Tax Bulletin of the Administrative Council of Tax Appeals

specific tax report

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Newsletter no. 65 – Year VI – August/2013

Dear Readers:

In this 65th edition of our Tax Bulletin of the Administrative Council of Tax Appeals ("CARF"), we will comment on a decision in which the CARF accepted the deductibility of expenses with amortization of premium deriving from the takeover of companies integrating the same economic group.

We also examined a decision in which the Superior Chamber of Tax Appeals ("CSRF") ruled that only an unjustified opposition by the Tax Authorities relative to the use of credits of the Tax on Manufactured Products ("IPI") leads to the monetary adjustment by the SELIC rate.

Enjoy your reading.

Internal Premium – Deductibility

"CORPORATE TAKEOVER. AMORTIZATION OF PREMIUM. ARTICLES 7 AND 8 OF LAW NO. 9,532/97. TAX PLANNING NOT TO BE OPPOSED AGAINST THE TAX AUTHORITIES. NON-OCCURRENCE. The performance of corporate restructuring through an operating company does not result in a different tax economy from the one to be obtained without using an operating company and may, therefore, not be qualified as having a tax planning opposable against the Tax Authorities. The "abuse of right" presupposes that the right was exercised to the detriment of the right of third parties, and may not be invoked if the purpose of using an operating company, exposed and approved by the regulating authorities, was to protect rights (minority shareholders), and not violate them. As there was no excess in terms of tax law -since the tax result obtained would be the same if an operating company had been used- nor in terms of corporate law -since an operating company was used exactly for protecting the minority shareholders- the practiced acts may not be considered and the premium amortizations may not be rejected."

The present case deals with Tax Assessments relative to the Corporate

Income Tax ("IRPJ") and to the Social Contribution on the Net Income ("CSLL") of the calculation periods of 2005 to 2009. The assessment arises from the rejection of expense deducted by the taxpayer related to the tax amortization of premium that was allegedly generated "intra-group" and would therefore be nondeductible.

According to the Tax Auditors, this deduction unduly deducted the tax bases and made the payment of the monthly estimates insufficient, and also led to the undue offsetting of the negative basis of the CSLL.

The operation that resulted in the premium can be summarized as follows:

Company "A" was the parent company of companies "B" (recently organized) and "C". The latter, in turn, controlled company "D" (the Taxpayer), which had an assessment report of future profitability issued by an independent company, prepared at the request of company "A".

Company "B" increased its capital, which was paid up by "A" with shares from company "C".

Later, company "C" reduced its capital in the amount of its ownership interest in company "D" and then gave this interest to "B".

Lastly, "D" took over company "B", its former parent company, leading to the deductibility of the premium.

When examining the formation of the premium, the Tax Authorities took into account the assessment report on the market value, based on the expectancy of future earnings of company "D", as well as the documentation relative to the succession of the corporate acts described above. As a result of these analyses, the Tax Authorities concluded that (i) the corporate alterations involved companies of the same economic group, subjected to a single command and with the purpose of separating the financial activities; (ii) an internal premium had been created and that there was no receipt of the payment related to the respective operation (takeover of "B" by "D"); (iii) an operating company had been used (herein company "B") whose single purpose was to generate a tax benefit to the creators, with the formation of a book premium.

Lastly, the Tax Authorities invoked article 20 of Law-Decree no. 1,598/1977 and article 7 of Law no. 9,532/1997, under the claim that this legislation conditions the right to the premium and to the respective amortization to the existence of a "*free negotiation among the parties and that the investor justified and provide the basis for the payment of the premium on part or the entire capital of the invested company*".

In an Objection made on the merits, the Taxpayer claimed, in sum, that unlike what was claimed by Tax Authorities, the operations had a business purpose and did not solely seek a tax benefit.

Such operations, according to the Taxpayer, fit into the worldwide context of separating industrial and financial activities of the economic group into two large areas, with a view to improve the management of the financial transactions and prepare the global sale of share control, which happened in 2006.

The Taxpayer also pointed out that identical operations also occurred outside the country, all of which caused by legitimate business and economic reasons, these being prior to and independent from the tax effects. Furthermore, due to requirements related to the US market, the operations should maintain the arm's length conditions. Therefore, the operations described earlier should be carried out at fair market value, as if the companies involved were not related. For this reason, the group was supposed to accept the report issued by the independent companies on the assessment of the Taxpayer's fair market value. It also stated that the price of the takeover had been duly paid to company "D", according to the transfer receipt attached to the case records.

