Tax Bulletin of the Administrative Council of Tax Appeals

specific tax report

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Dear Readers,

In this 35th edition of our Tax Bulletin of the Administrative Council of Tax Appeals ("CARF"), we will comment on a decision wherein the Council ruled that the deduction of the Corporate Income Tax ("IRPJ") and the Social Contribution in the Net Income ("CSLL") of the amounts paid for the Profit and Result Sharing Program ("PLR"), depends on the performance of article 2, of Law no. 10,101, dated December 19, 2000, ("Law 10,101/2000"), which provides for the allocation of profit sharing contributions to employees.

We will also analyze a decision in which the CARF decided that profits earned through a branch or related company are not subject to additions, exclusions, and the offsetting set forth or authorized by the Brazilian legislation, and are to be ascertained pursuant to the rules of the rules of the domicile of the branch or invested company. The deductibility rules of the provision for bad debts ("PDD") set forth in Law no. 9,430, dated December 27, 1996, ("Law 9,430/96) therefore do not apply to such results. Within this decision, it was judged that the result of the positive exchange variation, arising from the assessment of equity accounting of a branch or invested and related company abroad, is not to compose the taxable income of the Brazilian company, for lack of a legal provision. Within this context, the CARF ruled that Normative Rule no. 213, dated October 7, 2002, ("IN 213/02"), which thus provides on the matter, has no legal grounds, for which reason it may not be applied in this case.

In this edition, we will also analyze a decision in which the CARF debated on the concept of input material applicable to the calculation of the credits of Contribution to the non-cumulative Employee Profit Distribution Program ("PIS") and the Contribution to the Social Security Funding ("Cofins"), ruling out the application of the strictest definition of input material, provided for in the legislation of the Tax on Manufactured Products ("IPI"), to such contributions.

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Deductibility of the amount paid to workers on the basis of the Profit and Result Sharing Program ("PLR")

"EMPLOYEE PROFIT SHARING PROGRAM (PLR). DEDUCTIBILITY. The deductibility of the amounts paid on the basis of Profit and Result Sharing Program (PLR), depends on the adoption of clear and objective rules, specified in a collective agreement/convention of the class union or a private agreement adopted through prior negotiation with the workers' committee, which includes the participation of the respective class union."

The decision synthesis in question deals with the appellate decision rendered by the CARF in an examination process arising from Tax Notices issued for the collection of the IRPJ and CSLL relative to the calendar year of 1997, due to the rejection of expenses in the ascertainment of the Taxable Income, with amounts paid to employees on the basis of Profit and Result Sharing ("PLR").

Pursuant to article 2, of Law no. 10,101/2000, the company using the PLR system is to adopt clear and objective rules, specified in a collective agreement or convention of the class union or a private agreement adopted through prior negotiation with the workers' committee, which includes the participation of the respective class union.

The taxpayer, summoned by the Inspection to provide clarifications thereon, informed that the rules set in its PLR were defined in the Collective Labor Agreement of the Bank Employees' Union ("Bank Employees' CCT") and that, taking into account the use of such Convention, there was no need to form an employee committee and consequently to register the agreement with the class union.

However, the Inspection issued Tax Assessment Notices, as it considered that the membership of the Taxpayer's employees union was not that of Bank Workers, but rather that of the Union of Employees of Commerce Autonomous Agents and of Assistance, Expert Examination, Information and Research Companies, and Accounting Services of the State of São Paulo ("Big Union" - *Sindicatão*).

When filing its Opposition, the taxpayer essentially claimed that the payments were made based on the Collective Agreements ("CCT") of the *Sindicatão*, which allowed the application of employees, in this case, the Bank Employees' CCT.

The Federal Revenue Judgment Office ("DRJ") dismissed the Opposition, claiming, in sum, that the failure to meet the criteria of Law no. 10,101/2000 prevents the deduction of the amounts paid as PLR of the Taxable income.

