

TAX NEWS

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1. SUPERIOR COURT OF JUSTICE DECIDES ON INCIDENCE OF INCOME TAX WHEN EMPLOYMENT CONTRACT TERMINATED

The first panel of the Superior Court of Justice held no income tax is owed on amounts paid under voluntary redundancy programs (*programa de demissão voluntária*), because the employer has no margin to pay amounts beyond that which is owed. The holding in Superior Court of Justice Binding Precedent 250 therefore applies: “Indemnification received for joining the voluntary redundancy program is not subject to income tax.”

On the other hand, income tax is due on amounts the employer pays when it is not required to since these are not in the nature of an indemnification.

In the case in question, the employer was not required to make the payment called a “non-recurrent bonus,” so it was subject to income tax. On the other hand, the “spontaneous compensation” was considered to have been paid within the context of the voluntary redundancy program and was therefore not subject to income tax.

2. COUNCIL MAINTAINS 30% LIMIT FOR INCOME TAX

The first panel of the upper chamber of the Tax Appeals Administrative Council (*Conselho Administrativo de Recursos Fiscais*) changed the holding that had previously been

adopted by the Tax Appeals Board and now applies the legal limit of 30% for using tax losses to offset income and social contribution taxes when a company closes.

The former position of the Tax Appeals Board was that the 30% limit could not be imposed when a company ended its activities, for example in a merger. However, in the decision issued, the majority of judges on the Tax Appeals Administrative Council held that the limit should be imposed because there is no law allowing the full use of the tax losses.

3. FEDERAL REGIONAL COURT LETS CASE AGAINST INCLUDING ISS IN COFINS GO FORWARD

A recent decision by the Federal Regional Court for the Third Region (São Paulo) opened the way for a case seeking to exclude the Service Tax (*Imposto sobre Serviços*), or ISS, from the calculation basis for the Social Security Financing Tax (*Contribuição para o Financiamento da Seguridade Social*), or COFINS, tax to go forward. The claim had been suspended until a final decision on Request for a Declaratory Judgment on Constitutionality no. 18 had been decided by the Federal Supreme Court. This request for a declaratory judgment challenged the constitutionality of including the Tax on the Circulation of Merchandise and Services (*Imposto sobre Circulação de Mercadorias e Serviços*), or ICMS, tax in the calculation basis for the COFINS tax.

Although the company's request to exclude the ISS tax from the calculation basis for the COFINS tax was not granted, Federal Appellate Judge Regina Helena Costa decided to let the case go forward, holding there was not a correspondence between the matters at issue in each of the situations.

4. FEDERAL REVENUE CHANGES ITS MIND AND EXEMPTS PARTNERS BY SERVICE QUOTAS

The Sixth Tax Region of the Federal Revenue Department, which covers the state of Minas Gerais, changed its mind and stated that the income tax and social security tax are not incident on dividends received by professionals who frequently form “companies by service quotas” such as lawyers, doctors and architects. This decision is explained in Answer to Query no. 140.

There is a great deal of concern among these professionals because of an answer to query published in September 2009 in the same tax region that stated these dividends were subject to taxation as though received by employees. The former Answer to Query no. 116 was amended by Answer to Query no. 140. With this new tax position, in practice partners by quotas of service are exempt from the income tax (with a progressive rate up to 27.5%) and the Social Security tax (11%) on dividends they receive.

The new answer to query, however, makes the legal criteria for profit distributions being exempt clear: the dividends must be distributed within the limit of the profit calculated in the annual balance sheet or interim balance sheets.

5. TAX SUBSTITUTION LOOKED AT AGAIN IN A NEW FEDERAL SUPREME COURT APPEAL

The possibility of restitution of the ICMS tax for companies included in the tax substitution system will be decided as a binding precedent. This means other cases dealing with the same matter will be suspended until the Federal Supreme Court has decided the appeal brought by an oil industry company against the state of Minas Gerais.

A request for a declaratory judgment on constitutionality involving the state of São Paulo was already being heard by the Federal Supreme Court. However, the fact that this case will become a binding precedent should mean that the case will be heard over again from the beginning with a different panel. In the mentioned request for a declaratory judgment on constitutionality, the judges are split five to five in a case valued at a minimum of R\$2 billion for the state of São Paulo alone.

6. SUPERIOR COURT OF JUSTICE REJECTS WITHHOLDING INSS IN SIMPLE SYSTEM

Confirming a precedent regarding the matter, the First Section of the Superior Court of Justice decided that the tax collection system for those who choose to file under the SIMPLE option is not compatible with the tax substitution system imposed by article 31 of Law 8212/91. That law instituted a system for paying the Social Security tax by the entity receiving a service withholding 11% at the time the invoice is paid. The court held that micro-companies and small companies that choose the SIMPLES system are not subject to this rule since they are subject to a specific tax system that provides for a single tax payment under the system instituted by Law 9317/96.

This is the first time the Superior Court of Justice has considered this issue using the repetitive appeal system. This means the Superior Court of Justice will not accept more appeals on the identical issue, and the lower courts, although they are not obligated to, should follow the Superior Court of Justice's holding in the matter. This should mean less delay in resolving such cases.

