Tax Bulletin of the Administrative Council of Tax Appeals

specific tax report

SOUZA, SCHNEIDER, PUGLIESE e SZTOKFISZ ADVOGADOS

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Dear Readers:

In this 61st edition of our Tax Bulletin of the Administrative Council of Tax Appeals ("CARF"), we will comment on a decision which canceled the assessment notice based on the piercing of the corporate veil of a company abroad for the direct taxation on the income earned by its indirect subsidiaries abroad.

We also examined a decision in which the CARF considered that a fine is not applicable when it is proven that the tax debtor acted or paid the tax according to the interpretation provided by a final and unappealable administrative court decision rendered prior to the occurrence of the taxable events.

Enjoy your reading.

Profits abroad – Direct and Indirect Subsidiaries – Need to Consolidate Profits in the Direct Subsidiary

"MATTER: CORPORATE INCOME TAX - IRPJ

Calendar year: 2006

INDIRECT SUBSIDIARIES BASED ABROAD. TAXATION SYSTEM IN BRAZIL.

Income earned by way of another legal entity, in which a branch, office, subsidiary or associate company holds any type of ownership interest, albeit indirectly, is to be previously restated in the balance sheet of the branch, office, subsidiary or associate company for the purpose of determining the taxable income and tax basis of the CSLL of the beneficiary in Brazil.

PIERCING THE CORPORATE VEIL. LACK OF LEGAL REQUISITES.

Disregarding the recognition of a company as a separate legal entity with the purpose of reaching profits earned by their subsidiaries is undue, without evidence of the occurrence of any event provided for under the law (abuse of right, lack of substance of the company or occurrence of simulation or fraud).

PRESUMED TAXATION.

The decision rendered in the principal assessment applies to the ensuing CSLL assessment, in relation to the cause and effect ratio that binds them."

The Appellate Decision at issue deals with the taxation on the income earned by way of the direct and indirect subsidiaries abroad, for the collection of the Corporate Income ("IRPJ") and the Social Contribution on the Net Income ("CSLL").

This assessment notice was issued against the Assessed Company as the one having tax liability by succession, pursuant to article 132 of the National Tax Code ("CTN"), since it took over a company that held direct and indirect control of companies abroad. In fact, the entire taxed income of the Assessed Company had been earned by the merged company, through its Brazilian subsidiary and foreign subsidiaries.

Before the takeover of the companies by the Assessed Company, its corporate structure in Brazil was composed of two companies. One of them ("Brazilian Holding Company"), the company that was audited initially, held 100% ownership interest in the other company ("Brazilian Subsidiary").

Abroad, the Brazilian Subsidiary directly and fully controlled the company based in the UK. Furthermore, it held 59.3% ownership interest in the holding company located in Austria, a country that has entered into a Treaty to Avoid Double Taxation with Brazil. The other 40.7% of this holding company in Austria was held by the Brazilian Holding Company.

The Brazilian Holding Company also had the entire control of the companies in Italy and the Netherlands.

In turn, the Austrian Holding Company held the entire control of the companies based in Singapore, Madeira Island, and the Cayman Islands.

Therefore, the Brazilian Holding Company held direct control of the Brazilian Subsidiary, the Austrian Holding Company, and companies in the Netherlands and Italy. As to the companies based in the UK, Singapore, Madeira Island, and the Cayman Islands, it held indirect control.

The Brazilian Subsidiary, in turn, held control only of the company based in the UK. After it was taken over by the Brazilian Holding Company, it then held direct control of this company.

Following the audit process, the Tax Authorities decided to disregard the recognition of the Austrian Holding as a separate legal entity and add the profits of the companies based in Singapore, Madeira Island, and the Cayman Islands directly to the net income of the Assessed Company.

In addition, the Tax Authorities determined the direct taxation of the income earned by the UK company, disregarding the existence of the Brazilian Subsidiary.

The Auditors based their assessment notice on article 74 of Provisional Measure no. 2,158-35/2001, viewing that the profits earned by subsidiaries abroad, whether direct or indirect subsidiaries, would be considered available on the date they are computed and should be added to the profits and loss of its holding company.

