tax bulletin

96

The Administrative Council of Tax Appeals

Specific tax report n° 96 • Year VIII • March 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 96th edition of our newsletter, we will comment on a decision in which the Administrative Council of Tax Appeals ("CARF") ruled that the capital gain earned in share exchange operations without money involved, carried out between legal entities, is subject to taxation.

We also commented on a decision in which the Superior Chamber of Tax Appeals ("CSRF") heard a stock market demutualization case and upheld the assessment of the PIS and Cofins on the revenue earned by a securities and exchange brokerage firm upon disposal of shares of the stock exchange.

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

Exchange of Ownership Interest – Capital Gain – IRPJ and CSLL

Demutualization – PIS and Cofins – CSRF Decision

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.

Enjoy your reading!

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tax bulletin

96

The Administrative Council of Tax Appeals

Specific tax report n° 96 • Year VIII • March 2016

"EXCHANGE OF OWNERSHIP INTEREST. INCOME IN AMOUNT GREATER THAN AMOUNT PREVIOUSLY PAID. ASCERTAINMENT OF TAXABLE CAPITAL GAIN. POSSIBILITY.
In the event of exchange of ownership interest between legal entities, in which the amount received is superior to the one delivered, the ascertainment of taxable capital gain is applicable, unless where otherwise expressly provided for by the law."

The decision in question deals with a Tax Assessment Notice issued for the collection of the Corporate Income Tax ("IRPJ") and the Social Contribution on Net Income ("CSLL") charged on the alleged capital gain earned in an ownership interest exchange operation between legal entities.

In this particular case, an exchange agreement without any money consideration, was entered into between a company in the paper manufacture industry and another company in the pulp manufacture industry, in order to exchange investments held by such companies in subsidiaries ("Company A" and "Company B").

In addition, as defined in the exchange agreement, the Parent Company of Company B made a financial contribution in the subsidiary, the amount of which was delivered by the latter to a contracted company, by order of the Parent Company of Company A, for the construction of a plant to be delivered in exchange. Later, the parties definitively closed the exchange, amending their respective articles of incorporation.

When conducting audit procedures, the Tax Authorities sustained that the exchange operation resulted in capital gain to the Parent Company of Company A, to the extent that the business established between the parties would not correspond to an exchange, but to a purchase and sale, considering the existence of payment in cash, which corresponded to the largest portion of the consideration received by the assessed party, carried out through capital contribution in Company B. Furthermore, according to the Tax Authorities, there was an unquestionable equity increase of the Parent Company that received the shares of Company B in exchange, accompanied by the ascertainment of a discount by the Parent Company of Company B.

By virtue of this fact, a Tax Assessment Notice was issued to demand the IRPJ and CSLL on the capital gain allegedly obtained by the Parent Company of Company A with the exchange operation.

The Tax Assessment Notice was objected by the Taxpayer, who claimed, in sum, (i) the lack of payment of the price in cash, taking into account that the capital contribution made in Company B was exclusively intended for the construction of the plant of that company; (ii) the lack of availability of the funds invested in Company B, which de-characterizes the taxable event of the tax liability; and (iii) the existence of a business purpose for the performance of the exchange operation.

In examining the case, the Federal Revenue Judgment Office ("DRJ") accepted the objection, as it viewed that the de-characterization of the exchange agreement is not applicable, since the invested amount was unduly considered by the Tax Authorities as a repayment, and that the equity increase verified by the Auditors would be merely a potential gain, arising from the evaluation of the new investment by the net equity of the invested company, which would not integrate the taxable income of the Appellant. This decision led to the filing of an Ex-Officio Appeal before the CARF.

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In the analysis of the case, the 2nd Ordinary Panel of the 3rd Chamber of CARF's 1st Judgment Section, through a casting vote, partially granted the Ex-Officio Appeal, as it saw that the operation under analysis was one of exchange of ownership interest, and not of purchase and sale, which implied the ascertainment of taxable capital gain deriving from the overstated difference between the equity value of the ownership interest received and the value of the ownership interest given in exchange. In this regard, the Judgment Panel affirmed that the taxation of the capital gain in exchange operations could only be ruled out in the case of an exchange of real estate units, regulated by Normative Rule of the SRF no. 107/88. Moreover, the Judgment Panel ruled out the ex-officio fine, as it viewed that the existence of exchange simulation was not demonstrated, since the subject matter of the entered into business was proven.

Against this decision the Taxpayer then filed a Special Appeal with the CSRF, claiming that the legal transaction of exchange does not lead to an equity increase to the exchange parties, as it is the case of a mere exchange (substitution) of one asset for another, there being no capital gain involved.

When hearing the Special Appeal, the Rapporteur stated that there is no express legal provision ruling out the taxation of the capital gain earned in share exchange operations without any money consideration. The reason is that said transaction fits into the cases that represent equity increases, taxable by the IRPJ and by the CSLL. In addition, according to the Rapporteur, this conclusion is grounded on Opinion no. 1.722/2013, of the Attorney General Office of the National Treasury ("PGFN"), which ruled that the capital gain existing in operations involving the exchange of real estate assets is taxed.

Contrarily, in the explanation of vote, one of the Councilors stated that there is no law, strictly speaking, providing for the taxation or exemption of the exchange of shares without money consideration, and that there is legal equivalence of the installments, so that the revenue arising from the entrance of the received asset is necessarily neutralized by the cost or expense corresponding to the asset given in exchange. Along the same line, another member of the Council stated in the explanation of his vote that the equity increase under analysis exclusively derived from the recording of the investment by the Equity Method, which has no tax effects by express legal determination.

