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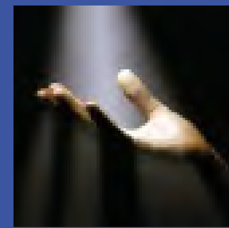

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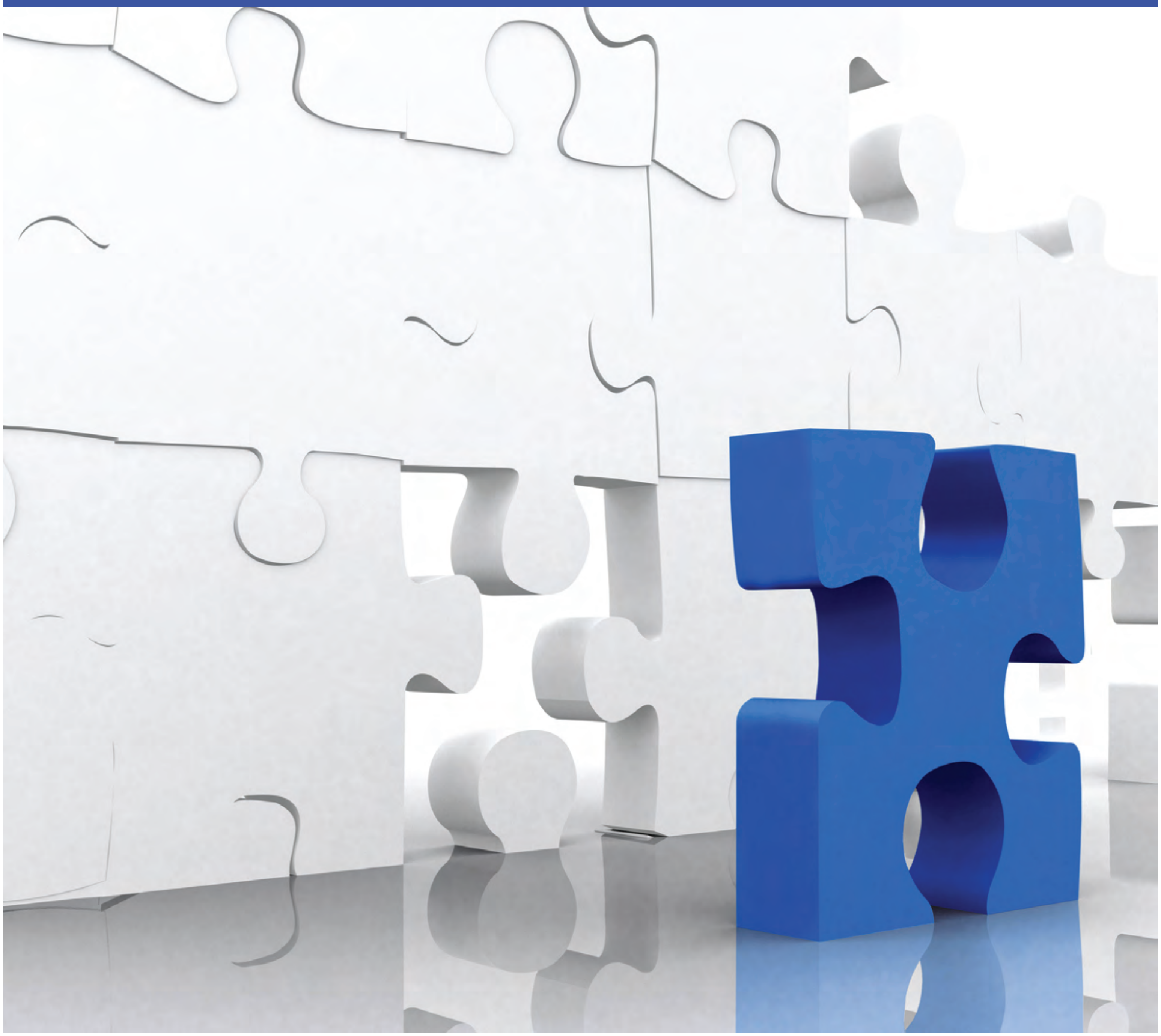
# Tax administration review



# CIAT/AEAT/IEF
# Tax Administration Review

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## Editorial Policy

The Technical Cooperation Agreement signed by CIAT and the State Secretariat of Finance and Budgets, the State Agency of Tax Administration (AEAT) and the Institute of Fiscal Studies (IEF) of Spain, provided for the commitment of editing a review that would serve to disseminate the different tax approaches in force in Latin America and Europe.

An Editorial Board formed by CIAT officials (The Executive Secretary, the Director of Tax Studies and Research, the Training & Development of Human Talent Directorate and Heads of the Spanish) is responsible for determining the topics and select the articles for each edition of the Review.

The articles are selected by the Editorial Board, through a public announcement made by the CIAT Executive Secretariat for each edition of the review. It is open to all officials of the Tax, Customs Administrations and/or Ministries of Economy and Finance of the CIAT member countries and associate member countries. Likewise, those members of the MyCIAT Community not belonging to any of the aforementioned entities may also participate, following evaluation by the Editorial Council.

