Tax Bulletin of the Administrative Council of Tax Appeals

specific tax report

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Dear Readers:

In this 63rd edition of our Tax Bulletin of the Administrative Council of Tax Appeals ("CARF"), we will comment on a decision in which the CARF cancelled the assessment intending to charge the Individual Income Tax ("IRPF") on the capital gain capital gain deriving from share incorporation transaction.

We also examined a decision in which the CARF equated the taxation of the Real Estate Investment Fund ("FII") with the taxation applicable legal entities, by force of article 2 of Law no. 9.779/99, and ruled that the administrating institution has exclusive responsibility for the tax obligations (accessory and principal bookkeeping obligations) of the FII.

Enjoy your reading.

IRPF – Lack of Capital Gain in the Incorporation of Shares – Inexistence of Fraud or Simulation

"MATTER: TAX ON INDIVIDUAL INCOME IRPF

Fiscal Year: 2008

PUNITIVE FINE. JUSTIFICATION OF APPLICATION. NEED TO CHARACTERIZE CLEAR INTENTIONS OF FRAUD.

The evidence of malice required by the law to classify the penalty is to be stated in the evidentiary stage of the proceeding, and should be undisputed and clearly demonstrated. Therefore, the assessment of the punitive fine of 150% is to be justified in detail and verified in the case records. Furthermore, the law states that there should be a clear intention of fraud by the taxpayer, in the cases defined in articles 71, 72, and 73, of Law no. 4,502, of 1964. The lack of inclusion of any asset or right in the Annual Adjustment Statement (Statement of Assets and Rights) alone does not characterize a clear intention of fraud that justified the imposition of a punitive fine of 150%, provided for in § 1 of article 44, of Law no. 9,430, of 1996, since the material conduct for its characterization is lacking.

TAX LAW. ABUSE OF RIGHT. RULING OUT OF NON-LEVY BY THE TAX AUTHORITIES. ASSESSMENT.

LACK OF LEGAL PROVISION.
There is no basis in the Brazilian legal system for the tax authorities to rule out the legal non-levy of taxes, under the claim that there is an abuse of right. The concept of abuse of right is worthy and applied by the Courts to solve some disputes. There is no legal provision for the authorities to use such a concept for ex-officio assessments. The assessment is bound to the law, which cannot be ruled out under subjective claims of abuse of right.
TAX PLANNING. BUSINESS SIMULATION.
SUBSTANCE OF ACTS.
The tax planning made according to the legal rules and that is not characterized as transactions lacking a business purpose cannot be considered simulation if there are no sufficient elements to characterize it.
Simulation is not verified when the practiced acts are lawful and its manifestation reveals consistency with the private law doctrine adopted, the taxpayer then assuming the consequences and burden of the legal forms chosen, even if motivated by tax economy purposes.
SHARE INCORPORATION TRANSACTION. RESOLUTION DUE TO THE LEGAL ENTITIES INVOLVED IN THE TRANSACTION. INEXISTENCE OF A TRIGGERING EVENT OF THE CAPITAL GAIN OF PARTNERS INDIVIDUALLY.
The incorporation of shares, provided for in article 252 of Law no. 6,404, of 1976, differs from the takeover of companies and capital subscription in assets. In the incorporation of shares, there is the transfer of all the shares (and not of equity) and the merged companies then becomes the full subsidiary of the merging, without being dissolved, that is, it remains with rights and obligations. In this case, there is the substitution in the partner's equity, by an identical value, of the merged company's shares, without his participation, since the resolution is made by the legal entities involved in the transaction.
SHARE INCORPORATION TRANSACTION. ASSESSMENT PM THE PARTNERS INDIVIDUALLY. DATE OF THE TAXABLE EVENT CONSIDERED BY THE ASSESSING TAX AUTHORITIES. LACK OF PAYMENT.
Law no. 7,713, of 1988, in its article 2, determines that the Individual Income Tax is due under the accrual basis accounting, as the capital gain is being earned. If there is no payment on the date of the taxable event considered by the assessing tax authorities, it may not be considered as having been earned by the Taxpayer, according to the Principle of Entity, since it did not become legally or economically available, therefore there is no taxable event of the Income Tax. The taxation of such earnings, as the case may be, will depend on the effective delivery of the amounts to the Taxpayer."