Thus, the CSRF, by majority vote, dismissed the Special Appeal of the Taxpayer, in order uphold the assessment of the tax credit against the assessed company. he proceeding in question addresses the tax treatment given to bonuses in kind, and the Tax Authorities issued tax assessment notices in order to require IRPJ, CSLL, PIS and COFINS credits from the Taxpayer for, among other accusations, its failure to add the bonuses in kind granted to its customers to its net income or for unduly deducting them from its gross revenue.

"MATTER: CONTRIBUTION FOR THE FUNDING OF THE SOCIAL SECURITY - COFINS
Date of taxable event: Oct. 31, 2007, Nov. 30, 2007
SECURITIES. RECORD. CURRENT ASSETS.
The available funds and the rights realizable within the subsequent fiscal year are classified in the current assets. The Bovespa Holding S/A and BM&F shares, received due to a transaction termed demutualization of the São Paulo Stock Exchange Bovespa and BM&F, which were traded within the same year, a few months after they were received, are to be recorded in the Current Assets.

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tax bulletin

96

The Administrative Council of Tax Appeals

Specific tax report n° 96 • Year VIII • March 2016

PIS AND COFINS. TAX BASIS. OPERATING GROSS REVENUE. SECURITIES BROKERAGE FIRM. SALE OF SHARES. DEMUTUALIZATION

For legal entities acting as a securities brokerage firm whose purpose is the subscription of shares, purchase and sale of shares, for its own account and for third parties, the tax basis of the social contributions is the operating revenue (Gross Revenue), typical revenues from the purchase and sale of shares of BM&F S.A. and Bovespa Holding S.A., received as a result of the corporate transactions termed 'demutualization'."

The decision in question addresses tax assessment notices issued for the formation and collection of credits of the Contributions to the Social Security Funding ("Cofins") and to the Employee Profit Distribution Program ("PIS") on the earned revenue, by a securities and exchange brokerage firm, at the disposal of Bovespa Holding S.A and BM&F S.A. shares earned from the demutualization process. According to the Tax Authorities, the shares received by the Taxpayer should be recorded in their current assets and not in the permanent assets, meaning the disposal revenue is not supported by article 3, § 2, IV, of Law no. 9.718/1998, which excluded the revenue deriving from the disposal of assets of the permanent assets from the tax basis of the PIS and Cofins.

In their opinion, regardless of the equity securities of the associations being originally recorded in the permanent assets, the corporate transactions practices resulted in the alteration of their legal nature, and the manner the demutualization was planned and performed would indicate the intention of the involved parties to dispose of the received shares. In this case, pursuant to article 179, I, of the Corporations' Law, the shares should have been classified as integrating the current assets of the Taxpayer, and the proceeds of the sale taxed by the PIS and Cofins.

In its objection, the Taxpayer claimed that for the performance of its activities, it was obliged to hold the equity securities of Bovespa and BM&F, which were recorded in its permanent assets and, considering that the new shares received by Bovespa Holding S.A and BM&F S.A were mere substitutions of the equity securities, the tax treatment should be identical: that is, the recording of the new shares in the permanent assets. Secondarily, the Taxpayer claimed that the sale proceeds should not be taxed by the PIS and Cofins, as they do not fall into the definition of "revenue" contained in article 3 of Law no. 9.718/1998, whose § 1 had been declared unconstitutional by the Federal Supreme Court and repealed by Law no.11.941/2009.

The Taxpayer's argument was dismissed by the DRJ, which upheld the assessment, leading to the filing of an Ex-Officio Appeal. When hearing the Taxpayer's claims, the CARF upheld the Decision of the DRJ, and a Special Appeal was filed with the CSRF, which rejected it, by majority vote.

The Rapporteur of the Special Appeal, drafter of the concurring opinion, followed the substantiation utilized by the Tax Authorities at the time the assessment notices were issued, as well as the position of the DRJ and the CARF, highlighting that the Judiciary has already expressed their position on the matter on some occasions and has upheld the assessments. In fact, according to the Rapporteur, the recording of the shares in the company's assets is based on the possibility of the taxpayer's choice to remain as the owner of said shares (permanent) or dispose of them (current) and, since the start of the demutualization process, the Taxpayer's intention to dispose of its shares after receiving them was clear.

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The concurring opinion was followed by the majority of the Councilors, except for two Councilors, who delivered an explanation of their vote as they viewed that the shares should have remained recorded under the permanent assets of the Taxpayer. In their opinion, there was only the exchange of equity securities for shares, and not the acquisition of new assets, which would justify the maintenance of the accounting classification.

In addition, one of the Councilors pointed out that the proceeds of the sale of shares should not be taxed by the PIS and Cofins since, pursuant to accounting and legal rules, they do not have a revenue nature. The second Councilor to explain her vote presented the argument that the Tax Authorities had violated the prohibition contained in article 108, § 1, of the National Tax Code ("CTN") – taxation by analogy – and that the RFB had altered the legal criteria of assessment, violating article 146 of the CTN, owing to the fact that, in 1997, there was issued COSIT Tax Ruling no. 13/1997, in which it was declared that the demutualization operation would be neutral from a tax standpoint. In 2007, however, the tax authorities adopted a new position through COSIT Tax Ruling no. 10/2007.

Thus, the CSRF, by majority vote, dismissed the Special Appeal filed by the Taxpayer, fully upholding the tax assessment notices due to the revenues earned at the disposal of Bovespa Holding S.A. and BM&F S.A. shares received at the end of the demutualization operation.

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tax bulletin

96

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