The Assessed company reacted against this Tax Assessment Notice filing an Objection, claiming that the taxation on the profits earned by the indirect subsidiaries of the Austrian Holding should not be levied thereon but on the Brazilian Holding Company and Brazilian Subsidiary, which at the time of the audited period, had not been taken over by the Assessed Company yet. In fact, the Tax Authorities used the accounting records of the Brazilian Holding Company and consolidated all the profits and losses of the group, without respecting the independence of each company of the group.

Moreover, there wouldn't be any legal provision authorizing the piercing of the Brazilian Subsidiary's veil, which would imply the nullity of the assessment due to lack of motives.

For these reasons, according to the Assessed Company, the tax assessment would contain an error in the identification of the debtor of the tax liability.

In addition to the core issue of the argument, the Assessed Company claimed the Auditors violated Normative Rule (IN) no. 213/02, which regulated article 74 of MP no. 2,158-35/01. This is because the IN provided in its article 1, § 6, that the profits of the indirect subsidiaries abroad are to be consolidated in the balance sheet of the direct subsidiary. This income ascertainment method of indirect subsidiaries is called *vertical consolidation* by the Assessed Company, as opposed to *horizontal consolidation*, applicable to direct subsidiaries, pursuant to article 1, § 5 of IN no. 213/02.

Thus, the IN expressly determines the income to be consolidated and only later should the taxpayers recognize the income, including it in the tax bases of the IRPJ and CSLL, as set forth in article 7 of IN no. 213/02.

The Assessed Company therefore correctly computed its income through the consolidation of the profits and losses of the indirect subsidiaries in the direct subsidiary and only after that did it recognize the taxable income. Therefore, as the Tax Authorities were not complying with the legislation in force, the assessment was illegal.

Furthermore, according to the Assessed Company, the Tax Authorities had failed to provide the grounds for disregarding the recognition of the Austrian Holding as a separate legal entity – not even based on article 116 of the CTN. Such lack of grounds would make it impossible to have a direct taxation on the income of the Assessed Company earned by the indirect subsidiaries.

In examining the Objection, the Federal Revenue Judgment Office ("DRJ") granted it based on the tax debtor identification error and on the definition of the taxable matter, i.e., in the disregard of the recognition of the Brazilian Subsidiary and Austrian Holding as separate legal entities.

The reason is that the Austrian Holding's profits should have been recorded proportionally in the Brazilian Holding Company and in the Brazilian Subsidiary, which held ownership interest of 40.7% and 59.3%, respectively, thereon.

Therefore, the taxpayer would not only be the Brazilian Holding Company, but also the Brazilian Subsidiary. Despite the correction of the inclusion of the Assessed Company in the assessment as the liable party, this does not rule out the assessment's error regarding the identification of the tax debtors, and thus the ascertainment of the taxes, which led to the violation of article 1, § 6, of IN no. 213/02.

In addition, the DRJ considered that the Tax Authorities failed to respect the *vertical consolidation* method of the profits earned by the subsidiaries abroad, brought by articles 1, § 6, and 7 of IN no. 213/02.

In fact, the profits of the indirect subsidiaries should have been recorded in the equity of the Austrian Holding (which had direct control thereon), and only later would there be the taxation on its income in Brazil.

Moreover, the Auditors had no grounds to pierce the corporate veil of the Austrian Holding and the Brazilian Subsidiary. As no error was verified in the formation of these companies, the *vertical consolidation* (article 1, § 6, of IN no. 213/02) and *horizontal consolidation* (article 1, § 5, of IN no. 213/02) methods should not have been ruled out.

It was then proven that there was an error in the identification of the taxable matter, which made the assessment defective. Because of this, the DRJ then granted the Objection.

In an Appeal, the CARF upheld the Decision of the DRJ by its own grounds.

SOUZA, SCHNEIDER, PUGLIESE AND SZTOKFISZ ADVOGADOS law firm is available to its clients should they have any questions on the above decision.

Voluntary Fine – Article 80 of Law no. 4,502/64 – Procedure in Compliance with Final and Unappealable Administrative Court Decisions

"FINAL AND UNAPPEALABLE ADMINISTRATIVE COURT DECISION. VOLUNTARY FINE. NON-APPLICABLE.
In the formation of IPI tax credits, the fine provided for in article 80 of Law no. 4,502, dated 1964, does not apply when it is proven that the tax debtor has acted or paid the tax in compliance with the tax interpretation contained in the final and unappealable administrative court decision, rendered prior to the occurrence of the taxable events."