This decision originates from the assessment of the IRPF, relative to the base year of 2007, due to an alleged lack of taxation on capital gains earned in the disposal of ownership interest deriving from a share incorporation transaction among companies in which the Taxpayer had ownership interest. Thus, the Tax

Authorities equated the incorporation of shares with one of the types of disposal of assets and rights subject to the ascertainment of capital gain. Furthermore, according to the Tax Authorities, the practiced transactions were simulated, which would lead to the application of the punitive fine of 150%, also imposed.

Against this assessment, the Taxpayer then filed an Objection, claiming that the purpose of the incorporation of shares is only to transform a given company into a full subsidiary of another company, nothing else. As a consequence, the Taxpayer argued that the exchange of shares of the companies in which it had ownership interest, without the transactions of funds and without any alteration in the acquisition cost, does not represent economic availability, only the exchange of assets.

Furthermore, even if it were accepted that the transaction represented any type of gain, there was no cash float for the Taxpayer, so there was no charge of the IRPF.

The Federal Revenue Judgment Office ("DRJ") dismissed the Objection, on the grounds that in the incorporation of shares, there is the disposal of assets by the shareholders of the merged company, pursuant to article 3, §3, of Law no. 7.713/88, and the transfer of shares is then burdensome and appraised in cash. Therefore, the difference between the acquisition cost and the transfer value should be taxed as capital gain, regardless of the financial flow.

Dissatisfied, the Taxpayer filed a Voluntary Appeal claiming, in sum, the same reasons stated in the Objection.

When hearing the Voluntary Appeal, the CARF, by unanimous voting, granted the Appeal and dismissed the assessment fully.

At first, the Reporting Councilor clearly stated that it is up to the CARF third party oversee the legality of the assessment, regardless of the Objection of the Voluntary Appeal.

Thereafter, the Councilors then examined the punitive aspect of the voluntary ex-officio fine, as they viewed that for the resolution of the case, it would be necessary to address such topics as tax evasion and simulation.

Therefore, the rapporteur stated that tax evasion is the conscious act of the Taxpayer seeking, through unlawful means, to eliminate, delay or reduce the payment of a tax. However, he argued that tax evasion can be divided into lawful (which he calls tax avoidance) and unlawful, the difference lying on the means used by the Taxpayer to achieve his objective: legitimate in the tax avoidance and unlawful in the tax evasion.

In the Reporting Councilor's opinion, unlawful evasion, represented according to the tax laws as malice, collusion or simulation, needs to meet four essential requirements in order to be considered as such: i) the intention to harm or commit a fraudulent act; ii) that the maneuver was the cause of the act or consent of the injured party; iii) the existence of a cause and effect ratio between the maneuver and the benefit reached; and iv) intentional participation of one of the parties.

Moreover, a very important element to constitute tax avoidance or evasion would be the timely difference when seeking the tax economy. While in the tax avoidance the agent's intention is not to cause the taxable event of the tax liability, the tax evasion, would be characterized as the use of unlawful means to escape from the payment of a tax whose taxable event has already occurred.

As to simulation, the Councilor states that it is the legal transaction that fails to reflect the reality, since the intention for the act to have a different effect from the one effectively performed is verified therein. This doctrine may be subdivided into absolute, when there is no intention of producing any act (not even those seeking to give an appearance of legality to the transaction), and relative, when the act is practiced with the intention of practicing another act.