### Correspondence

Every communication must be addressed to: revista@ciat.org or to P.O. Box 0834-02129, Panama, Republic of Panama.

### Author's Responsibility

The opinions expressed by the authors do not represent those of the institutions for whom they work or those of the CIAT Executive Secretariat.

CIAT/AEAT/IEF
Tax Administration
Review

# Content

No. 41
August 2016

# Message from the Executive Secretary

Dear readers:

*Márcio Ferreira Verdi*

On behalf of the CIAT Executive Secretariat, I am pleased to present to all the member countries and associate member countries tax administrations officials of our organization and, in general, to the entire International Tax Community, the N° 41 Edition of the CIAT/AEAT/IEF Tax Administration Review. It is edited as part of the Technical Cooperation Agreement between the CIAT, the State Secretariat of Finances, the Institute of Fiscal Studies (IEF) and the Tax Administration State Agency (AEAT) of Spain.

In this edition of the magazine will present nine (9) articles focused on taxation issues in countries of America Latin and Europe: Considerations on anti-avoidance standards in the Brazilian legal system; The “CSR Tax Registry” and the requirement for tax information in the social balance report; Considerations for an analysis of transfer pricing comparability in Latin America; Improving the efficiency and effectiveness of the AUR Program; The taxation of the dividends in Ecuador; The myth of the banking secrecy before tax authorities; Application of the general anti-avoidance rule in Chile; National and international changes in tax environment: An opportunity to promote the control of the inheritance tax in Chile.

In the technological field, we present the article: Spanish tax framework and international tax planning for research, development and technological innovation activities.

We are grateful for the high interest that has welcomed the call for presenting contributions for this Review edition.

We hope that this publication will stimulate the transfer of knowledge, the transformation of information into learning and, in fine, constitute a useful resource of practical applicability for the International tax community.

Márcio Ferreira Verdi
**Executive Secretary**

# WHO TOOK AWAY MY COMPARABLE? CONSIDERATIONS FOR AN ANALYSIS OF TRANSFER PRICING COMPARABILITY IN LATIN AMERICA

**Fernando Becerra O´Phelan**


## SYNOPSIS

It is becoming more common to hear public outcry when media say that multinationals entities (MNEs) do not fully pay their taxes. Actions to mitigate this problem were published in 2015; however, they did not consider some specific actions that Latin American countries need to improve in order to tackle base erosion. The first installment of this article addresses topics such as the lack of data, adjustments and other items affecting the comparability of the transfer pricing analysis, as well as the challenges faced by tax authorities.


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**Content**



After decades of international coexistence with the Arm's Length Principle as a cornerstone on which transfer prices are structured, in recent years we have heard voices growing louder to change this approach. However, despite the insistence of academics and non-governmental organizations, alternatives to the current model failed to convince the countries to make the leap towards what, in theory, would be a fairer distribution of the benefits.

In effect, theoretical alternatives like "unitary taxation" or criticized as in the case of the "formulary apportionment", used in the United States to distribute the profits achieved by MNEs among the states participating in an operation, were discarded, and instead, a global consensus was reached to fix the current system. Therefore, the challenge now is to provide technical tools and transparent information to support tax administrations to control international taxes, without discouraging private investment, generating double taxation or moving away from the predictability that every company expect from a modern authority.

In this regard, one of the reasons for criticizing the Arm's Length Principle is the practical limitation to identify comparable companies or comparable transactions that allow met the market value at independent parties would agree to operate. This problem is accentuated in the case of developing countries, where the lack of public information obstructs the work of data collection and analysis.

In fact, the G-8 Group of Leaders, in their press release of June 2013 point out in item 29 that:

> "The ability of tax administrations to compare relevant price information across jurisdictions is essential for the effective operation of transfer pricing rules, and a lack of data on comparable transactions is a significant issue for effective tax collection, particularly in developing countries. We ask the OECD to find ways to address the concerns expressed by developing countries on the quality and availability of the information on comparable transactions that is needed to administer transfer pricing effectively".

Thus, this issue is considered by the Organization for Cooperation and Economic Development (OECD), which identifies risky situations of profit shifting faced by developing countries which are not included in the BEPS project ("Base Erosion and Profit Shifting"). A more extensive elaboration of this specific problem can be found in "Transfer Pricing Comparability Data and Developing Countries" (OECD, 214).

The topics addressed in the first part of this article are as follows: First, how the lack of companies used as comparable, and how a vague analysis of the transfer pricing comparability, can become one of the reasons why the taxable of Latin American countries is eroded. Second, the challenges faced by the tax administrations to mitigate them.

A second installment part of this article will analyze the impact generated by asymmetries of information ("moral hazard") in Latin America, a product of the lack of comparable transactions, either in assessing the value of intangible; low value-added services; cross-border commodities transactions, following recommendations on actions 8-10 of the BEPS project. Practical alternatives to this lack of comparable operations will be proposed, such as the implementation of simplified measures, safe harbors and the coherence and consistency of the so-called "sixth method".

## 1. LACK OF INFORMATION ON COMPARABLE COMPANIES

As noted above, both taxpayers and tax administrations in Latin America face practical limitations to select companies that are truly comparable, in order to successfully apply the methods based on gross or operating margins[1].