Currently there are few companies filing under the SIMPLE system that face the problem of withholding 11% for Social Security when they receive a service. This is because Supplementary Law 126/06, which is the law that introduced the "Supersimple" system, explicitly says companies that choose that system are not subject to the withholding tax under Law 8212/91. Earlier laws, however, had left room for doubt, which is why some companies receiving services took a more conservative position and chose to make the withholding under discussion to avoid possible challenges from the tax authorities. In these cases, it is up to companies choosing the simplified tax system to request reimbursement for the improperly withheld tax from the treasury.

7. TAX APPEALS ADMINISTRATIVE COUNCIL CHANGES HOLDINGS

In recent decisions on administrative appeals against federal tax infraction notices, the Tax Appeals Administrative Council held in favor of the tax authorities, issuing important decisions regarding tax planning brought by taxpayers.

The new structure created for the old Tax Appeals Board from December 2008 could have influenced the change in the holding. Previously, each hearing panel was made up of eight administrative law judges, four of whom represented taxpayers and four the tax authorities. The panels continue to be evenly balanced, but now they have only six administrative law judges.

Companies were defeated in at least four cases. In one of the cases in which there was a holding that changed in favor of the tax authorities, the company sought to fully deduct the tax loss resulting from the merger of another company from corporate income and social contribution taxes. The First Section decided there is no legal provision for doing so, although the Tax Appeals Board had been holding that it could be done (regarding this decision, see our additional comments in item 2 of this newsletter). In another case, the Third Panel of the Upper Chamber of the body decided the deadline for requesting a tax refund runs five years after the improper payment. Before this decision, the body had held the deadline was up to five years after a Federal Supreme Court decision had declared the tax unconstitutional.

In two other cases, the Tax Appeals Administrative Council held that the company in question had to pay the tax due, plus an enhanced fine of 150%, even though there was no evidence of fraud, but only of a sham transaction. In similar decisions issued under the old structure, the administrative law judges usually reduced the fine unless there was actual evidence of fraudulent intent and fraud. It bears emphasizing that in all the decisions regarding tax planning, the importance of the economic content of the transaction is becoming ever clearer.

New changes in the holdings of the Tax Appeals Administrative Council could appear soon since 40 new administrative law judges should be selected. They will be selected by a blue-ribbon panel made up of representatives of the tax authorities, trade associations and unions. However, no definite date has been set for the selection.

8. STATE WINS “TAX WAR” CASES

The chambers of the Tax and Fee Court of São Paulo have decided that the tax credit equal to the full ICMS tax rate from São Paulo cannot be used by companies in São Paulo that have transferred merchandise between companies from the same group located in the states of Goiás, Mato Grosso, Mato Grosso do Sul, Minas Gerais or the Federal District, when they have paid the ICMS tax with a discount.

Under the decision, these companies cannot use the tax credit from the full amount of the ICMS tax in São Paulo because the National Treasury Policy Council has not authorized the discount to be given by the mention states. The tax benefit given in this situation would be void and, therefore, the tax credits it generates not usable. However, cases involving companies not belonging to the same economic group have not yet been heard and the results may be different in these cases.

9. FEDERAL REGIONAL COURT FOR THE 3RD REGION ALLOWS CREDIT OFFSETS

The use of federal tax credits, such as those resulting from the Tax on Industrialized Products (*Imposto sobre Produtos Industrializados*), or IPI, Social Integration Program Tax (*Programa de Integração Social*), or PIS and Social Security Financing Tax (*Contribuição para o Financiamento da Seguridade Social*), or COFINS taxes, to offset amounts owed for Social Security taxes has been being allowed by the Federal Regional Court for the Third Region in São Paulo.

The main argument used by the appellate court judges in São Paulo is that, after the creation of Brazilian Federal Revenue, which is also called Super Revenue (which was established by Law 11457/07), all these taxes are now administered by a single agency.

However, it is important to note that there is not a legal provision for this type of offset. Therefore, only the issuance of a regulation can provide a certain guarantee regarding the possibility of using these credits to offset Social Security debts.

10. POSSIBILITY TO USE ICMS CREDITS

The 21st Civil Chamber of the Court of Justice of the state of Rio Grande do Sul has held that ICMS tax credits from the acquisition of indirect inputs, such as lubricants for machinery, can be used without having to wait the period established by the so-called Kandir Law (Supplementary Law 87/96) for granting the benefit, which would occur in January 2011. The main argument used by the appellate judges is that if the time limit for using the credits established by the Kandir Law were imposed, it would violate the constitutional principle of no cumulative taxation.

The use of the ICMS tax credits, however, is not a settled issue. In this regard, the Superior Court of Justice has already issued a decision denying the use of accumulated ICMS credits to pay the tax owed in tax substitution.

11. PRELIMINARY DECISION CHANGES WAY TAX IS CHARGED

The 9th Public Treasury Court of São Paulo has issued a decision allowing the payment of the estate and donation tax based on the assessed value of real estate. The São Paulo Treasury Department had issued Official Letter from the Tax Administration Executive Committee number 27/2009 stating that the tax should be calculated based on the property's benchmark value. However, the decision held the assessed value of the asset or right, expressed in Brazilian currency, should be used for the calculation under Law 10705/00.

The arguments regarding the estate and donation tax are the same ones raised by taxpayers regarding *inter vivos* tax on the transfer of assets for consideration. The tax authorities have also begun requiring that the calculation of this tax be based on the benchmark value.

In regard to both taxes, there is a debate about whether the change in the method for calculating the tax leads to an increase in the amount owed, which can only be introduced by a law.

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