The Taxpayer affirmed that the choice for using the challenged operating company (company "B") occurred, among other possible reasons, in order to preserve the registration of foreign capital with the Central Bank of Brazil, and was also subject of previous analysis by the latter. According to the Taxpayer, this situation demonstrates the lack of feasibility of the Tax Authorities' arguments that the claimed operating company had been created with the sole purpose of allowing the premium amortization.

The Taxpayer further explained that there were studies on alternative means for carrying out the operations in question, in order to separate the financial from industrial activities. It mentioned the possibility of performing the operation by way of capital reduction, with the delivery of shares at market value (arm's length). However, Central Bank's Circular no. 2,997, of 08/16/2000, was in force, which determined the cancelation of part of the Registration of Direct Foreign Investment ("RDEIED"), in case of capital reduction with the delivery of ownership interest to a foreign partner. In addition, the accumulated devaluation of the real against the foreign currency rendered this alternative impossible.

Due to this, the option to use company "B" would enable the preservation of the RDEIED value and would also comply with Resolution of the National Monetary Council no. 3,040, of 11/28/2002, which required the intermediation of a holding company between Brazilian financial institutions and their parent companies that were not organized as financial institutions abroad.

The Taxpayer reaffirmed that the Central Bank of Brazil was consulted previously on all the transactions, including on the formation of a company denominated operating company ("B"), which occurred for business purposes, so as to avoid inefficiencies, expenses and harmful costs.

It further claimed that, although there was no law requiring corporate and extra-tax reasons for the validation of the legal transactions, the Taxpayer's operations occurred for legitimate corporate purposes that preceded the possible tax effects (premium), so their validity should be recognized. Therefore the claims of the Tax Authorities that they had occurred with the exclusive intention of creating premium amortization expenses should be disregarded.

When hearing the Objection, the Federal Revenue Judgment Office ("DRJ") ruled in favor of the assessment. It pointed out that the assessment did not challenge the formal validity of the acts practiced, but rather the deductibility of the premium amortization expense. According to the DRJ, what is challenged is not the veracity of the reasons that led to the separation of the Taxpayer's activity on a global level, but that the premium suppositions were not evidenced, which would be the acquisition of ownership interest and the economic basis.

The Taxpayer, due to the DRJ's refusal to recognize the validity of the arguments in the Objection, then filed a Voluntary Appeal to the CARF, repeating the arguments already presented.

In the opinion rendered by the Reporting Councilor, after dealing with the preliminary issues, he limited the analysis to the possibility of existence of an "internal premium", that is, the premium generated in operations among companies of the same economic group.

The Reporting Councilor states that the CARF's precedents that rejected the "internal premium" were based on the doctrine and on the position of the Brazilian SEC, which condition the existence of premium to the presence of independent and not related parties, as well as on the effective payment of the price of the legal transaction.

Based on the doctrine and on the reference legislation (articles 7 and 8 of Law no. 9,532/1977, article 20 of Law-Decree no. 1,598/1977 and article 385 of RIR/99), the Reporting Councilor claimed that the tax legislation did not contemplate the accounting requirement of carrying out the legal transaction with third parties that are not related, meaning that the internal premium should not be rejected. Therefore, according to the Councilor, only the presence of abuse of right would be able to prevent the deductibility of the premium created among the group.

The Rapporteur then concluded that there was no abuse of right by the Taxpayer, since all the operations challenged in the Tax Assessment took place as stated. He affirmed that there were no simulated or dissimulated acts and that "*It does not seem legitimate to conclude that the mere intention of the Taxpayer acting in a manner so as to have a tax economy would invalidate the effects of the transactions, even I such effects had resulted in the creation of an internal premium, due to absolute lack of legal provisions for this conclusion*".

The Reporting Councilor also rejected the arguments of the appealed decision, that corporate operations would require the existence of an economic interest.

In this regard, he claimed that such events as takeovers are exclusively decided by the shareholders and do not depend on financial or economic motivation. He also mentioned a precedent of the CARF on this specific matter (Appellate Decision no. 1301-000.711).

Based on the above appellate decision, the Reporting Councilor also analyzed the legislative treatment of the premium. He mentioned that before the amendment brought by Law no. 9,532/1997, Law-Decree no. 1,598/77 considered the premium at the write-off of the investment through the takeover, merger, and spin-off as capital loss, which is fully deductible. When this Law came into force the deductibility of the premium became conditioned to takeover, merger, and spin-off events and subject to the monthly deduction limits of 1/60.

Thus, he concluded that both the Tax Assessment Notice and the appealed decision created requirements that do not exist in the tax laws when requiring an economic content that justifies the takeover, merger, and spin-off events.