### a. They are just "potentially"

The first reflection we must ask by attempting to identify operations comparable to those made between related parties, is that these are unique, which makes impossible to find exactly the same. I.e., the synergies or fragmentation of the value chain within an MNEs have been planned with specific tasks towards a particular target, which makes them different from any other company coming into the market to compete independently.

Moreover, in practice, the entities selected as comparable are the headquarters (HQ) of those MNEs; i.e., is not the direct competitor or that entity that performs the entirety of their operations with independent parties. However, since the HQ is the one that consolidates the financial information, the effect of a potential overvaluation or sub-valuation produced with their related parties is mitigated and compensated.

Therefore, a first conclusion is that all the companies selected are "potentially" comparable; however, a diligent debugging process allows identifying those that approximate the behavior of a normal and robust market, reflecting what rational economic agents, under similar conditions, would agree.

### b. The twin limitations

Dependence from extractive natural resources, low industrialization and tight market penetration (concentration of businesses in certain cities or regions) cause that many economic sectors in Latin America are conformed by natural oligopolies that concentrate the market subsidiaries of foreign multinationals, which limits the competition and identification of potential comparable[2].

Even though the above-mentioned may vary in intensity from a territory to another, it is a fact that the Latin American countries, with shallow equity markets, face the same twin limitations: too few players and many of them are not bound to display public information for the investors.

In the Peruvian case, an example of what could have been the start for trying to overcome this situation was the obligation to companies, not listed on the stock market and reaching a certain income level, to present annually their audited financial statements to the security market supervisory entity ("SMV"). However, this initiative was vetoed by the Constitutional Court in 2016, ruling the unconstitutionality of the law, recognizing the right to privacy of the companies that this standard, they say, violated. So this information was presented for the fiscal years 2013 and 2014 only.

1. *The Resale Price and Cost Plus (Traditional Methods) suggest an evaluation at the level of gross margins; while the Transactional Net Margin and the Residual Profit Split ( Profit Methods) analyzed returns at the operational level.*
2. *Just as an example to outline that situation in Peru, one MNE of the brewing industry reached a market share of 97% in 2014. In addition, in 2014, a cement MNE concentrated 51% of the local sales; and a telecom company obtained 71% of the market share.*

Thus, in Peru only very little public financial information are published, mainly from mining companies[3], which are unrepresentative for a capital importing country, which should aiming to build performance benchmarks.

The following table attempts to measure the representativeness of the main players in the countries that compose the Pacific Alliance (Peru, Mexico, Chile and Colombia), trade bloc that aims to facilitate the economic integration, with respect to their GDP (2014):

**Table 1**

**Importance of the leading companies in the Pacific Alliance regarding their respective shares of GDPs**

| Countru | Main Groups | Revenue (Billions of USD $) | % GDP | % GDP Accumulated |
|---|---|---|---|---|
| **Mexico** | America Movil | 61.60 | 2.87 | 4.54 |
| | Femsa | 20.00 | 0.93 | |
| | Grupo Alfa | 15.90 | 0.74 | |
| **Colombia** | Ecopetrol | 37.70 | 5.91 | 8.24 |
| | Grupo Aval | 9.00 | 1.41 | |
| | Bancolombia | 5.90 | 0.92 | |
| **Chile** | Antar Chile | 24.40 | 6.15 | 14.70 |
| | Cencosud | 20.70 | 5.22 | |
| | Falabella | 13.20 | 3.33 | |
| **Peru** | Relapasa | 4.11 | 1.11 | 2.87 |
| | Banco de Crédito del Perú | 3.28 | 0.88 | |
| | Telefónica del Perú | 3.27 | 0.88 | |

**Source:** Forbes Magazine Global 2000 - year 2014 / Top Online Peru Publications

**By**: Author

Thus, we can observe that in Chile, the incomes of three conglomerates represented in 2014 approximately 14.7% of GDP and this suggests how concentrated the market is.

By contrast, it seems that in Peru the market is diversified; however, the effect produced by the informal sector in the economy distorts the obtainable conclusions[4].

In Mexico, the inbounds of one single MNE are almost 3% of the national GDP; without taking into consideration the Pemex State Company, the largest oil producer of Latin America.

Therefore, a way of celebrating the first five-year term (2011-2016) of the Pacific Alliance could be to make accessible the financial data of its main companies. This can be done, while respecting

3. *In 2016, twenty mining companies listed on the stock market of Lima published their financial information.*
4. *"Them features structural of the informality labor in the Peru not have changed significantly during the last decade, of this mode, the rate of informality labor urban average between the 2004 and the 2014 is between 53% and 75% according to the definition of informality" (Cespedes, 2015).*

the tax secrecy, building a representative regional database that would enable sharing information between the tax administrations, as well as providing the private sector with efficiency ratios by sectors. There is no doubt that this would encourage competition.

Therefore, if the countries of the Pacific Alliance have promoted the creation of the Integrated Latin American market, regional market for trading equity securities, and are currently discussing the implementation of a platform allowing the exchange of information on migration, the proposal made here corresponds to the objectives that this block has stated.

