessory obligation may be challenged in the Judiciary, as it offends the constitutional principle of proportionality for being, strictly speaking, unnecessary, given that the Transitional Tax Accounting Control (*Controle Fiscal Contábil de Transição - "FCONT"*) fully accomplishes the duty of promoting the adjustments arising from the RTT, especially since we are dealing with transitional adjustments that soon will be replaced by a new legislation on the taxation of income and profits.

It is also important to stress that the taxpayer, in accordance with article 10 of the IN, must elaborate balance sheet, income statement and the accrued profit and loss statement based on the accounting standards in force on December 31, 2007.

II – DEBENTURE PREMIUMS / SUBSIDIES TO INVESTMENTS AND DONATIONS

Regarding the debenture premiums, some procedures must be observed to avoid the including of this benefit in the calculation basis of Corporate Income Tax and Contribution on the Net Income ("CSLL"), such as: (i) the recognition of the debenture premium in the results account by the accrual method and in accordance with the provisions issued by the Brazilian Securities and Exchange Comission (*Comissão de Valores Mobiliários - "CVM"*); and (ii) the exclusion, from the Taxable Income Control Register (*Livro de Apuração do Lucro Real – "LALUR"*), of the amount of the net income resulting from the premium and its maintenance on specific profit reserve.

However, the premiums will be taxed if given different destination from the explained above, including in the events of: (i) capitalization of its value and subsequent capital reduction with reimbursement to shareholders, (ii) capital reduction with reimbursement to members within 5 years before the issue of debenture premiums and subsequent capitalization of its value; and (iii) integration of debenture premiums into the calculation of the mandatory dividends. In the first two cases, the tax incidence will be the value refunded, limited to the amount of deductions arising from debenture premiums.

The subsidies to investments and donations are also not taxed, since they observe the same procedures applicable to the debenture premiums and the retained net profit in the corresponding reserve, to the extent of the net income. If the company assesses, in the period, less accounting loss or net income than the portion of revenue from subsidies to investments and donations booked in income, the company cannot

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constitute the reserve, which, therefore, shall be constituted in subsequent years.

It should be noted that IN has not brought innovations in relation to fiscal neutrality of the debentures premiums and subsidies to investment and donations, referred to Articles 18 and 19 of Law No. 11,941/09.

III – EQUITY ACCOUNTING METHOD

For RTT purposes, under article 15 of mentioned IN, the relevant investments (in associated and controlled companies) of the legal entity will be valued at equity value, through the equity accounting method (*Método de Equivalência Patrimonial – "MEP"*), pursuant to article 248 of Law no. 6,404/76 in its wording in force on December 31, 2007.

Thus, the definition of "relevant investment", "associated" and "controlled company" must be extracted, respectively, from Articles 247, 243, § 1, and 243, § 2, of Law no. 6,404/76 in effect on December 31, 2007. In this sense, for RTT purposes, will be considered as associated a company that participates with 10% (ten percent) or more of the corporate capital of another, without controlling it, disregarding the "significant influence" currently in effect.

Under Article 16 and 17 of IN, the taxpayer, in each balance sheet, should evaluate the investment on associated and controlled companies, with information provided by them, through MEP, according to the accounting methods and criteria in force on December 31, 2007.

In the case of investment on company domiciled abroad or taxed on presumed or arbitrated profit, the IN determines that the investing company carries out the necessary adjustments in the balance sheet of the associated or controlled company in order to eliminate the relevant differences arising from the different accounting criteria.

It is possible to note, regarding associated and controlled companies abroad, an inconsistency with the provisions of IN no. 213/02, which regulates the taxation of profits, income and capital gains earned abroad by corporations domiciled in Brazil. Indeed, Article 6 states that the financial statements of subsidiaries, branches,

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controlled or associated companies abroad will be prepared according to the standards of commercial legislation of the country of domicile. Only in the absence of such rules the Brazilian law would be applied. Still, the IN no. 213/02 provides that, after translated and converted into Brazilian Reais, the accounts should be classified according to the rules of Brazilian commercial law and used in order to assess the taxable income and the basis of social contribution.

Hence, there are two rules issued by RFB which deliver conflicting guidelines about the same situation: on one hand, IN no. 1,397/13 provides that the value of the equity of the investee is determined according to the rules in force on December 31, 2007. On the other hand, IN 213/02 provides that the investees' financial statements are prepared in accordance with standards of commercial legislation of the country of domicile.

Notwithstanding, we believe that, since the IN 213/02 specially provides for the taxation of profits, income and capital gains earned abroad by corporations domiciled in Brazil, it should prevail over the provisions of IN 1,397/13.

IV – PRESUMED PROFIT

As for the presumed profit, IN came only reiterate the applicability of the RTT for companies opting for this system, which was already provided for in Article 20 of Law no. 11,941/09.

V – PIS AND COFINS

The IN also provides, for PIS and COFINS, that legal entities shall calculate their tax bases in accordance with the rules of each contribution and the use of methods and criteria in force at December 31, 2007, including for purposes of determining the credits on non-cumulative systematic.

In this sense, IN determines adjustments in the calculation bases of these contributions, which consist of adding or excluding revenue which taxation was, respectively, deferred from prior periods or later periods, resulting from the difference between accounting methods and criteria in relation to those applicable to tax laws.

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VI – FUNCTION, VALIDITY AND EFFECTIVENESS

Finally, due to the fact that normative instructions have merely interpretative character of legislation already in force (in this case, the law regarding RTT - Law no. 11,941/09 - although this is not the case of IN no. 1,379/13 which, in fact, usurped the role of the legislator), is possible that the Tax Authorities apply all provisions of IN from the enactment of Law 11.941/09. This understanding (though illegal), can be applied immediately, since the IN no. 1,397/13 took effect on the date of its publication.

Should you need any further information or clarification, please do not hesitate to contact us.

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