Therefore, the position of the Councilors is that the activity of the taxpayers seeking a lower tax burden will be legitimate (tax avoidance), provided that the following requirements are met: i) anteriority to the taxable event; ii) lawfulness of the practiced act; and iii) no simulation characterization.

When shifting these issues to the concrete case, the Councilors found that these requirements were not present, thus stating that "*entering into a valid legal transaction, whose choice derives from the autonomy and free initiative of the private entity, implying the lack of subsumption of the fact to the tax rule, leading to the classification into the tax rule that sets forth less burdensome requirements or ensuring tax benefits, is perfectly legal and not susceptible of being disregarded by the administrative authorities. (...) Thus, in the event of preference for a given form, it is not acceptable for it to be ignored, for the mere reason that its economic result is similar to another form taxed differently*".

Due to this, as to the punitive fine, the Judged considered it to be unacceptable, since the Tax Authorities did not rely on simulation but on the failure to state the alleged capital gain in the statement of earnings, a fact that, alone, does not reveal the intention to deceive the Tax Authorities, a necessary element for the imposition of an ex-officio fine.

According to the rapporteur, it is not enough to have an unlawful act to impose the fine; what is essential is to have a clear intention of fraud. So, the failure to state capital gain, if any, would only be omission of earnings.

With regard to the merits, the Councilors viewed that there is no disposal in the incorporation of shares, but a legal subrogation of the company's shareholders. In their view, the incorporation of shares is a typical corporate operation, regulated by article 252 of Law no. 6,404/76, while the disposal is a transfer act, the transfer of domain. For the Reporting Councilor, subrogation does not depend on the intention of the partners or shareholders, since it is the legal entities the ones to decide about the incorporation of shares. In turn, the disposal, according to the rapporteur, *"requires the waiver of a right and is therefore voluntary. Taking into account that in the real subrogation derived from the law there is the substitution of one thing for another due express legal provisions, disposal should not be taken as a real subrogation"*.

In addition, the capital increase of the merging company and the consequent valuation of its shares are facts inherent to the formation process of a full subsidiary.

Lastly, the Reporting Councilor states that the IRPF is computed through the accrual basis accounting, and that the taxes are charged as the capital gain is earned. Therefore, is there was no payment for the alleged "gain", but only substitution of the asset, there is no taxation.

Due to this, the Reporting Councilor concluded that *"even if the incorporation of shares could be compared with disposal subject to the ascertainment of capital gain, no amounts were received by the Appellant which, under the accrual cash accounting, the possibility of the income tax charge is also ruled out"*.

The other Councilors followed his opinion, and the Voluntary Appeal was granted unanimously.

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

Real Estate Investment Fund – Equivalence to Legal Entity – Tax Responsibility of the Administration Institutions

"REAL ESTATE INVESTMENT FUND. TAXATION. EXCEPTIONALNESS.
Upon verifying that the real estate venture is fully explored (100% of the business) by a single shareholder (100% of the shares) of the Real Estate Investment Fund, the circumstances authorizing the application of the provisions in article 2 of Law no. 9,779/99 are present, that is, the mentioned Fund is subject to the taxation applicable to the legal entities.

"EXPENSES WITH TAXES (PIS AND COFINS) DEDUCTION.
When the PIS and COFINS' requirements have been formalized in the same proceeding, such taxes whose deductibility is not prohibited by the law, the tax assessment authority, by ex-officio duty, must deduct the respective value for purposes of determining the taxable income and the CSLL basis."

REAL ESTATE INVESTMENT FUND. TAX LIABILITIES. FULFILLMENT OF RESPONSIBILITIES.
Pursuant to article 4 of Law no. 9,779/99, except for the responsibility of the paying sources to withhold the tax on the earnings subject to the tax charge in the events provided for in the legislation in force, the tax responsibility for the fulfillment of the

other tax liabilities (accessory and principal bookkeeping obligations), including those deriving from the provisions in article 2 of the mentioned law, is of the administrating institution of the Real Estate Investment Fund."