Therefore, the constrain would not be the lack of potentially comparable companies to build benchmarks, but to implement mechanisms improving the information flow; procedure that can follow the high standards proposed by OECD for the exchange of automatic information, ensuring thus reliability, traceability and transparency in its use. This proceeding is no different for any of the countries that seek to comply with FATCA and CRS international regulations.

Thus, it would be convenient to establish a workgroup composed of technicians from the four countries, to assess and propose solutions of tax convergence with a view to reduce the international tax gaps and harmonize its treatment.

### C. The use of Secret Comparables

The hidden or secret comparables are information accessible only to the Tax Administration and in respect of which there is a duty of confidentiality in compliance with the tax normative. Given this obligation, the following questions would arise:

Can this information be used for transfer pricing issues? If the answer is yes, which are the conditions that enable their use?

In this regard, the OECD guidelines of transfer pricing applicable to multinational enterprises and tax administrations (IEF, 2010) in paragraph 3.36 point out:

> "Tax administrators may have information available to them from examinations of other taxpayers or from other sources of information that may not be disclosed to the taxpayer. However, it would be unfair to apply a transfer pricing method on the basis of such data unless the tax administration was able, within the limits of its domestic confidentiality requirements, to disclose such data to the taxpayer so that there would be an adequate opportunity for the taxpayer to defend its own position and to safeguard effective judicial control by the courts".

Regarding the above mention, the use of secret comparable information would be possible if two conditions are met: i) to provide the taxpayer with the necessary and sufficient information so that he can defend its position; and (ii) comply with the tax rules on confidentiality. However, in practice, is it possible to meet these two conditions at the same time?

Tax rules on confidentiality protect the taxpayers' right to confidentiality, which is not absolute, as all constitutional rights, and may therefore be validly limited in order to protect other rights or the common good, such as the tax collections of a country. Therefore, the cornerstone is to determine the core of the right to confidentiality of taxpayers that cannot be limited without emptying the other content.

According to one interpretation, the core is the information that identifies the hidden comparable, to be understood as the name or company name, tax identification number, brands, industrial or commercial secrets among other distinctive signs. Thus, Latin American tax administrations, without transgressing the duty to maintain confidentiality, could reveal various items. For example: i) outlook of the business; (ii) entity size; (iii) market level where operates; (iv) amount of sales; (v) gross profitability; and (vi) operating profit, without this implying having infringed their rights and/ or the tax reserve. However, the question still arises if this information is sufficient for the taxpayer to exercise conveniently his right of defense for transfer pricing purposes and, in particular, when applying operating margins methods (non-traditional), comparing companies´ returns.

In this regard, if the company selected as secret comparable owns valuable brands and other specific intangible, this information should not be disclosed. Nor would be shared the extraordinary facts that could affect, positively or negatively, the profitability of the comparable; i.e. financial elements that affect and determine the gross and operating profitability of the company. Moreover, not disclosure the name of the taxpayer could not demonstrated that weather is or not part of an MNE, main condition where the arm's length principle is based.

Therefore, with the limited financial information to which taxpayers would have access, they could not exercise properly the right of defense to validate the accuracy of comparability with other companies, when profit margin methods are applied.

However, it is important to highlight that this situation is quite different from comparing market conditions or contractual terms through traditional methods (Comparable Uncontrolled Price), where the trend or market behavior is what we try to identify. Thus, contracts between third parties are reviewed and the conditions in which a particular sector agrees on business with third parties are studied, without violating the confidentiality or the taxpayer's right of defense. It is important to note that Action 10 of the BEPS project, with regard to cross-border commodities transactions, suggests that tax administrations identify trends and market conditions at the time of determining a presumptive quotation period; and an option to achieve it is building an internal database of contracts. Further details of this procedure will be addressed in the second part of this article.

Therefore, we confirm the need to promote broad and transparent information to markets, which serve as a sector reference parameter to taxpayers, and provide toolkits to Latin American tax administrations to demand fair payment of taxes.

### d. External information

The lack of local comparable companies imposes that both taxpayers and tax administrations opt to select companies that operate in similar industries, even though they are not in the same geographic market. Thus, in theory, their results should converge, regardless of the territory where they are produced. This approach leads, in general, to less precise searches but broadens the framework of analysis. Companies with public information from abroad are an alternative that, potentially, approach to the sector that will be compare. The comparability adjustments that allow eliminating the distortions between different countries is another challenge that remains.

In this regard, the OECD notes in its Guidelines that:

> 1.36"(…) In order to establish the degree of actual comparability and then to make appropriate adjustments to establish arm's length conditions (or a range thereof), it is necessary to compare attributes of the transactions or enterprises that would affect conditions in arm's length transactions. Attributes or "comparability factors" that may be important when determining comparability include the characteristics of the property or services transferred, the functions performed by the parties (taking into account assets used and risks assumed), the contractual terms, the economic circumstances of the parties, and the business strategies pursued by the parties.

> 3.35. "Taxpayers do not always perform searches for comparables on a country-by-country basis, e.g. in cases where there are insufficient data available at the domestic level (...)."Non-domestic comparables should not be automatically rejected just because they are not domestic. A determination of whether nondomestic comparables are reliable has to be made on a case-by-case basis and by reference to the extent to which they satisfy the five comparability factors. (...)".

