tax bulletin

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The Administrative Council of Tax Appeals

Specific tax report n° 104 • Year IX • November 2016

Dear Readers:

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

In this 104th issue of our note, we comment on a decision in which the Administrative Council of Tax Appeals (Conselho Administrativo de Recursos Fiscais - CARF) examined the difference between sham transactions with or without fraud for the purpose of imposition of increased fine, as well as a decision in which CARF decided that the profit of an indirect subsidiary should be directly added to the real profit and CSLL basis of the Brazilian entity.

To directly access the text referring to each of these topics, click on:

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

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"TAX PLANNING. SHAM TRANSACTION. INCONSISTENCY. TRANSACTION WITH GOODWILL.
Despite the taxpayer and its economic group not having carried out an illegal transaction legally characterized as such, there is evidence of incompatibility between the transactions performed and the one that could legally trigger goodwill, with actual increase of value that would represent an investment with expectation of future profitability, and this validates a reinterpretation of the events and the write-off of the amounts amortized.
INCREASED FINE. REINTERPRETATION OF EVENTS. SHAM TRANSACTION WITHOUT FRAUD.
The reinterpretation, by the Tax Administration, of the legal transaction carried out by the taxpayer characterizes it as a 'sham transaction', but not as a fraudulent one in the sense of malicious illicit act. For this reason, it is relevant to separate the concepts of 'fraudulent sham transaction' and 'non-fraudulent sham transaction'. Both allow tax agents to disregard the acts performed by the taxpayer for tax purposes, but only the former allows the imposition of an increased fine."

This decision concerns an Infraction Notice issued to charge Corporate Income Tax (*Imposto de Renda Pessoa Jurídica* - "IRPJ") and Social Contribution on Net Profit (*Contribuição Social sobre o Lucro Líquido* - "CSLL"), as well as increased fine, due to the alleged undue reduction of the calculation bases of such taxes because of the amortization of internal goodwill.

Tax Agents claimed that the goodwill, derived from transactions within the same economic group, was created "*without business purpose*". Based on that opinion, Tax Agents claimed there was a "sham transaction", disregarded the transactions and wrote off the amortization of goodwill, charging the IRPJ and CSLL not paid and imposing an increased fine of 150% on taxes.

In its Defense, the taxpayer claimed there was business purpose and refuted Tax Agent's claims that a vehicle-company had been used for the transactions and that there was no payment for the shares purchased. Moreover, the taxpayer claimed there was no sham or illicit act, so the increased fine did not apply.

The First-Instance Judgment Office (*Delegacia da Receita Federal do Brasil de Julgamento* – DRJ) denied relief to the taxpayer's claims, affirming the charge. A Voluntary Appeal was then filed and the case was tried by CARF, which granted partial relied to the appeal, reverting DRJ's decision only in what concerns the increased fine.

Initially, the reporting counselor understood the taxpayer has the right to carry out a corporate reorganization aiming to reduce the tax burden, provided that it is not an illicit act defined by legislation as such.

Based on this position, CARF stated that sections 71 to 73 of Law No. 4,502/64, adopted as grounds for the imposition of the increased fine, only apply to cases of tax evasion, fraud and colluding. Besides, it noted that criminal law provides specifically for illicit conducts in which the taxpayer uses deceptive acts to trick the Tax Administration, aiming to reduce the tax burden, as provided by section 1 of Law No. 4,729/65 and Law No. 8,137/90.

Hence, CARF understood that the mere purpose of avoiding or reducing the payment of taxes, when carried out through licit actions, does not suffice to trigger the imposition of increased fine. Concerning this matter, the definition of a "sham transaction" is different from the definition of fraud, since there could be a sham transaction with or without fraud, and only the former triggers the application of increased fine.

That court understood the Tax Administration has the right to reinterpret the legal constitution of the facts in order to verify whether there was a sham transaction, with or without fraud, in corporate transactions, considering the only paragraph of section 116 of the National Taxation Code. Such provision allows Tax Agents to "*disregard legal acts or deals carried out with the purpose of dissimulating the occurrence of the taxable event or the nature of the elements that are part of the tax obligation*".

Therefore, CARF understood there is "*the form of the transaction presented by the taxpayer*", which must reveal a licit content, and "*the form of the transaction interpreted by the Tax Administration*". Based on these perspectives, the Tax Administration is responsible for reviewing the transactions and deciding whether they are consistent. For this reason, CARF stated that "*the incompatibility between the actual facts and the situations chosen by the legal system concerning the constitution of the legal form of business deals or* [structures] *allows them to be disregarded for tax purposes*".