In sum, the Tax Authorities assessed the FII, as they viewed that this Funds would be subject to taxation of the legal entities, based on article 2 of Law no. 9,779/99, under the justification that the FII had a single shareholder and made investments in real estate ventures of a company controlled by this shareholder. It is worth pointing out that these investments consisted of the "acquisition" of several real properties by the shareholder before the subsidiary, for the lease of these properties to the company itself.

Furthermore, the Tax Authorities issued a Joint Tax Debt Instrument against the Financial Institution Administrator of the Fund, pursuant to article 124 of the National Tax Code ("CTN") and article 4 of Law no. 9,779/99.

Dissatisfied, the Fund filed an Objection claiming, in sum, that: (i) the Financial Institution, on behalf of the Fund (fiduciary property), is the sole acquirer of the real properties, meaning article 2 of Law no. 9,779/99 does not apply, since there is no investment of funds in ventures that have the builder as their as incorporator, or the partner, shareholder of the Fund; (ii) the acquisition of real estate that has already been finished or built to be leased does not characterize as real estate ventures, for purposes of application of article 2 of Law no. 9,779/99 (this provision would apply to the real estate venture whose enforcement is in progress); and (iii) the Tax Authorities disregarded the expenses with PIS and COFINS requirements, for the purpose of ascertaining the IRPJ and CSLL.

The Administrating Institution, in turn, claimed in its Objection (i) that the administrator of the fund is responsible for complying with the obligations of the Fund (article 4 of Law no. 9,779/99), meaning joint liability does not apply to the present case, pursuant to article 124 of the CTN, used as grounds for the tax assessment; (ii) that this is the liability of third parties, provided for in article 134 of the CTN, for which it always holds secondary liability.

After examining the Objections, the Federal Revenue Judgment Office of Brazil ("DRJ") upheld the assessments in full. Due to this decision, the Fund and the Administrating Institution filed their Voluntary Appeals, repeating the arguments already presented in the case records.

When hearing the Voluntary Appeal, the Panel, by unanimous vote, considered that the Fund is subject to taxation imposed on the legal entities, as they viewed that the shareholder of the Fund was the partner of the real estate venture intended by the Fund. Refer to the except of the concurring opinion in this sense: "*The real estate venture is therefore represented by real property belonging to Mr. (...), which are 'acquired' by the Real Estate Investment Fund, whose sole shareholder, at least in the calendar* *year of this proceeding (2005), is Mr. (...) himself."*

Next, the Councilors, by majority vote, viewed that the PIS and COFINS' requirements are to be deducted from the tax bases of the IRPJ and the CSLL, as they are taxes whose deductibility is not prohibited by the tax laws.

Lastly, the CARF recognized that this is not the case of joint liability provided in article 124 of the CARF, but instead of liability by substitution provided in article 128 of the CTN. According to the Court's position, the liability of the Administrating Institution derived from an express Law (in this case, article 4 of Law no. 9,779/99), which ascribes the tax liability for tax credits to third parties (Administrating Institution) bound to the taxable event of the respective obligation, excluding the responsibility of the one that has a direct relationship with the taxable event (Real Estate Investment Fund). In other words, the Administrating Institution has exclusive responsibility (and not joint liability) for the tax liabilities not fulfilled by the Real Estate Investment Fund.

Therefore, the CARF ruled out the claims of the Administrating Institution that it would be the case of applying article 134 of the CTN, as it regarded that the legislation does not have any rules attributing to the Investment Fund the responsibility for the fulfillment of the obligations it practiced.

Furthermore, although the Tax Authorities have issued a Joint Tax Debt Instrument based on article 124 of the CTN and the Appellate Decision ruled for the application of article 128, the Reporting Councilor found that this is not the case of *reformatio in pejus*, under the argument that there was a legitimate adaptation to the legislation in force and does not represent, from a practical aspect, a more burdensome circumstance for the financial institution.

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