The United Nations, in their Practical Manual on Transfer Pricing for Developing Countries (2012) mention that:

> 5.3.4.13 "With regard to geographic location and product/service market, independent companies operating in the same market(s) as the tested party, where available, will generally be preferred. However, in many countries, especially developing countries, the availability of independent comparables, or of public information on independent comparables, is limited. Use of foreign comparables may therefore be needed, although this can also be difficult for many developing countries without access to relevant databases and with limited resources to analyze and adjust the foreign comparables".

Meanwhile, in Peru, section d) article 32-A of the Income Tax Law points out that:

> "When for purposes of determining the comparable transactions, available local information is not available; the taxpayers can use information from foreign companies, and must make the necessary adjustments to reflect the differences in the markets"

However, comparability will be increased if the market conditions where these companies operate are similar to those of the tested party, both in size and in the particular regulation (i.e.: NAFTA, CAN, Mercosur or Pacific Alliance economic clusters). Certainly, there are more similarities in the way and risks of doing business between Latin American and resources-rich countries, than among developed countries. Hence, it is important to promote the construction of regional samples; for example, the use of pan-European comparables are recurrent and accepted in Europe. However, OECD in its guidelines 3.35 indicates:

> "Whether or not one regional search for comparables can be reliably used for several subsidiaries of an MNE group operating in a given region of the world depends on the particular circumstances in which each of those subsidiaries operates"

Therefore, it can be concluded that, for purposes of applying methods based on gross or operating margins, it is possible to use of non-domestic comparable companies, preferably from regional or similar markets, if they satisfy the five comparability factors and the delineation approach suggest in the BEPS Project (Actions 8-10).

**e. The databases**

Commercial databases (DB) are used as sources of information, both financial and functional, for the identification of external comparables. They collect public data, essentially accounting, of the memoirs and reports for investors, who then adapt to perform searches in accordance with certain parameters. Although this is a widespread practice, there is a certain distrust because of the limitations of these databases for the comparability analysis (Rubio, 2010):

1. Not all countries provide reliable information that feed the DB;
2. Even when they have it, they do not always have the same information available or with the same accounting standards;
3. Many DB are not intended to be used for performing transfer pricing documentation;
4. Analyses of comparability with DB often give more importance to the number of comparables than to their quality

5. The cost of these DB may be important for small and medium-sized enterprises.

Thus, the selection of comparables must go beyond what the DB present. It is necessary to filter and complement the results with other reliable sources of information. In addition, often, the comparables companies present their information in a language other than the one used in the country where the assessment is performed; therefore, the readability of the evidence is an issue.

On the other hand, it must be mentioned that, from a survey carried out by CIAT in 2013 to a group of tax administrations of Latin America and the Caribbean, six of them relied on the DB of the private provider Osiris; three had contracted with Compustat; and four noted that they had not even acquired one.

The survey also identified the following as the main advantages of using DB:

- Access to world information;
- Support for risk analysis;
- Verification of data that companies provide in their transfer pricing documentation; Homogeneous data access;
- Access to simple search engines that extract information quickly and timely;
- Access to comparables for control processes;
- These databases are the most used by taxpayers, so a same parameter of comparison for the validation of data is generated; and
- Ranges of benefits by sectors can be built.

As disadvantages, tax administrations indicated the following:

- They do not have enough information about the companies in Latin America and the Caribbean;
- In many legal systems, this information cannot be considered as evidence in the courts, for being “non-public” information;
- They are not available in the official languages of the countries, which may create translation barriers in the inspections; and
- They represent a high cost for various tax administrations.

Finally, they point out that the process of selection of comparable companies should be transparent, systematic and objective. The burden of proof rests on who proposes them, usually taxpayers; hence that it is mandatory to have documentation that supports the qualitative and quantitative filters used, even more when an audit case is in progress.

## 2. COMPARABILITY ADJUSTMENT FOR LATIN AMERICAN COUNTRIES

As is mentioned above, for the purposes of increasing or improving the comparability between the tested party and the companies selected, different adjustments should be carried out. However, two types of comparability adjustments are carried out: the business-related and the capital-related.

The first one seek to approximate functional similarities between the parties. Issues such as the terms of payment; negotiated amounts; costs of intermediation; accounting reclassifications; capacity installed and used; packaging, freight and insurance; among others, should be verified. The consistency of functional analysis is challenging; for that reason, the object and the basis by which these adjustments are proposed must be supported by the taxpayers, who bear the burden of proof.

In this regard, CIAT´s working paper states:

> "Any time an adjustment does not reflector express reasonability and accuracy, it is likely to be rejected by the competent authority, and ultimately it is the first element that the tax authority must evaluate before an adjustment to improve the comparability. If the two abovementioned elements are properly proven and documented, it is more probable that a fiscal authority will accept the adjustment."

Comparability adjustments are necessary as long as they meet their purpose of improving the analysis, and if they are properly used; conditions that often are not met. The CIAT, in its survey among the tax administrations of the region, list the main reasons of rejection:

- They do not improve the comparability.
- Irrelevant idle capacity.
- Excessive or faulty intermediation costs.
- They have no economic justification and/or the adjustment does not correspond with reality.
- The reasoning on the adjustment is faulty.
- The adjustment is not properly documented.
- Arithmetic and substantial errors in the formulas.
- Implied interest rates of the capital adjustment are incorrect.

