Tax Bulletin of the Administrative Council of Tax Appeals

specific tax report

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Dear Readers,

In this 34th edition of our Tax Bulletin of the Administrative Council of Tax Appeals ("CARF"), we will comment on a decision of this Council, which ruled for the non-qualification of revenue omission upon the due verified occurrence of capital increase in a company and subscribed by foreign companies.

We shall also address a decision in which the CARF removed a fine qualification, reducing it to 75%, as tax evasion, fraud, and collusion were not characterized as such in an operation seeking tax economy.

Enjoy your reading.

IRPJ – CSLL – PIS – COFINS
Revenue Omission – Total Cost Disallowance

"MATTER: CORPORATE INCOME TAX – IRPJ
Calendar year: 1999 (...)
REVENUE OMISSION – PROOF OF CAPITAL INCREASE IN THE MERGED COMPANY.
When there is evidence in the records of the origin of capital increase in the merged company, subscribed by foreign companies, and taking into account that, if there were an infraction committed by the merged company, the ascertainment of the respective taxes should be carried out separately, the respective assessment should be cancelled. (...)
INDUSTRIAL CORPORATION – PRODUCTION COST – NECESSITY – TOTAL COST DISALLOWANCE - IMPOSSIBILITY.
In case of an industrial corporation, which necessarily needs to incur production costs, the total cost rejection does not apply, under penalty of, by logical consequence, considering the assessment mandatory, based on the fixed profit, and any assessment carried out based on the taxable income to be groundless. The costs exceeding the amount stated by the tax debtor as deductible at the ascertainment of the taxable result is also to be released.
TOTAL DISALLOWANCE OF FINANCIAL EXPENSES – ASSESSMENT INCONSISTENCIES.
When there is evidence in the records of financial expenses, it is up to the administrative authorities, after the required analysis of the tax action, to

disallow expenses which effectively are not deductible, since in the assessment activity, it is up to the tax authorities to present the evidence of the matter which consolidates the act. The financial expenses which were disallowed in excess of the amount stated by the tax debtor as deductible at the ascertainment of the taxable result is also to be released (...)."

The decision synthesis in question concerns an appellate decision rendered by the CARF, examining an administrative proceeding arising from a Tax Assessment issued for the collection of the Corporate Income Tax ("IRPJ"), Withholding Income Tax ("WHT"), Social Contribution on the Net Income ("CSLL"), contribution to the Employee Profit Distribution Program ("PIS") and the Contribution to the Social Security Funding ("COFINS"), relative to the calendar year of 1999, under the claim that the Taxpayer had omitted revenues, and unduly deducted financial costs and expenses, among others.

As to revenue omission, the Inspection considered that there was no documentary evidence of (i) accounting operations recorded in the long-term receivables and as obligations with financings relative to credited amounts; and (ii) relative to unjustified capital increase contracts made with foreign companies allegedly located in tax-favored jurisdictions.

Thereafter, the Inspection disallowed the financial costs and expenses incurred by the Taxpayer, based on allegedly not substantiated accounting records.

In its defense, however, the Taxpayer opposed the arguments on which the assessment was based, for which reason an investigation was conducted in order for the Tax Authorities to verify the "logical relation of the assessment", as well as all the existing documentation related to the case, which was later formalized and presented to the Taxpayer, which then presented its answer to such assessments.

The Federal Revenue Judgment Office ("DRJ"), when examining the filed Opposition, ruled that the amounts received by foreign companies, on the basis of capital increase, were duly substantiated. However, due to a loan involving such amounts, later discovered, the assessment was upheld as to this part, since it characterized that the operation, as a whole, was merely legal fiction.

With regard to full cost disallowance, the Judging Panel decided that it cannot be accepted that an industrial establishment, in the regular course of its activities, does not have costs related to the sold products.

Thus, the full cost disallowance would not be compatible with the ascertainment of the IRPJ by the Taxable Income, but instead by the Fixed Profits, which tax basis is not the adjusted net income, but the gross income, not considering the effectively incurred costs. Due to such, the DRJ released the entire assessment arising from costs.

As to the disallowance of financial expenses, although the Taxpayer had submitted several document copies to the Inspection to rule out the taxation deriving from such disallowance, the DRJ decided that the Tax Authorities is entitled to examine the original

documents, and that Taxpayers are required to keep and present them whenever requested, until the expiry of the tax credits. For this reason, the Judging Panel then decided to maintain the tax credit.

At the time of decision of the DRJ, the Taxpayer brought a Voluntary Appeal, whereby it reinforced the arguments presented in its Opposition, and, in sum, affirmed that the Inspection had disregarded and failed to examined the presented documents, without any justification.

It also claimed that, in the case in question, there is no characterization of legal presumptions that justify the presumption of revenue omission, considered by the Inspection as such, and also defended that the origin of the funds for capital increase carried out by the company, later merged, was duly substantiated, and that it was also "not challenged by the inspection, and was recognized by the DRJ".

Furthermore, taking into account the tax credit amount released by the DRJ, the Judging Panel then filed a Mandatory Appeal.

In the judgment of the Appeals, the CARF rendered a decision in which the members of the Panel, by unanimous vote, dismissed the Mandatory Appeal – upholding the release of the disallowance related to the Taxpayer's costs.

With regard to the Voluntary Appeal (granted partially as to the merits), the councilors ruled that, in relation to the financial expenses, such disallowance should only reach the amounts stated by the Taxpayer, disregarding the amounts disallowed above what was stated.

According to the Judgment Panel, it is up to the Tax Authorities to carry out a thorough analysis of the tax proceeding, so as not to lead to any, as in fact demonstrated in the case in question, taking into account that there was a mistaken expense disallowance.

