

MEMORANDUM TO CLIENTS

REGULATION OF TRANSITION TAX REGIME *VERSUS* COMPENSATION OF MEMBERS AND SHAREHOLDERS (DIVIDENDS E AND INTEREST ON NET EQUITY)

Date **09/19/2013**

On September 17, 2013, the Brazilian Federal Revenue (*Receita Federal do Brasil - "RFB"*) issued the Normative Instruction (*Instrução Normativa - "IN"*) n. 1,397/13, which provides for the Transition Tax Regime (*Regime Tributário de Transição - "RTT"*) established by Articles 15 and following of Law 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. 1,397/2013 aims to regulate many controversial issues involving the RTT, among which stand out the dividends and interest on net equity (*Juros sobre o Capital Próprio - "JCP"*), which therefore will be analyzed on the possible tax consequences and illegalities.

At first, we emphasize that this IN establishes the Tax Bookkeeping (*Escrituração Contábil Fiscal - "ECF"*) 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, 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.

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.

I – DIVIDENDS

Specifically on dividends, Article 26 of IN No. 1.397/2013 establishes that profits and dividends paid or credited by corporations taxed according to the taxable income system (*Lucro Real*) will not be included in the taxable basis of the Corporate Income Tax (*IRPJ*), the Social Contribution on Net Income (*CSLL*) and the Individual Income Tax (*IRPF*) of the beneficiary entity or individual, but also determines that those profits and dividends are those obtained “*within the methods and criteria in effect on December 31, 2007.*”

This ruling is in line with the one issued by the Attorney General of the Treasury (*Procuradoria-Geral da Fazenda Nacional - “PGFN”*) in Normative Opinion/PGFN/CAT/no. 202, of January 7, 2013, when that body issued guidance that, to achieve tax neutrality, the excess of dividends paid as compared to the taxable profits are liable to tax.

Thus, according to Article 28 of the IN, the amount of profits and dividends that exceeds those calculated according to the ECF should be taxed as follows:

- **Individuals:** withholding tax calculated according to the Monthly Progressive Table as an advance of the tax due in the Annual Adjustment;
- **Resident Corporations:** the amount should be included in the calculation basis of the Corporate Income Tax (*IRPJ*), the Social Contribution on Net Income (*CSLL*), but there is no mention of withholding;
- **Non-Resident Investors:** withholding tax of 15%;
- **Non-Resident Investors, Domiciled in Tax Favorable Jurisdiction:** withholding tax of 25%.

Therefore, if the dividends declared and distributed according to the new accounting rules introduced by Law No. 11,638/07 and 11,941/09 outweigh the dividends calculated in accordance to the ECF, the differences paid to the shareholder (individuals or non-resident investors) will be subject to withholding tax, or will be taxed by *IRPJ* and *CSLL* in the case of a legal entity domiciled in Brazil.

The purpose of this memo, exclusively created for the clients of this Firm, is to inform them on the major legal changes and news. ²
Should there be any questions, our attorneys will be fully available for any further clarification.

It is important to note that the mentioned IN is illegal because the Articles 16 and 21 of Law No. 11,941/09, which deal with the fiscal neutrality of RTT, only refer to the neutrality of accounting changes relating to the revenue, costs and expenses, for tax purposes. The referred legal provision do not claim that the dividends should be calculated according to the accounting methods of December 31, 2007.

Therefore, the IN has abandoned the concept of dividends foreseen in the commercial Law and created a kind of “fiscal dividend” without any legal basis. The dividends, however, for tax purposes, have always been calculated based on net income in accordance with commercial legislation, including for the purposes of the tax exemption provided in Article 10 of Law No. 9,249/95. For this reason, the dividends are calculated based on corporate law concepts, which cannot be changed by the tax law for the purpose of collecting taxes, mainly through a IN.

Thus, we believe that the mentioned IN overstepped the limits of the provisions relating to the RTT under Law No. 11,941/09, by forcing taxpayers to calculate dividends based on the accounting criteria of December 31, 2007, which may be subject to challenge by taxpayers.