On the other hand, the second type of adjustment are those that aim to "soften" the impact on the capital produced by the financial leveraging used by foreign companies. I.e., if the companies with access to more developed financial markets are used as comparable, it is presumed that the cost of borrowed or leased capital will be lesser than the one that entities in Latin America would get; therefore it is economically reasonable to take into account these differences before comparing the profit margins achieved by the parties.

Thus, in order to eliminate or minimize the effects that distort comparability, emerging countries should quantify and isolate the risk associated with the capital that companies based in developed countries implicitly incorporate in their financial statements. However, no consensual procedure currently allows put in place this.

Indeed, while adjusting the working capital is the usual practice to mitigate these differences, such as accounts receivable, payment and inventory; this measure may be necessary but is not sufficient.

I.e., it might not be enough to bring to zero the implicit interest to which the non-domestic companies sell or buy at credit, simulating this way that they have not benefited financially from lower interest rates or bringing these financial accounts to the level of the Latin American country. In fact, a risk premium should be included by sector risk and country risk, attempting to approximate transversely the systemic risk at the location where the revenue occurs.

It would be naive to believe that it is enough to verify the effect of three financial accounts so that the profitability achieved by a European or North American country becomes comparable to the a Latin American or African.

What independent third party, acting as a rational economic agent, investing in a developing country (facing increased risks due to lack of political stability, legal security, and limited infrastructure, among others) would want to get a return on his investment equal to those achieved in a developed country?

If the portfolio model relies on the fact that greater risk is rewarded with greater profitability, and if all investments in financial assets are valued using discount rates, why not adding adjustments by sector risk? Why could we not add the systemic local risk to the foreign company margin as part of the transfer pricing comparability analysis?

Now, despite the fact that all statistical models have their limitations, the financial theory shows these tend, in the long term, to adjust the market. Thus, Gonnet, Starkov and Maitra (2013) proposed an adjustment to the capital cost that attempt to include this effect. In this regard, they isolate the financial component of the above-mentioned financial accounts; leading to zero the Return Over Capital Equity (ROCE), to then calculate the Weighted Average Cost of Capital ("WACC"), both for the tested party in the emerging country and for the comparable companies in the developed world. Finally, the differential of the WACC is calculated and the result is added to the ROCE of the comparables, in order to include the premium demanded by investors, which is associated with the various risks in the WACC (country, sector, market share, access to credit, interest rates, among others).

Therefore, it is possible to conclude that the adjustments to increase the business or functional comparability and those of financial or capital comparability are fundamental. That is why the G20 has charged the OECD and the World Bank to develop and propose toolkits for the mitigation of these asymmetries. It is expected that a document with the relevant recommendations will be issued in October 2016. In the particular case of accuracy adjustments related to the line of business, the correct delineation of functions, assets and risks will be put into practice (Action 8-10 BEPS); documentary evidence supporting will be the key On the other hand, the methodological alternative to capital adjustments that was presented above should be evaluated by Latin American countries; however, other formulas can be discussed. The reality is that the actual approach (adjustments to accounts receivable, payment and inventories) has to be improved in order to include the underlying risk of investing in a risky region. The Pacific Alliance, with the technical support of CIAT, can be the platform that, in a coordinated manner, promote the measures proposed by OECD/WB and/or others that are adapted to our economies. Unfortunately, there is no simple solution.

## 3. OTHER ELEMENTS THAT AFFECT THE COMPARISON

### a. Recurring losses

Every company is formed with the aim of generating profit; however, there are situations that may prevent this goal[5]. The OECD guidelines in its paragraph 3.65 state the practical application in these situations:

> "Generally speaking, a loss-making uncontrolled transaction should trigger further investigation in order to establish whether or not it can be a comparable. Circumstances in which loss-making transactions/ enterprises should be excluded from the list of comparables include cases where losses do not reflect normal business conditions, and where the losses incurred by third parties reflect a level of risks that is not comparable to the one assumed by the taxpayer in its controlled transactions. Loss-making comparables that satisfy the comparability analysis should not however be rejected on the sole basis that they suffer losses".

The inclusion of comparable companies with recurring losses over a period of years should be evaluated case-by-case, passing through the five steps of the analysis of comparability, showing evidence that the losses reflect lower conditions in the market of these transactions. It would not be an economic sense, for example, to use unprofitable entities when the tested party is characterized as a low-risk supplier or a contract manufacturer.

5. *See paragraph 1.70 to 1.72 of the OECD guidelines (2010).*

Strictly speaking, a company selected as comparable must be robust and represent a sector whose objective is to generate profits. The whimsical and little argued inclusion of loss-making entities generates disputes. Ecuador faced a similar situation that led by 2015 to publish measures to standardize the analysis of Transfer Pricing; point 2, paragraph VII, D, referred to "Selected Comparables" notes that:

> "Not presenting operating losses (both before and after the application of comparability adjustments) in the year under analysis. Unless the taxable person justified objectively and in detail that such losses are a feature of the business, by circumstances of market, industry or other criteria of comparability and clearly establish that the conditions that have led to loss are not consequence of characteristics affecting comparability."