The taxpayer then brought a Voluntary Appeal with the Administrative Council of Tax Appeals ("CARF"), alleging that: (i) the legislation in force allows the deduction of amounts paid as PLR; (ii) the CCT is the formal source of Labor Law; (iii) the CCT includes employees, regardless of their association with unions; (iv) the Bank Employees' CCT meets the requirements of Law no. 10,101/2000; and (v) the CCT of *Sindicatão* accepts the application of

more beneficial rules to employees, in this case, the CCT of Bank Employees' Union.

The CARF rendered a decision dismissing the Taxpayer's Voluntary Appeal, as it considered it is necessary to observe the rules set forth in Law no. 10,101/2000 for the deduction of the amounts paid as PLR.

In fact, the Reporting Councilor considered that, although the payments were made while Provisional Measures nos. 1,539/96 and 1,539/97 were in force, it is necessary for the company to negotiate previously with the committee chosen by the employees, which includes the participation of a class union representative, the purpose of which is to set clear and objective rules, containing the setting of goals for employees and positive results for the company, as well as criteria relative to assessment, periodicity, term, and period for agreement review.

In the Reporting Councilor's view, the agreement between the committee and the company consists of a proper means to ensure the inexistence of the forbearance nature and the independence as to any other interests of the paying source, which is indispensable for ensuring the deductibility of the amounts paid on the basis of PLR.

In the case at issue, the Reporting Councilor observed that a PLR was prepared through a collective agreement, connected to a union that does not have the company's employees as its members, which prevented the compliance with Law no. 10,101/2000. He also added that the company could invoke any agreement or convention without being bound to any, such forbearance which prevents the deductibility of the amounts paid as PLR from the tax basis of the IRPJ and CSLL.

Due to this lack of enforcement, the argument that the *Sindicatão* would allow the adoption of more beneficial rules to the employee could not be accepted.

Upon these considerations, the Councilors thus decided to uphold the rejection of expenses with the PLR payment.

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Inapplicability of Brazilian deductibility rules to profits earned abroad – Non-taxation of the equity accounting positive result of a branch or related company domiciled abroad

"SUBSIDIARY DOMICILED ABROAD. ASCERTAINMENT OF THE RESULT. VERIFICATION. The ascertainment of the result of a subsidiary domiciled abroad can be made based on the legislation of the country in which it is domiciled. However, the transactions which affect the tax status of the parent company in Brazil are subject to their effective performance.

EQUITY ACCOUNTING. EXCHANGE VARIATION. The positive result of the equity accounting in the investing company, arising from

exchange variations in the invested company's equity, does not integrate the ascertainment of the taxable income, for lack of provisions in the formal law in this regard".

The decision synthesis of the Appellate Decision issued by the CARF, transcribed above, deals with an administrative proceeding arising from a Tax Assessment Notice which required the Corporate Income Tax ("IRPJ") and the Social Contribution in the Net Income ("CSLL"), as Tax Authorities considered that the taxpayer had failed to tax the exchange variation of its investment in branches and subsidiary abroad in the calendar year of 2002, and that it had unduly deducted with provisions for bad debts.

As a matter of fact, the Tax Authorities dealt with the exchange variation as if it were profits, regarding that it should have been added to the net income of the Taxpayer, for purposes of ascertainment of the Taxable Income.

As to the rejection of expenses with provisions for bad debts com provisions for bad debts, the intent of the Inspection was grounded on §2, item I, of article 25 of Law no. 9,249/95, according to which "*the branches, head branches, and subsidiaries are to demonstrate the ascertainment of income earned in each fiscal year, pursuant to rules of the Brazilian legislation*" (emphasis in the original text). Thus, they considered that the deduction of such expenses should comply with the provisions in article 9 of Law no. 9,430/96, which in this case did not occur.