The case in question deals with Tax Assessment Notices aimed at the collection of amounts in connection with the tax on manufactured products ("IPI"), related to the periods between October 2002 and December 2006.

In fact, the Tax Authorities challenged the IPI credits computed by the Taxpayer arising from acquisitions of tax-exempt input of a legal entity established in the Manaus Free Trade Zone. This ascertainment was made based on Writs of Mandamus filed by the Taxpayer in order to ensure his credit right.

The Tax Assessment Notices were opposed by the Taxpayer, who claimed, in sum, that the matter relative to the right to the IPI credit arising from the acquisition of input in tax-exempt transactions has already been consolidated in the case laws of the Federal Supreme Court ("STF"), whose leading case was Extraordinary Appeal (RE) 212.484-2, so the tax collection should therefore be cancelled, by force of the provisions in article 1 of Decree no. 2,346/97.

Furthermore, the Taxpayer also claimed that the imposition of the fine contained in article 80, item I, of Law no. 4,502/64, with wording provided by article 45 of Law no. 9,430/96, did not apply, since he had acted in accordance with the position of the last tier of the administrative court on the matter, meaning the event set out in article 486 of the IPI Regulation, approved by Decree no. 4,544/02 (article 459 of RIPI/98), was verified, whose legal origin is article 76 of Law no. 4,502/64.

After the Federal Revenue Judgment Office determined an investigation in order to verify any error in the ascertainment of the tax credit stated in the Tax Assessment Notices, it upheld the assessment, reducing the tax credit amount according to the outcome of the investigation.

Dissatisfied with that, the Taxpayer then filed a Voluntary Appeal, repeating the arguments presented in the Objection, quoting decisions of the Super Chamber of Tax Appeals that contained a position in line with the procedures adopted by the Taxpayer in relation to the IPI credits arising from the acquisition of exempt input.

In issuing her opinion, the Reporting Councilor verified that in the appellate decisions mentioned by the Taxpayer in the Appeal, the court had actually dismissed the Special Appeal of the Attorney General of the National Treasury Office and upheld the application of the STF's position that it would be legitimate for the IPI taxpayer to receive the amount relative to the tax in the acquisitions of input under the tax-exemption system.

Therefore, based on article 486 of the IPI Regulation, the Reporting Councilor decided to cancel the voluntary fine provided for in article 80 of Law no. 4,502/64, for the periods in which it was proven that the Taxpayer had acted or paid the tax according to the tax interpretation contained in the final and unappealable administrative court decision, handed down prior to the occurrence of the taxable events.

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Team responsible for preparing the **Tax Bulletin of the Administrative Taxpayers' Council of Tax Appeals**:

Igor Nascimento de Souza
(igor@ssplaw.com.br)

Henrique Philip Schneider
(philip@ssplaw.com.br)

Eduardo Pugliese Pincelli
(eduardo@ssplaw.com.br)

Cassio Sztokfisz
(cassio@ssplaw.com.br)

Fernanda Donnabella Camano de Souza
(fernanda@ssplaw.com.br)

Diogo de Andrade Figueiredo
(diogo@ssplaw.com.br)

Flávio Eduardo Carvalho
(flavio@ssplaw.com.br)

Wilson Rodrigo Vieira da Silva
(wilson@ssplaw.com.br)

Rafael Monteiro Barreto
(rafael@ssplaw.com.br)

Sidney Kawamura Longo
(sidney@ssplaw.com.br)

Rafael Fukuji Watanabe
(rwatanabe@ssplaw.com.br)

Rodrigo Tosto Lascala
(rodrigo@ssplaw.com.br)

Laura Benini Candido
(laura@ssplaw.com.br)

Marina Lee
(marina@ssplaw.com.br)

Pedro Lucas Alves Brito
(pbrito@ssplaw.com.br)

Ana Paula Caldin da Silva
(acaldin@ssplaw.com.br)

Viviane Faulhaber Dutra
(viviane@ssplaw.com.br)

Tiago Camargo Thomé Maya Monteiro
(tiago@ssplaw.com.br)

Flavia Gehlen Frosi
(flavia@ssplaw.com.br)

Rua Cincinato Braga, 340, – 9 andar
São Paulo/SP – Phone: (55 11) 3201-7550

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