As can be noted, to avoid arbitrariness, the Ecuadorian tax administration clearly circumscribes the use of comparable companies with losses to certain extraordinary situations that the taxpayer must support with documentary evidence; this creates predictability and avoids disputes. The other Latin American tax authorities should imitate this normative approach.

**b. Multi-year data**

Using data from multiple years may be useful to check the facts that may have influenced the price, as well as to obtain information from the business cycles that influence its formation; however, these concepts are often interpreted incorrectly.

In this regard, the OECD guidelines indicate that:

> 3.75 " In practice, examining multiple year data is often useful in a comparability analysis, but it is not a systematic requirement. Multiple year data should be used where they add value to the transfer pricing analysis. (...)".

> 3.77 " Multiple year data will also be useful in providing information about the relevant business and product life cycles of the comparables (...) " may have a material effect on transfer pricing conditions that needs to be assessed in determining comparability (...)".

> 3.78 "Multiple year data can also improve the process of selecting third party comparables e.g. by identifying results that may indicate a significant variance from the underlying comparability characteristics of the controlled transaction being reviewed (...)"

> 3.79 " The use of multiple year data does not necessarily imply the use of multiple year averages (...)".

These extracts show a line of ideas regarding the use of multiple-years information, which should not confuse their contribution to the analysis of comparability with the statistical purposes for the determination of the market range. Multi-year data should be used to measure the impact of products cycles and/or the economic situation on profits, as well as to understand the business context of the operation to compare. They do not imply that such information is necessarily part of the mathematical determination to obtain the range of prices or profit margins, or the consequent tax adjustment it is the case.

Mexican and Canadian tax authorities recognize this approach normatively to improve comparability. Thus, the article 179, fifth paragraph, of the Mexican income tax law mentions:

> "When the cycles of business or commercial acceptance of a product of the taxpayer cover more than one year, comparable operations of two or more exercises, anterior or posterior, may be considered."

For its part, the CRA's Canada in its communiqué TPM-16 (2015) says:

> 15. "(…) It is important to note that in the Guidelines, the OECD discusses the use of multiple years of data in the form of information relevant to a comparability analysis. The OECD does not promote averaging multiple years of numerical data to establish comparability (...) ".
>
> 29. "While multiple years of data may be useful to select, reject, or determine the degree of comparability of potentially comparable transactions, transfer prices for a given year should be determined based on the results of a single year of data from each of the comparable transactions. Therefore, taxpayers should not average results over multiple years for the purpose of substantiating their transfer prices in an audit context. The CRA will look at the results for comparable data and apply them on a year-by-year basis (...)"

The above shows that, in the Mexican case, the financial information from the comparable could be used for more than one year, if the stated hypothesis can be demonstrated. Furthermore, the CRA limited the use of the multiple years only to comparability analysis, leaving the statistical determination of the adjustment to a single year. This situation is similar to the proposal by Ecuador at point 2, paragraph VII, clause (C), referred to "The profitability indicator selection" where indicates that:

> "The profitability indicator, for operations, segments or analyzed companies as well as operations, segments, or comparable companies, must be calculated only with the financial information of the year under analysis. If operations, companies or comparable business segments have been identified, for which there is no financial information of the year under analysis, the year immediately prior to the analyzed year could be used, if it is proven that the relevant conditions were similar in both periods".

This way, the approach of the tax authorities regarding the use of multiple years as element for comparison is confirmed, when it contributes value to the Transfer Pricing analysis. Determination, if there is a doubt, must be applied to the tax exercise of the tested party and, in the case of the companies selected as comparable, both Canada as Ecuador require using it on the same year, while Mexico suggests it, but does not limit it, subjecting this to more evidence on the part of the taxpayer.