Lastly, the Reporting Councilor stated that, although this is not a legal requirement for the premium deduction, the business purpose of the operations in question existed to the extent that the worldwide separation of the Taxpayer's financial and industrial activities was in progress, with the purpose of selling the latter. There was then a "*clear corporate context in the operations, and not only the predominantly tax content*". Furthermore, the previous analysis of the operations by the Central Bank of Brazil and the need to preserve the registration of foreign capital with the Bank justified the use of the alleged operating company (company "B"), so the Reporting Councilor recognized that its use was not limited to enabling the tax amortization of the premium.

Thus, by majority vote, the Taxpayer's appeal was granted, recognizing the deductibility premium amortization expenses as legitimate.

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IPI – Presumed Credit – Reimbursement – SELIC – Lack of State Opposition

"MATTER: TAX ON MANUFACTURED PRODUCTS - IPI
Calculation period: April 1, 1997 to June 30, 1997
PRESUMED IPI CREDIT. REIMBURSEMENT. ADJUSTMENT BY SELIC. LACK OF STATE OPPOSITION.
The opposition contained in the state act, whether administrative of normative, preventing the use of the right to IPI credit (deriving from the application of the constitutional principle of non-cumulativeness), disregards the mentioned credit as book credit (meaning that which is recorded by Taxpayers in their accounting records), so the adjustment for inflation is legitimate, under penalty of undue enrichment of the Tax Authorities (Analogical application of the precedent of the First Section subject to article 543C, of the Code of Civil

Procedure - CPC: REsp 1035847/RS, Rapporteur Justice Luiz Fux, judged on 06.24.2009, DJe 08.03.2009). If there is no unjustified state opposition, there is no adjustment of the IPI book-entry credits by the SELIC rate.
APPLICATION OF ARTICLE 62A OF RICARF. MATTER HEARD UNDER THE REPETITIVE APPEAL SYSTEM BY THE STJ.
Pursuant to article 62A of CARF's Internal Regulations, the final decisions on the merits, rendered by the Federal Supreme Court and by the Superior Court of Justice in infra-constitutional matters –under the system provided for in articles 543B and 543C of Law no. 5,869, dated January 11 1973, of the Code of Civil Procedure– are to be repeated by the Councilors in the trial of the appeals at CARF.
Special Appeal of the Prosecution Granted."

The present case deals with the possibility of adjusting the amounts contained in a request for reimbursement of IPI presumed credits by the SELIC rate.

In a Voluntary Appeal, the Second Chamber of the Second Taxpayers' Council granted the Taxpayer's claim, recognizing the right to adjustments for inflation of the credits object of the request for reimbursement, claiming, in sum, that reimbursement would be "*a kind of refund*".

Dissatisfied, the National Treasury then filed a Special Appeal with the CSRF, alleging that a refund and a reimbursement are two different things, and that there is no legal provision dealing with the application of the SELIC rate in reimbursement cases.

When examining the Special Appeal, the Reporting Councilor stated that the matter related to the adjustment of the reimbursement of presumed IPI credit by the SELIC rate has already heard by the Superior Court of Justice ("STJ"), under the system in article 543-C of the Code of Civil Procedure ("CPC"), that is, in what is termed the repetitive appeal system. This is Special Appeal no. 1.035.87/RS, reported by Justice Luiz Fux, tried on June 24, 2009.

The mentioned precedent recognizes that there is no adjustment for inflation on IPI book-entry credits. However, in case of an "*opposition in the state act, administrative or normative, preventing the use of the credit right arising from the application of the non-cumulative principle, the mentioned credit is not considered a book-entry credit*".

Thus, according to the STJ, this opposition to the use of credits would have the Taxpayer to resort to the Judiciary, leading to a delay in the exercise of the Taxpayer's right, therefore calling for the adjustment for inflation of the amounts, under penalty of undue enrichment of the Tax Authorities.

Based on this Precedent, the Reporting Councilor ruled for the application of article 62-A of the Internal Regulations of the Administrative Council of Tax Appeals ("RICARF"), with wording from MF Rule (*Portaria*) no. 586, of 12/21/2010.

Pursuant to the mentioned provision, in its judgments, the CARF should repeat the definitive decisions on the merits rendered by the Federal Supreme Court and by the STJ, under the systems provided for in articles 543-B and 543-C of the CPC.

However, in examining the case, it was verified that in fact there was no unjustified opposition by the Tax Authorities as to the exercise of the Taxpayer's right. It was also confirmed that the request for reimbursement of the IPI book-entry credits had been fully granted by the relevant authority.

Therefore, as there was no unjustified state opposition, there would be no right of adjustment for inflation of the IPI book-entry credits by the SELIC rate.

By majority vote, the CSRF then granted the Special Appeal filed by the National Treasury.

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