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Tax Administrative Decision in Tax Planning Practice - The RBS Case

Taxpayer Council´s Appellate Decision no. 101-94.340 of September 9, 2003 handed down by the Superior Chamber of Tax Appeals

RBS Administração e Cobrança Ltda. ("RBS") was issued an infraction notice by the federal tax authorities (by way of simplification, "IRS") for collection of capital gains tax.

The IRS claimed that RBS had resorted to deceptive simulation to avoid taxation.

In 1999 Telefonica Interactiva do Brasil Ltda. ("Telefonica") subscribed to a share capital increase of Nutec Informática S.A. ("Nutec"). The subscription price included a significant premium amount.

Telefonica's subscription represented 16.67% of the total issued shares of Nutec. This afforded Telefonica a controlling interest in Nutec.

RBS was among the Nutec shareholders at the time, being its prior shareholder. RBS booked its investment in Nutec with basis on the equity pick-up method. Here it is important to bear in mind that equity pick-up is nontaxable.

After Telefonica's subscription and as a minority shareholder RBS had the right to withdraw from Nutec and request redemption of its shares. Less than 3 months after Telefonica's subscription, RBS exercised this right and received from Nutec an amount equivalent to that shown on RBS's books, as adjusted by equity pick-up (which, naturally, considered the effect of the premium paid by Telefonica). As a result, no tax was payable.

The IRS, however, challenged the redemption on the ground of simulation. This is to say that in the IRS' view RBS and Telefonica dressed up a 'subscription followed by a redemption' as an arrangement that was in truth a 'share purchase agreement' between themselves, all with the intent to avoid capital gains tax. Generally, simulation is to be understood as the structuring of a transaction in such a way as to give it an appearance that disguises its true nature.

Invoking simulation, the IRS sought to disregard the Telefonica's subscription followed by RBS's redemption and treat the equity pick-up amounts recorded by RBS arising from the Telefonica premium as taxable financial gains.

Particular attention should be drawn to the following factual and documental elements the IRS used in making its case:

(i) prior to Telefonica's subscription Nutec shareholders were considering prospecting investors to expand business. They engaged a consulting company to value Nutec. The IRS had access to the assessment and noted that based on it the amount paid by Telefonica for 16.67% of Nutec was very similar to the amount that would have been payable to acquire a 100% ownership interest in Nutec. The IRS found peculiar that a reputable audit company had not been engaged to produce a detailed appraisal report and argued that the absence of any such report was indication that the subscription price paid by Telefonica exceeded significantly the market value of the 16.67% portion of Nutec;

(ii) on the same day of Telefonica's subscription, two shareholder agreements were signed, namely: (a) Shareholders Agreement 1, establishing that at any time, any minority shareholder, including RBS (which the IRS maintained was actually the seller of the Nutec investment) could redeem its Nutec shares. This Agreement was signed by all Nutec shareholders, including RBS; and (b) Shareholders Agreement 2, which would only become effective if RBS opted to redeem its shares in Nutec within 3 months from the date of execution. This Agreement was executed among Telefonica (which the IRS maintained was the purchaser of the Nutec investment) and all minority shareholders of Nutec but RBS to govern their relationship in the event RBS withdrew from Nutec. The IRS argued that it had never been the intention of RBS and Telefonica to create a longstanding shareholding relationship at all. RBS had planned on exercising redemption under Shareholder Agreement 1 from the very beginning. Indication of this was precisely Shareholders Agreement 2. The real purpose of the structure set forth in these agreements was the transfer (purchase and sale) of Nutec shares from RBS to Telefonica; and

(iii) also, on the very same day Telefonica subscribed to Nutec shares, RBS borrowed different bank loans in an amount corresponding to half of the amount that would be subsequently withdraw from NUTEC, that was secured by a pledge on bank certificates of deposit ("CDB") acquired by Nutec. The IRS saw this as a means by which Telefonica was actually partially transferring or anticipating to RBS half of the proceeds of the "purchase price" in exchange for RBS' shares of Nutec.

RBS appealed to the Taxpayers' Council in an attempt to annul the capital gains tax assessment arising from its alleged infraction. The Taxpayer's Council found that no intent of simulation was present and that the transaction could not be characterized as a share purchase since RBS's withdrawal was merely a possibility and not an effective obligation. In the Council's opinion, insofar as the transaction was completed in conformity with tax and commercial legislation and properly recorded and accounted for it could be said to fit more closely the description of an "indirect legal transaction" (negocio juridico indireto) rather than a simulation. This can be said to mean that the IRS cannot disregard a structure that the parties have chosen to use if this structure is not prevented by law. This is especially true if the parties had a purpose to implement and recorded all the steps to pursue such purpose as these steps were effectively performed.

The Attorney of the National Treasury (Procurador da Fazenda Nactinal) filed an appeal to CSRF ("CSRF") (higher administrative level for tax matters). Last October 14 members of CSRF's First Panel ruled against the National Treasury, thereby cancelling the tax assessment notice. Hearing the appeal were 10 CSRF members representing both the National Treasury and the taxpayer in equal number (5 for each side). Six members voted in favor of the taxpayer (rejecting the National Treasury's appeal) and 4 against.

The CSRF members that voted against the taxpayer did so in reliance on the same points (above) that led to the tax assessment notice, especially the existence of Shareholder's Agreement 2 and the RBS borrowing backed by CDS's belonging to Nutec.

For the CSRF members that voted in favor of RBS, these elements were not sufficient to corroborate simulation. The taxpayer (RBS) was to be given the benefit of the doubt instead. Specifically concerning Shareholders Agreement 2, they understood this was not a valid and sufficient element to demonstrate a potential intention that RBS always knew it would depart from Nutec as of Telefonica's subscription date especially because RBS was not party to such Agreement 2. And they considered the likelihood of truthfulness of the defense argumentation: the defense tried to demonstrate that there was a shareholder disagreement between RBS (previous controller of Nutec) and Telefonica (successor controller of Nutec after its subscription) which reached an unsustainable level and triggered RBS's withdrawal from Nutec. Only the Relater understood that even if the intension of RBS was to withdraw its NUTEC investment as of Telefonica's subscription that an "indirect legal transaction" would have took place which in his view would be acceptable. Moreover, majority of CSRF members in favor of the taxpayer defended that only proof of simulation could call the transaction into question since currently there is no specific and valid anti-avoidance rule applicable in Brazil (making reference to the lack of regulation of Complementary Law 104/01, which introduced sole paragraph into article 116 of the Brazilian Tax Code). Therefore, they concluded that the absence of proof of simulation warranted a favorable decision be given the taxpayer.

In our view, while relevant in illustrating the extent of evidence required to dismiss a transaction as simulation and recognizing the absence of a valid anti-avoidance rule in Brazil, the decision given in the RBS case frustrated the expectations of tax practitioners in Brazil. This was mainly because: differently from Taxpayers' Council winning vote in this case (which defended the legitimacy of an "indirect legal transaction"), the very majority of CSRF members were concerned primarily with factual and documental elements of the case so as to identify some degree of business or economic substance in the transaction (for purpose of dismissing or not simulation) rather than defining clear boundaries within which taxpayers may perform their legal tax planning (tax avoidance). This is why, in our perception, the decision is not to be seen as a leading case.

CLARIFICATIONS ON THE MATTERS CONTAINED HEREIN SHOULD BE ADDRESSED TO OUR OFFICE.

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