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"INTERNATIONAL TAXATION ASPECTS THAT AFFECT MANAGEMENT OF THE TAX ADMINISTRATIONS"

Subtopic 1.2:

"EFFECTIVE APPLICATION OF ANTI-ABUSE CLAUSES TO AVOID DOUBLE TAXATION"

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Introduction

The increase in the international flow of income arising from services, interest, dividends and royalties has led to opportunities to decrease the tax burden of taxpayers through tax avoidance or evasion[1]. These tax advantages not only cause losses in tax revenue, but also competitive imbalances, both in the country of the investor as well as in the investee country. The large international capital mobility, together with the intangibility of transactions involved in revenues, have raised challenges for tax administrations to fight abusive tax planning using related parties abroad.

Within the framework of international organizations, there is a global trend to fight abusive tax planning involving the use of several countries, causing, among other effects, the erosion of tax revenue base and adverse effects on local competition. The Organization for economic co-operation and Development – OECD recently published a report on Addressing Base Erosion and Profit Shifting [2] which concludes in the need of a greater dynamism and co-operation between tax administrations, both in regards to the update of the legal bases, as well as in terms of exchange of information and adoption of effective and integrated anti-abuse measures in fighting this type of practice.

Often, this type of tax planning is accomplished using conventions for the avoidance of double taxation. A clear purpose of the conventions is to promote freedom of investment decisions by eliminating international double taxation. Furthermore, its objectives also include the prevention and the fight against abusive tax planning and international tax avoidance.

•International Context

The global financial crisis of 2008 led to hardening the fight against tax avoidance and evasion, given the difficulty of Governments to provide a favorable environment for investments without compromising the tax base. At the G-20 meeting held in London in 2009, leaders expressed the importance of adopting measures to fight abusive tax planning, through the adoption of countermeasures such as: request for greater transparency by taxpayers and financial institutions; taxation at source on payments; non deductibility of expenses paid to residents in uncooperative jurisdictions and review of policies and conventions to avoid double taxation.

Another point worth mentioning is the effective fight against international tax planning through conventions for the avoidance of double taxation such as the work of the Global Forum on Transparency and exchange of information for tax purposes (Global Forum).

1 Tax evasion is the practice of an unlawful act, by which the taxpayer violates tax liabilities, providing false statements or directly disobeying the law. On the other hand, tax avoidance corresponds to practice a lawful act, by which the taxpayer wants fiscal savings by using a Transaction or structure which makes a specific tax rule no longer applicable. Internationally, this practice occurs through manipulation of facts or creation of structures in a given territory, in order to influence the characterization. The term "tax avoidance" does not necessarily correspond to any irregular or improper tax planning. Therefore, given the scope of the expression, it is necessary that its interpretation is always within a context, and never in a separate way.

2 OCDE, 2013, *Addressing Base Erosion and Profit Shifting - BEPS*

With the standards established by the Global Forum, the exchange of information has become a more solid and efficient instrument in fighting the abusive use of conventions.

Without an intense and coordinated information exchange, the fight becomes unsuccessful, since obtaining data about parties abroad depends mainly on the cooperation from foreign tax authorities. The work of the Global Forum can make tax administrations identify hidden structures and international operations before the control. Undoubtedly, it is an essential factor in the fight against the abusive use of conventions.

- **Anti-abuse clauses in the conventions to avoid Double Taxation**

Since 2003, the Tax Affairs Committee of the Organization for the Economic Co-operation and Development (OECD) comments on art. 1 of its Model Convention stand towards the existence of a general principle of the conventions to avoid double taxation, whereby their benefits should not be applied when the main purpose for certain operations is to ensure a more favorable tax position, contrary to the objective and purpose of the Convention.

According to the OECD (paragraph 22 and 22.1 of the comments to article 1rst), rules that offer ways to fight abuse of treaties as "the principle of substance over the form", "economic substance" and "general anti-abuse rules" do not conflict with the treaties.

Thus, when analyzing a supposed conflict of a particular situation with the treaties, the following must be reminded:

(i) the benefits of a Convention should not be applied when the main purpose is to ensure a more favorable tax position
(ii) (ii) the purpose of a Tax Convention is to avoid double taxation and not promote the "double taxation", and
(iii) (iii) the Convention does not exclude the application of domestic anti-abuse rules.

In Brazil, in 2001, the single paragraph of art. 116 was inserted in the national tax code (CTN), establishing that "the administrative authority may disregard acts or legal transactions carried out for the purpose of disguising the taxation event or the nature of the constituent elements of the tax obligation, in compliance with the procedures established by the ordinary law". In spite of the law referred in the clause, which has not yet been issued, the control of the Federal Revenue Service has discussed, in certain cases, situations that may intend to basically reduce taxes, and the anti-avoidance principle stated in the CTN has been adopted in judicial and administrative tax litigation decisions, in favor of the Public Administration when there is evidence of avoidance.