Dissatisfied with this, the taxpayer filed oppositions to the Tax Assessment Notices claiming that the exchange variation of the investment abroad, assessed by the equity accounting, should not have been added to the tax basis of the IRPJ/CSLL, mainly after the presidential veto to article 46 of Provisional Measure no. 135/03, and the repeal of article 9 of Provisional Measure no. 232/04, which before were clear in such determination.

He also claimed that the Brazilian legislation is not able to regulate the ascertainment of profits outside the National Territory. At most, it can determine the taxation in Brazil of profits earned abroad, but not determine how it is to be ascertained. Therefore, the control of offsetting, additions, and exclusions of the taxable income earned abroad is undue.

The Federal Revenue Judgment Office ("DRJ") examined the Opposition filed by the taxpayer, but upheld the Assessment regarding the above matter. The Taxpayer opposed to this decision, and then resorted to the CARF, based on the same arguments presented to the DRJ.

Initially, the Reporting Councilor observed that the Inspection, in fact, taxed the positive result of the equity accounting, which in turn was caused by the exchange variation of the investment in the branches and subsidiary company. That said, the Reporting Councilor then ruled that there is no legal basis for the positive result of the equity accounting to be taxed by the IRPJ/CSLL. On the contrary, it argued that article 23 of Law Decree no. 1.648/78 established the exclusion of this result in the ascertainment of the Taxable Income.

Furthermore, he declared that Normative Rule no. 213/02 violates the law in this regard, meaning it may not serve as grounds for an Assessment.

He therefore disregarded such Assessment.

As to the deductibility of expenses with provisions for bad debt, the Reporting Councilor stated that "*it is not possible to grant an extra-territorial range to tax laws outside the scope of international treaties. Thus, as a general rule, the legal entity is subject to the tax rules of the country in which it is domiciled. Upon verifying that the ascertainment of the result took place without any violation of the local rules, the stated income is then accepted*".

Then, in theory, the judgment would be in the sense that the Brazilian rules concerning the control of the deductibility of provisions for bad debt would not apply to the profits of branches, head branches, and subsidiaries domiciled abroad.

However, the Reporting Councilor ruled that, in the case in question, the taxpayer failed to demonstrate to the Tax Authorities, when so requested, the amounts that composed this provision and the reasons for its formation.

That is, although the Taxpayer was not obliged to comply with article 9 of Law no. 9,430/96 in order to proceed with the deduction of the provisions for bad debts, it has to provide the occurrence of the transactions and its non-compliance with documentary evidence, which, in this case, did not occur. It therefore accepted the assessment with regard to this aspect.

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Non-cumulative PIS and Cofins' Credit – Concept of Input Material Applicable to such Contributions

"EXCLUSION FROM TAX BASIS. SALE TO EXPORTING COMPANY. In order for sales to exporting companies, with specific export purposes, to be excluded from the tax basis of the contribution, they are to prove that they fit into some of the legal provisions for exemption.

NON-CUMULATIVE METHOD. INPUT MATERIAL. MATERIAL FOR MACHINERY MAINTENANCE. The concept of input material within the credit ascertainment system through PIS and Cofins accumulation is to be understood as any and all necessary cost or expense for the company's activity, pursuant to the IRPJ legislation, and the concept brought by the IPI legislation may not be used, since the substantiality of this tax is different from the substantiality of the contributions under analysis.

ELECTRICAL ENERGY CREDIT. PROOF OF EFFECTIVE CONSUMPTION. The credit relative to costs with electrical energy can only be accepted by proving the effective entire consumption of the amount billed to the business establishment, and there is no legal provision to support and regulate the use, through apportionment of any kind.

The case in questions deals with the Request for Redress of a credit balance of the contribution to the non-cumulative Employee Profit Distribution Program ("PIS"), made by the taxpayer seeking the recognition of the right to receive amounts relative to: (i) services provided to the order of a predominantly exporting company; (ii) acquisitions of materials for the maintenance of machinery and equipment; (iii) expenses with electrical energy; and (iv) stocks of openings existing at the time they enter the non-cumulative system.

