TAX BULLETIN

THE ADMINISTRATIVE COUNCIL OF TAX APPEALS

84

Specific tax report nº 84 • Year VII • March 2015

Dear Readers:

This publication **Tax Bulletin # The Administrative Council of Tax Appeals** is to inform our clients and interested parties on the main issues being discussed and decided in this court.

In this 84th edition of our newsletter, we will comment on the decision in which the Administrative Council of Tax Appeals (Conselho Administrativo de Recursos Fiscais, CARF) canceled the tax assessment related to IRPJ (Corporate Income Tax) and CSLL (Social Contribution on Net Earnings), since it understands that the corporate reorganization undertaken by the company has not occurred solely for tax savings purposes.

We also examined a decision in which CARF canceled an action for recovery of the Social Security Contributions on amounts paid on the purchase of shares resulting of a Stock Option Plan, understanding that this transaction includes no consideration for the work, representing only business within the civil and corporate scopes.

Click over the topics below to directly access each text:

Corporate Income Tax (IRPJ) and Social Contribution on Net Earnings (CSLL) – Corporate Reorganization – Business Concentration – Business Purpose

Stock Option Plans ¬– Non-Compensation Nature – Inapplicability of Social Security Contributions

Souza, Schneider, Pugliese e Sztokfisz Advogados law firm is available to its clients should they have any questions on the decisions commented on in this newsletter.

Enjoy your reading!

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"Subject: Corporate Income Tax – IRPJ
Fiscal Year: 2007, 2008
CORPORATE REORGANIZATION. EXCLUSIVE TAX-RELATED MOTIVE NOT EVIDENCED. ABSENCE OF SIMULATION. POSSIBILITY OF ADOPTING A LESS BURDENSOME WAY. UNFOUNDED ENTRY.
The records evidence that the corporate reorganization carried out by the audited company was oriented primarily to concentrate its business in a single entity, and such reorganization has certainly occurred both de facto and de jure. Since the non-tax-related corporate motive is present; since no simulated or otherwise corrupted actions or business are in cause; and since multiple paths could lead to the intended outcome, we cannot rule out the one adopted by the taxpayer under the sole pretense of being the less burdensome one from the tax perspective."

The decision in question addresses the Assessment Notice issued to enforce the Corporate Income Tax ("IRPJ") and the Social Contribution on Net Earnings ("CSLL"), based on the claim of improper tax planning, characterized by the sole purpose of reducing the tax burden applicable to the earnings of investing companies.

In the case at hand, the corporate groups to which the Taxpayer belongs engaged in a corporate reorganization that initially consisted in changing the tax regime to the presumed profit method and in increasing the share capital of one of the companies in the group ("Company A"), resulting in the inclusion of the Taxpayer in the corporate structure of the latter. Immediately thereafter, three other companies in the group ("Companies B, C and D") were accepted as members, through capital subscription, paid by transferring corresponding assets to virtually all industrial campuses of such companies. Later, Companies B, C and D were absorbed by the Taxpayer, which became the majority owner of Company A's shares. In addition, the following year, after returning to the taxable income regime, Company A offset a portion of the calculated earnings by using tax losses and negative tax bases for the CSLL of previous periods.

When conducting the auditing procedure, the Tax Authority understood that the transfer of assets from Companies B, C and D during the reorganization would have been occurred artificially, since no business purpose other than tax savings was revealed. This is because Company A having opted for the presumed profit regime led to less burdensome taxation of the income of the investor companies – which opted for the taxable income regime. In addition, the reorganization allowed Company A to leverage amounts accrued as tax losses and negative basis, thus representing a mockery of the legal prohibition for the successor company to leverage tax losses of the former company, for, although this is not related to the "merger" legal form, the effects achieved are contrary to the spirit of the law.

Therefore, the Tax Authorities disregarded – for tax purposes – the corporate transactions conducted and arbitrarily defined the earnings of Companies B, C and D, allocating the revenues, costs and expenses of each one to the respective production campuses, as well as the offsetting disallowance done by Company A.

Challenging the Tax Authorities ruling, the Taxpayer, as the successor of the investing companies, claimed, among other arguments, the avoidance of the entry due to lack of legal support to back the assessment notice. In this regard, it stressed that the corporate reorganization had a business purpose, in that it was intended to concentrate production activity in a single legal entity, providing greater operating synergy and significant reduction of the costs incurred to maintain the previous structure.

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The Judgment Office of the Brazilian Federal Revenue Service ("DRJ") kept the understanding of the Tax Authority and partially upheld the Challenge, only to recognize the possibility of deducting the amounts paid during the reference period and the expiration of the Treasury right to enforce CSLL tax credits required of one of the investing companies.

When considering the issue, the Administrative Council of Tax Appeals ("CARF") acknowledged the legitimacy of the tax planning carried out, understanding that the concentration of activities has occurred in fact, not only de jure, and that the operation did not have solely the taxation reduction purpose. In this regard, the Reporting Board Member asserted that "if multiple paths led to the same outcome" it would be inappropriate to demand that the corporate group adopted the more burdensome option from the tax perspective.