•Developments in administrative litigation in Brazil

Until 2003, the Administrative Council of Tax Appeals (CARF), the second instance in the Brazilian tax litigation, adopted a more formal position in their trials. Since 2004, the CARF made changes of its position and has held infringement notices issued by the Brazilian tax authorities based on mechanisms to fight the abuses such as fraud to law, simulation, abuse of rights and discussion about the purpose of negotiations. In these courts, there are possibilities of abusive tax planning both internal (not involving parties abroad) and external.

In cases such as operations routinely called "House and separates" (Constitution and changes in corporate membership with only one day apart, for exclusive tax saving purposes), retroactive incorporation (companies with huge accumulated losses incorporate large and profitable companies, when the opposite would be more probable) and the registration of legal entities without economic substance in countries with which Brazil holds treaties have been analyzed considering more the principles involved and the substance of negotiations rather than just formalities and mere legal compliance.

This fact demonstrates a clear change of approach of Brazilian judges who are applying typical mechanisms and mainly from countries governed by common law systems in a civil law country.

• The Brazilian case-application of the substance over form principle and Results of Fighting Abusive tax planning

An emblematic case of Brazilian litigation concerns the attempt by the taxpayer, to use a Convention for the avoidance of double taxation between Brazil and Spain, aiming at preventing the taxation on income arising from a third company, Spanish subsidiary, established in Uruguay, a country with which Brazil has no treaty signed.

According to domestic legislation, the profits of a subsidiary of a Brazilian company abroad are subject to taxation by the internal revenue service of Brazil. The particular situation involved a Brazilian "Company A", who owned a direct subsidiary in Spain ("company B"), a country with which Brazil has signed a Convention for the avoidance of double taxation. "Company B", in turn, had two direct subsidiaries "C" and "D" in Uruguay and Argentina, respectively. The Brazilian taxpayer argued that, as a result of the Treaty with Spain, the profits of its indirect subsidiary in Uruguay ("company C") would be free from taxation in Brazil, since the link between the Brazilian company would only be with the "Company B", located in Spain.

The second instance of administrative litigation has considered that the Treaty with Spain could only be used to exempt from taxation its own operating profits of "company B", in the amount of R $ 80,562.176,03. The result of the indirect subsidiaries, for a total value of $ 1,456,791,283 .68, should be taxed in Brazil, since there is no Convention for the avoidance of double taxation between Brazil and Uruguay, country where the indirect subsidiary "C" is located.

The specific case reported above is described with more detail in Judgment No. 101-97,070 CARF. The following are excerpts from the trial with the reasoning used by counselors:

EXCERPTS: PROFITS ABROAD THROUGH INDIRECT SUBSIDIARIES

With the aim to apply art. 74 of the provisional measure No. 2,158-35, the results of indirect subsidiaries are considered directly received by the Brazilian investor and their taxation in Brazil is not subject to the rules of the international treaty signed with the country of residence of the direct-controlled one, especially when these results were not produced in operations carried out in the country of residence of the subsidiary, showing the tax planning for not taxing them in Brazil.
(...)

"The applicant cannot invoke in his favor the Treaty signed between the contracting States, that aimed to avoid double taxation of profits earned by residents of the respective States in order to obtain a tax saving resulting from profits earned by other controlled/interconnected company residing in a third State and which are not entitled to benefit because of its substantial situation."
(…)

"In fact, there is no way to consider under the Brazil-Spain Treaty, profits earned in a third country without a Treaty, which is just like crossing one of the Contracting States, since by the rule stated in art. 7 of the Treaty, the profits earned through another legal entity, in which the subsidiary or affiliate abroad keep any type of corporate participation, even if it is indirectly, they will be considered in the balance sheet for corporate purposes, as well as, for the purpose of determining the taxable income and the tax base of the CSLL of beneficiary in Brazil. "
(Judgement No. 101 CARF-97,070-process nº 16327.000530/2005-28)

* MP-Provisional Measure

Since 2010, approximately R$ 30 billion (US$ 15 billion) related to cases of abusive tax planning (national and international) have already been released, considering, among others, the substance principle over form. The developments in litigation have demonstrated the importance of this principle, reflecting the number of cases held in with taxpayers.

•Challenges of Tax Administrations

On the international scene, Tax administrations have the challenge of dealing with the reality of a globalized world, without imposing unnecessary barriers to the capital flow, giving the desired tax neutrality in the natural economic formation processes of transnational groups, preserving the basis of each State.

In this context, it may be necessary to review the principles for a new paradigm in treaties, discussing mechanisms to avoid both double taxation and double non-taxation.

Another important point to be studied is the search for more objective criteria for the standardization of international regulations, such as transfer pricing. The growing stream of income from interest, royalties and intangible services impose challenges to bring objective solutions on matters that often lie in the subjectivity field.

Finally, there is a need for a commitment for establishing a convergence to an international standard that facilitates the exchange of information between tax administrations. Only with an effective flow of information and cooperation between the worlds it is possible to fight international planning.