Based on this reasoning, the counselors considered there were features of a sham transaction in the case, but they did not consider the taxpayer committed a tax crime. In this situation, CARF understood that, although the act that triggered the amortization of goodwill did not actually occur, "*the records do not present any undoubtful proof of the will to deceive, that is, of the unquestionable intent to commit fraud, nor does it characterize any illicit act adopted by the taxpayer*". Therefore, the vote concludes that: "*Clothing the transaction with legal elements the taxpayer believes are allowed by law, without using illicit means or presenting a will to perform deceitful acts, cannot be penalized with an increased fine if tax agents reinterpret such transactions with the purpose of applying different tax effects*".

Based on the aforementioned, the Voluntary Appeal was partially granted, affirming the notice in regards to the taxes charged, and reducing the fine from 150% to 75%.

"NULLITY. REJECTION.
Since the first-instance decision did not present any innovation and Tax Agents did not violate rules concerning administrative acts, in particular IN (IRS) No. 213/2002, there is no nullity.
SUBJECT: CORPORATE INCOME TAX (IMPOSTO SOBRE A RENDA DE PESSOA JURÍDICA – IRPJ)
PROFITS EARNED BY A SUBSIDIARY ABROAD. AVAILABILITY.
For the purposes of computing IRPJ and CSLL calculation bases, profits earned by a subsidiary or affiliate company abroad are considered as being available to the parent company in Brazil on the date of the balance sheet in which they were assessed. This rule also applies when profits are earned by an indirect subsidiary situated in a country different than the one with which Brazil executed an international treaty. Charge affirmed."

The decision in point concerns an infraction notice issued to charge IRPJ and CSLL from a taxpayer that allegedly failed to add to real profit and to CSLL basis profits earned by an indirect subsidiary, situated in a jurisdiction with privileged tax regime.

Tax Agents claim that the company being charged controls another entity located in Spain. Such Spanish entity, in turn, controls another entity located in a jurisdiction with privileged tax regime. The latter entity earned profits in 2008, which were not added to the real profit computed by the Brazilian entity.

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Considering these facts, the Tax Administration considered the profits earned by the indirect subsidiary had to be added to real profit and CSLL basis, as set forth by section 74 of Provisory Law No. 2,158-35/2001, interpreted along with section 243, § 29, of Law No. 6,404/76.

In its administrative defense, the company claimed that the definition of subsidiary indeed encompasses indirect subsidiaries, as provided by Law No. 6,404/76. However, this does not mean that section 74 of Provisory Law No. 2,158-35/2001 establishes such addition to real profit and to CSLL basis shall occur at the time the indirect subsidiary assesses profits.

Following this reasoning, profits earned by the indirect subsidiary should firstly be consolidated in its parent company to then be added to the real profit and CSLL basis computed by the Brazilian entity. Moreover, in this situation, the profit earned by the direct subsidiary could not be taxed in Brazil due to the provision of article 7 of Treaty Brazil-Spain.

According to the taxpayer, admitting the availability of the indirect subsidiary's profits in the Brazilian company, without it passing through and being consolidated by the intermediate Spanish entity would mean the disregard to the legal personality of the latter, without legal grounds.

When examining the case, CARF understood Brazilian legislation brings no distinction between direct and indirect subsidiary. Therefore, in this case, if a Brazilian entity controls a Spanish entity, which, in turn, controls an entity situated in a jurisdiction with privileged tax regime, one should conclude the Brazilian entity controls the latter, so all effects inherent to such assumption apply.

Therefore, mentioning the STF's position, manifested in Action for Unconstitutionality No. 2,588/DF, which acknowledged the constitutionality of the taxation of the profit of a subsidiary situated in a jurisdiction with privileged tax regime at the moment it is assessed in its balance sheet, CARF understood the charge was legitimate in the case on point.

Concerning the claim of disregard to the Spanish entity's legal personality, it stated there was in fact the taxation, in Brazil, of profits earned the subsidiary situated in a jurisdiction with privileged tax regime, as authorized by Brazilian legislation. The validity of the existence and corporate structure was not even questioned, so it was not disregarded.

Furthermore, CARF understood the Treaty Brazil-Spain did not apply, since the addition of profit in the Brazilian entity refers directly to the company situated in a jurisdiction with privileged tax regime, irrespective of the Spanish entity.

For these reasons, CARF denied relief to the taxpayer's voluntary appeal and upheld the charges.

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