For the companies subject to the Presumed Profit (*Lucro Presumido*) method, the Article 27 of the IN No. 1,397/13 restricts the exempt dividends to the amount of the IRPJ calculated in accordance with the profit presumed method, diminished of all taxes and contributions which the company is subject to.

If the company intends to distribute the surplus profits of the IRPJ presumed tax basis, the taxpayers must maintain accounting statements showing that the profits is greater than the profit determined under the presumed profit rules. These accounting statements, however, must be the EFC, which adopts the effective methods and criteria on December 31, 2007. In other words, even if the company subject to the presumed profit method earns profits in an amount greater than calculated in presumed profit method, the company only may distribute the exempt dividends up to the amount of profit calculated according to the accounting criteria on December 31, 2007, which can also be subject to questioning by taxpayers.

II – INTEREST ON NET EQUITY (JCP)

According to the Article 14 of the IN no. 1,397/13, the legal entities may deduct from the IRPJ and CSLL tax basis the JCP paid to the partner or shareholder, taking into account the equity calculated according to accounting methods and criteria in effect on December 31, 2007.

However, as mentioned above regarding dividends, the IN is illegal in this aspect, since the Articles 16 and 21 of Law no. 11,941/09, which deal with the fiscal neutrality of RTT, only refer to the neutrality of accounting changes relating to revenues, costs and expenses, for tax purposes. That means, the referred legal provision do not claim that the equity should be calculated according to the accounting methods of December 31, 2007, as foreseen in the IN.

Furthermore, it is important to note that the Law No. 11,941/09, in Article 59, ruled that the JCP should be calculated based on the equity accounts, except the equity valuation adjustments account, which was introduced by the new accounting rules. That is, if the Law intended that JCP should be calculated based on the accounting criteria of December 31, 2007, it should have expressly done so, as compared to the equity valuation adjustments account.

In addition, it is worth remembering that the rules on the deductibility of JCP are based on concepts from corporate law (*e.g.*, equity and net income), which cannot be changed by the tax law for tax enforcement purposes. This means that there is only one net income and only one equity for tax purposes. Indeed, although the IN No. 1,397/13 is silent regarding the concept of profit, capital reserve and retained earnings, to which the JCP payments are limited (under Article 9, § 1, of Law 9,249/95), we emphasize that these elements should be considered based on commercial law, for the reasons already given.

Therefore, we understand that mentioned IN overstepped the limits regarding RTT provisions, as provided by Law 11,941/09, due to the requirement of calculating JCP based on equity accounts according to the accounting criteria as of December 31, 2007. There is also the possibility that these changes cause an increase of taxes, which could not have been done by an IN and, therefore, may be challenged by the taxpayers.

III – 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), it is possible that Tax Authorities understand that dividends and JCP calculated from the enactment of Law No. 11,941/09 should have been ascertained according to the methods and criteria in force as of December 31, 2007. This understanding (though illegal), can be applied immediately, since the IN No. 1,397/13 took effect on the date of its publication.

Given that, specifically concerning dividends, we emphasize that, if the entity does not promote (or did not promote) withholding, the beneficiary, after the calendar year is closed, will be liable for taxes on the amount received and may suffer a tax assessment if he does not offer (or did not offer) the “surplus” dividends to taxation, under Normative Opinion/PGFN/CAT/No. 202.

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

SOUZA, SCHNEIDER, PUGLIESE E SZTOKFISZ ADVOGADOS.

E-mail: ssplaw@ssplaw.com.br

Rua Cincinato Braga, 340, – 9º andar
São Paulo/SP - Tel. (55 11) 3201-7550

Brasília Shopping – SCN Quadra 5, Bloco A - Torre Sul – 14º andar – Sala 1406
Brasília/DF - Tel. (55 61) 3252-6153

The purpose of this memo, exclusively created for the clients of this Firm, is to inform them on the major legal changes and news. **5**
Should there be any questions, our attorneys will be fully available for any further clarification.