Thus, CARF has dismissed, by unanimous vote, the Ex-Officio Appeal and upheld the Voluntary Appeal to cancel the tax credit entry.

"SUBJECT: SOCIAL SECURITY CONTRIBUTIONS
Fiscal Year: 2006, 2007, 2008
STOCK OPTION PLANS. STOCK OPTION PLANS WITHOUT THE FINANCIAL PARTICIPATION OF THE EMPLOYER. NON-COMPENSATION NATURE. NON-APPLICABILITY OF SOCIAL SECURITY CONTRIBUTIONS.
Employers' stock options provided to employees or officers without the financial support from the employers, for a market-representative price, are not considered compensation or a taxable event for social security contributions, since these represent simply a business transaction in the civil/corporate domain.
INDIRECT CALCULATION. CALCULATION BASIS ARBITRATION. DISREGARD OF A PRIVATE BUSINESS TRANSACTION. NEED FOR DEMONSTRATING THE CALCULATION GROUNDS AND CRITERIA. MATERIAL FAULT. REVOCATION.
The issue at hand is the indirect calculation or arbitration of the calculation basis when the Tax Authority resorts to fiction or assumption of the taxable event, applicable only when the documentation produced is not trustworthy or when it is difficult to obtain. Further, the application of the legal rule authorizing such calculation methods – articles 148 of the National Tax Code (CTN), and Article 33, §6, of Act No. 8212/1991 – should be further indicated and supported. Tax Authority's contempt for such requirements, generating material faults of the credit determination action and revocation thereof.
Voluntary Appeal Upheld – Tax Credit Dismissed"

The decision in question addresses an Assessment Notice issued for the collection of Social Security Contributions on amounts paid on the purchase of shares through a Stock Option Plan.

Generally speaking, the Auditors concluded that every purchase of shares under a Stock Option Plan is characterized as compensation and integrates the wage subject to contributions (Social Security Contribution calculation basis.)

The Taxpayer filed a Challenge, which was dismissed by the Judgment Office of the Brazilian Federal Revenue Service ("DRJ"). Rejecting the decision, the Taxpayer filed a Voluntary Appeal with CARF, which, after reviewing in detail the taxation involving stock option plans and the case at hand, decided by majority vote to cancel the assessment notice.

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The Reporting Board Member began his vote by identifying the circumstances for applicability of social security contributions, and understood that these would apply to amounts paid in consideration for the work and/or for activities conducted on own account.

Continuing his vote, the Reporting Board Member established the difference between the “classic” Stock Option Plans and the “Phantom” Stock Options. Drawing on a legal theory article, the Reporting Board Member stated that, for the “Classic” Stock Option Plan, the company grants an employee the option to purchase a certain number of shares at a predefined price, conditioning the exercise of the option to the lapse of a particular share maturity period. After this period, the beneficiary may exercise the option to purchase the shares – through a sale agreement – at the price originally offered and evaluate the best moment to sell these. On the other hand, under the “Phantom” Stock Option Plan, the option to purchase the shares is not exercised by actually purchasing the shares. In this second method, the company pays to the employee the difference between the market value of the shares and the grant value, anticipating the potential resale by the participant. According to the Reporting Board Member, the amount paid by the company as a result of the “Phantom” Stock Option Plan is generally regarded as compensation.

After this comparison, the Reporting Board Member found that the case consisted of a classic stock option plan, since the cost of buying all shares was supported by the buyer (company employee/officer), whose value was obtained from an average of the last three share prices in the Stock Exchange prior to the execution of the option agreement. In addition, the Reporting Board Member stated that the company has not contributed with any amounts so that the beneficiaries could purchase such shares – it has just allowed the purchase thereof without the involvement of a Stock Exchange, introducing an opportunity for the concerned individual to invest in the company; further, the beneficiary accepted the risk of devaluation of the shares in the market at the moment of the sale.

Thus, the Reporting Board Member concluded that, since the purchase price assigned to the options was not linked to the consideration for the beneficiary’s work, but rather to the price of shares at the Stock Exchange, evidencing the complete interdependence of these legal relations, thus the social security contributions would be inappropriate in the case at hand.

The Reporting Board Member has also dismissed the Auditing Authority claims that the stock option plans would, further, be irregular, since they were granted only a few employees, arguing that there are no rules governing the matter. He also added that the Stock Option Plans are regulated by the General Meeting and are intended to more senior employees, thus stimulating others to achieve such positions.

Closing his vote, the Reporting Board Member saw the impossibility of determining the social security contribution calculation basis based on the purchase price assigned to the options, since these represent – until the actual sale – only expected amounts, and the taxation of such expectation is allowed only as provided for in law, since this is a estimation. Since there is no such legal provision, the taxation as applied would lead to the revocation of the assessment due to lack of grounds. In fact, the Reporting Board Member added that, in the case at hand, the value of the shares at moments after the actual purchases was lower, which would reinforce the revocation.

Thus, by majority vote, the Members of the Judging Panel followed the Reporting Board Member, upholding the Voluntary Appeal to cancel the tax credit.

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