Given the only partial grant of the request, the taxpayer filed a claim of inadmissibility, alleging, in sum, that: (i) it rendered services to the order of a predominantly exporting company; (ii) the acquisitions of materials for the maintenance of machinery and equipment fit into indispensable costs for the manufacturing and transportation of the goods intended for sale; and (iii) the expenses with electrical energy, though shared with another legal entity, were exclusively borne by itself, as it had rented the property from this other company.

Upon the dismissal of the claim of inadmissibility, the taxpayer then filed a Voluntary Appeal based on the same arguments mentioned above, and the records were sent to the Third Section of the do CARF to be judged.

Initially, with regard to the credits arising from the exemption of the PIS and the Contribution to the Social Security Funding ("Cofins") applicable to revenues arising from sales and service provision to export company, the Reporting Councilor deemed that the taxpayer failed to prove, with documentary evidence, the direct shipment of the products intended to export or to bonded warehoused, for account and by order of the acquiring export company, a legal requirement to be met for the enjoyment of this benefit.

As to the credits arising from the acquisition of material for machinery maintenance, the Reporting Councilor presented a lengthy explanation of the concept of *input material* to be used in the calculation of the non-cumulative PIS and Cofins.

In rejecting the definition of input material contained in Normative Rules nos. 247/02 and 404/04, which uses the definition contained in the legislation of the Tax on Manufactured Products ("IPI") for the non-cumulative PIS and Cofins, the Councilor warned that it is impossible to equate concepts and situations concerning taxes of completely different substantiality, in this case, revenue (PIS/Cofins) and product manufacturing (IPI).

In fact, based on doctrine and on former judgments of the Taxpayers' Council, the Reporting Councilor ruled that the concept of input material applicable to the PIS and Cofins must be the same as that applicable to the income tax, as the substantiality of such contributions (revenue) is closer to that set forth in the IRPJ than to the one established in the IPI. In the Councilor's words: *"in fact, due to the nature of the respective levy events (revenue/profits/ manufacturing), the concept of costs provided for in the IRPJ legislation (article 290 of RIR/99), as well as that of operating expenses provided for in article 299 of RIR/99, is more appropriately applied to the non-*

cumulative PIS and Cofins than the concept provided for in the IPI legislation."

The Reporting Councilor stated that when the concept of input material used for IPI purposes – which essentially includes only the raw materials, the intermediary products, and packaging material– is extended to the PIS and Cofins, the regulatory acts of the Federal Revenue of Brazil violated the strict tax legality (for lack of a legal in this regard) as well as article 109 of the National Tax Code, for diverging from the input material concept.

Along these lines, in staring that the cumulativeness of the PIS and Cofins is connected to the company's revenues, that is, to all the forces employed for the development of activities, the Reporting Councilor concluded that the concept of input material applicable to such contributions is to be connected to this feature.

Therefore, in analyzing the concrete case, he granted the classification given by the taxpayer – input materials – to the materials used in the maintenance of machinery and equipment, due to the essential nature of such for the manufacturing of products intended for sale. The rejection of credits related to such expenditure was then ruled out.

As to credits relative to electrical energy costs, the Reporting Councilor dismissed them, as he considered that the taxpayer had failed to prove that the electrical energy was fully consumed and billed exclusively to the establishments of its business, and because there is no legal provision supporting the sharing of such costs for credit purposes.

Lastly, as to the presumed credits on stocks of openings, calculated by the taxpayer by applying a different tax rate from the one set forth in law, the taxpayer's justification was ruled out, as it was grounded on an unconstitutional argument, so the dismissal of the respective credits was thus was thus upheld.

Therefore, in following the Councilor's position, the members of the Panel unanimously granted the recognition of credits arising from the acquisition of materials for the maintenance of machines, as they are directly connected to the taxpayer's activities, and are considered input material.

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