Moreover, the councilors were also convinced that that omission of revenue, arising from capital increase, could not prevail over the evidence presented by the Taxpayer. In addition, it was decided that the alleged illegal practice would be connected to the merged company, and that the amounts due by both companies prior to the corporate operation should be ascertained separately, which was not followed by the assessment in question.

Thus, the position that in case of evidence of the occurrence and origin of the capital increase carried out in the company (later merged by the Taxpayer) and subscribed by foreign companies, there is no revenue omission.

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

Tax Planning – Simulation – Indirect Legal Transaction– Punitive Fine

"TAX PLANNING. SIMULATION. INDIRECT LEGAL TRANSACTION. There is simulation when the intent stated in the legal transaction does not match the reality of the agreed upon business. In order to identify the nature

of the business practiced by the taxpayer, its cause is to be identified, even if such cause is verified in the succession of several intermediary businesses without cause, in the structuring of transactions otherwise known as step transactions. Thus, the legal transaction without cause cannot be characterizes as an indirect legal transaction. The tax-triggering event arises from the identification of the reality and the effects of the facts that have actually occurred, and not of intents formally declared by the contracting parties or the taxpayers. SIMULATION. The subscription of new shares of a corporation, with its pay up in case and premium registration, for the subsequent withdrawal of the original, with redemption of shares for safeguard and later cancellation, characterizes simulation of the sale of equity interest. TAX PLANNING. FINE. In the tax planning, when the belief of the taxpayer to be acting according to the law is identified, without concealing the practice and final intent of its business, the malice necessary to apply a punitive fine cannot be recognized, such element contained in the heading of articles 71 to 73 of Law no. 4,502/64.
(...)"

The synthesis at issue deals with the appellate decision rendered by the CARF in a judgment of an administrative proceeding, whereby the non-taxation of the earnings obtained as capital gain were opposed, such earnings originated from a corporate restructuring ("matching and separation"), considered by the Tax Authorities as simulation of sale of equity interest, therefore collecting the IRPJ and CSLL, adjusted by the SELIC rate, accrued by punitive and separate fines.

In brief, this is the case of tax planning whereby a company is transferred from a former partner to a third party, and the entrance of this third party and the withdrawal of the former partner takes place almost simultaneously.

In order for third parties to join the company, an "Investment and other Covenants Agreement" was entered into, in which the Taxpayer and its partner assign to third parties the right to subscribe and pay up capital in the company held by the Taxpayer at that time.

Thus, assignors subscribed new shares in the company, which were paid up with premium, resulting thus in an increase of the company's net worth. After that, due to equity accounting, this increase was reflected to the Taxpayer.

Therefore, the corporation's shares, for purposes of determining the capital gain at the disposition, had already been recorded in the amount they would be disposed of, due to equity accounting, which, according to the Tax Authorities, avoided the ascertainment of the capital gain.

The Inspection contends that, in the present case, there was a simulated disposition of shares, meaning the IRPJ and CSLL levied on capital gain earned by the Taxpayer should be collected.

In its defense, however, the Taxpayer claimed that it only performed such operation due to its financial urgency and because it had difficulty refinancing its short-term debts, which caused it to

resort to several loans, also with the BNDES, involving bonds of over half its capital. These reasons then led to the trade of its assets.

Furthermore, the Taxpayer claimed that the trade in question could have been made through several legal channels. Therefore, it chose one of them and performed, without any disagreement with its intent, which then excludes the event of simulation. In addition, it stated that there was a business purpose in the acts practices, which justified the entire operation.

The Federal Revenue Judgment Office ("DRJ"), in turn, fully upheld the assessment issued under the claim that there was simulation at the sale of shares on the part of the Taxpayer. Although it considered that, due to the publicity of all the acts practiced by the Taxpayer, tax evasion was not characterized, the DRJ viewed that in the operation in question, there is fraud, as well as collusion, in order to avoid taxation of the capital gain, for which reason it maintained the fine of 150%.

Due to such decision, the Taxpayer then brought a Voluntary Appeal, whereby it reinforced the difference existing between a simulation and an indirect legal transaction, in order to fit its operation into the second option and thus demonstrate the lawfully adopted procedure. With regard to the punitive fine, it claimed that there was no attempt to conceal the act, and that tax evasion could not be characterized, nor the clear intent of fraud.

According to the Repotting Councilor, the operation performed by the Taxpayer, for the purpose of classifying as simulation or indirect legal transaction, it should be broken down in two moments: (i) creation of a new company by the Taxpayer, transferring the assets, rights and obligations of the unit to be sold; and (ii) transfer of the equity interest held by the Taxpayer to the third party.

Thus, in analyzing the appeal, the Reporting Councilor verified that, although all the procedures adapted by the Taxpayer were legally provided for, they were adopted with the sole purpose of tax economy, concealing the future sale of the company. He therefore rendered his vote in the sense that in the operation performed by Taxpayer, there was simulation, as, in his view, there was no business purpose to carry out such acts, and that the single purpose of the corporate restructuring under analysis was that of tax economy.

Due to such, the Reporting Councilor upheld the tax assessments.

In relation to the punitive fine 150%, o Reporting Councilor considered that "*although the business was considered to have been simulated, ruling out its effects for tax purposes, identifying that the tax was due, it is clear that the Appellant believed its act was an indirect legal transaction, in a totally public manner, supported by positions that the business would be encompassed by the so-called tax avoidance fiscal*".

Thus, as in the present case there was no specific malice required by the law and necessary to characterize tax evasion, fraud, and collusion, the Reporting Councilor voted for removing the punitive fine, reducing it to 75%.

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

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