

Corporate Reorganizations Involving Real Estate Properties: Relevant Precedent from the Brazilian Supreme Court

By Celso Grisi and Giampaolo Riccio Marzulli

Abstract *The Brazilian Supreme Court ("STF") imposes a restriction on the Municipal Inter-Vivos Property Transfer Tax ("ITBI") exemption applicable to the capitalization of real estate properties into equity by taxpayers that do not act in the real estate business.*

Recently, the Brazilian Supreme Court's ("STF") Full Bench issued a relevant precedent ("Precedent") impacting corporate reorganizations involving the transfer of real estate properties in Brazil.

The Precedent (Extraordinary Appeal No. 796.376) was issued under the "general repercussion" systematic, which means, in practical terms, that it represents a binding decision so that the guidance established by the STF shall be mandatorily observed by all taxpayers operating in Brazil.

The subject matter under discussion in the Precedent refers to the exemption of the Municipal *Inter-Vivos* Property Transfer Tax ("ITBI") levied on the contribution of real estate properties into capital of legal entities (i.e., capitalizations, drop-downs, among others situations subject to the "ITBI Exemption") by domestic (legal entities and individuals) and foreign investors (legal entities, individuals, funds and others).

Firstly, it is important to keep in mind that the competence to charge the ITBI belongs to the Brazilian municipalities (i.e., there are approximately 5,570 municipalities, such as the City of São Paulo and Rio de Janeiro, for example) on transactions involving costly transfers of real estate properties (i.e., purchase and sale, equity's capitalization, assets' swaps, among others). The municipality where the real estate property is located is entitled to charge such tax.

The ITBI Exemption does not apply to transactions involving legal entities acting in the real estate business such as the purchase and sale of real estate and renting transactions, including built-to-suit, leasing and sale lease backs. To benefit from the ITBI Exemption, it is necessary to meet the applicable requirements provided by the legislation of the municipality where the asset is located.

In general terms, the ITBI Exemption does not apply under any circumstances to those legal entities that accrue more than 50 percent of their gross revenues from real estate activities for at least two continuous years, to the extent such entities are deemed as real estate companies by the legislation. The ITBI rates vary

Celso Grisi

cgrisi@mayerbrown.com

São Paulo (T&C)

+55 11 2504 46

Giampaolo Marzulli

gmarzulli@mayerbrown.com

São Paulo (T&C)

+55 11 2504 4687

according to the municipality, usually ranging between 2 percent and 4 percent on the (i) transaction value or (ii) on the market value of the real estate property estimated by the municipality, whichever is higher.

A very specific point of real estate properties' contribution into capital of legal entities was analyzed in the Precedent. As per Law No. 6,404/76 (i.e., Brazilian Corporations Laws – "BCL"), the equity (i.e., so-called *Patrimônio Líquido*) of the legal entities is composed by different "account statements," including (i) the capital; (ii) the capital reserves; (iii) the accumulated profits/losses; (iv) the Adjustments to Equity Valuation ("AAP"); and other accounts.

On a capital contribution of real estate properties (or any other asset, such as shares, intangibles assets, cash, among others) it is possible, under a legal and accounting perspective, to allocate the value of the contributed asset to "capital" and "capital reserves." In this regard, it is valid to highlight that said allocation is only tax efficient when the capitalization involves a Brazilian corporation (i.e., so-called *Sociedade Anônima* – "S/A"), as the allocation of assets into a Brazilian company's capital reserves (i.e., so-called *Sociedade Limitada* – "Ltda") will trigger the Corporate Income Tax ("CIT") levy at an aggregate rate of 34 percent on the full amount registered as "capital reserves."

The "capital" and "capital reserves" asset allocation in S/As is an important mechanism used under corporate reorganizations to balance the percentage ownership of each party.

For illustrative purposes, by allocating a portion of an asset value into "capital reserves," as a counterpoint to the full allocation of the asset value to "capital," it is possible to provide the new investor with a pre-defined ownership percentage of the equity interest (i.e., shares) of the invested company (i.e., X percent) based on the economic *rationale* of the deal.

The argument raised by the municipal tax authorities of São João Batista/SC (a small city located in the south of Brazil) in the Precedent outlined above was that the ITBI Exemption on real estate properties contributions should only apply to the portion of the asset contributed into "capital." As a result, the

portion allocated to "capital reserves" would be subject to the ITBI burden.

STF Full Bench granted the municipal tax authorities of São João Batista's request (seven in favor and four against), after a 10-year litigation, ruling that the ITBI Exemption should only cover the portion of the real estate properties allocated to capital, under the following terms: "*The ITBI immunity provided by Section 156, paragraph 2, item I of the Federal Constitution does not encompass the value of real estate properties exceeding the amount allocated to capital.*"

Accordingly, in light of the Precedent, the following ITBI aspects should be considered under corporate reorganizations involving real estate properties:

- (i) The Precedent did not establish any legal restriction on the transfer of real estate properties between Brazilian legal entities owned by foreign or domestic investors;
- (ii) Legal entities that do not act in the real estate business can still benefit from the ITBI Exemption (i.e., purchase and sale of real estate, renting and leasing transactions); and
- (iii) In the event that part of the real estate property is allocated to "capital" and "capital reserves," the portion attributed to "capital reserves" will be subject to the ITBI at rates varying from 2 percent to 4 percent.

There is a side question on whether the Precedent would trigger Individual Income Tax ("IRPF") impacts on capital gains at progressive rates varying from 15 percent (gains until BRL 5 million) to 22.5 percent (gains higher than BRL 30 million) upon the contribution of the real estate properties. This tax would only apply if the value of the capital contribution is higher than the acquisition cost of the real estate property indicated in the Individual Income Tax Return ("DIRPF"). Our view is that the Precedent was not issued with the purpose of ruling on capital gains taxations issues, but only on ITBI impositions.

Finally, the Precedent did not establish any tax restrictions on mergers and spin-offs of companies that own real estate—which tax immunity continues to be an important tool for corporate reorganizations.

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