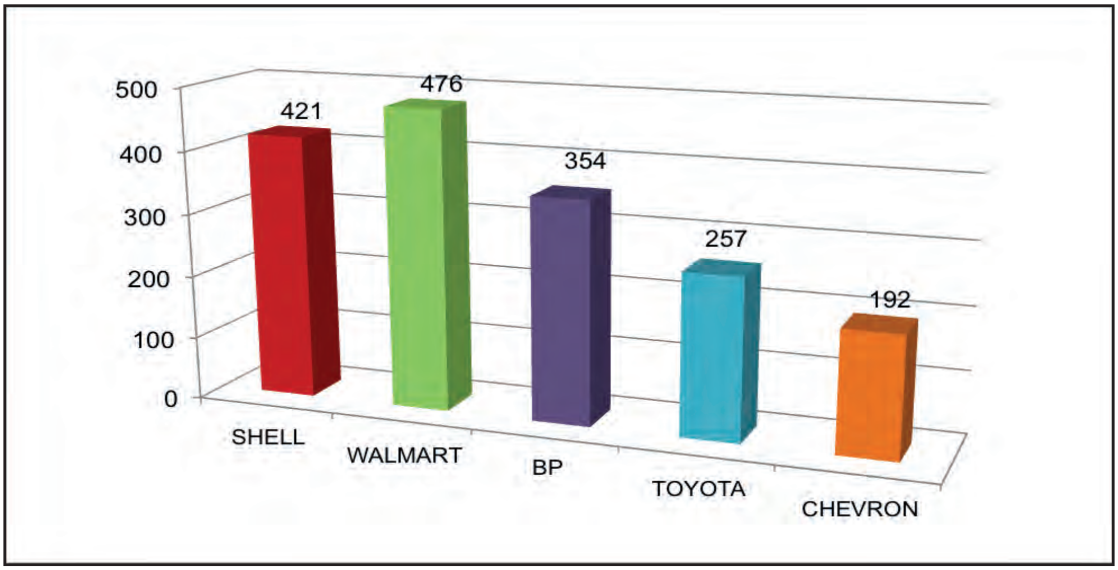
Therefore, in order to mitigate potential disputes, it is necessary that Latin American tax administrations specify in their normative the particular circumstances where it is useful to implement of multiple years of comparable companies for the statistical purposes of the determination. This approach, case-by-case, would seek to "soften" the trend of one-year profits when they face extraordinary situations, such as projects of more than one exercise (i.e. construction of roads or plants; mining or oil exploration), structural facts or circumstances that have influenced the price (climatic events such as droughts, closures or pest; financial, technological or political crisis), cycles of business, among others. It even be evaluated to make it extensive to the tested party; however, it is clear that since the income tax is of annual periodicity, the determinations or adjustments are applicable only for the financial year under analysis.

### c. Does size matter?

Another situation that could distort the analysis of comparability is the materiality of the selected companies. Although there is no limit of use and, in case of returns much above the market rate, the interquartile range filters them, it is motive of concern. In this regard, the following graphics attempt to explain this concern and estimate the size and relevance of the multinational companies in our countries:

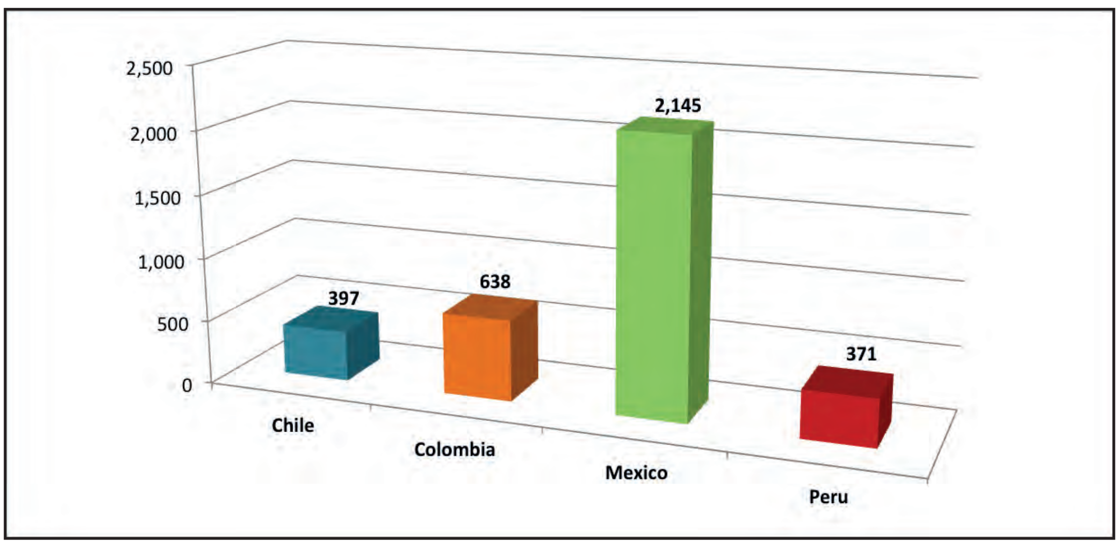
**Graphic 1**

**Income of World's largest companies**




**Graphic 2**

**GDP of the countries comprising the Pacific Alliance**




**Sources:** World Bank – Historical Series – GDP – PPA (Purchasing Power Parity). Bloomberg – Company Revenues in U.S. Dollars 2014.

**By**: Author

As we can see, in 2014 two MNEs obtained incomes exceeding the GDP reached by Peru and Chile. I.e., if they were countries, they would be among the biggest players of the Pacific Alliance. Wallmart (USA) alone has revenues approximately 25 times higher than Cencosud (Chile) and 350 times greater than Supermercados Peruanos (Peru). In a hypothetical case, would they be comparable? Situations like these call our attention, including the influence power that corporations of this magnitude have; however, this is not decisive per se.

Statz (2009) mentions that by use historical data and/or multiples data from companies that are much larger or smaller than the tested entity can lead to incorrect results on the value of the business. He also points out that (...) "Any market data used to estimate the value of a company should be limited to an appropriate size range".

Therefore, any effort to build a regional database, by individual companies or grouped by economic sectors of reference, will ensure accuracy in the transfer pricing comparability analysis.

## 4. CONCLUSIONS

Throughout this article, we have shared practical considerations, both for taxpayers and tax administrations, regarding certain limitations that prevent from performing an accurate analysis in the context of Transfer Pricing, when selecting comparable companies for the application of the margins methods.

First, it was conceptualized that companies are just "potentially" comparable, this since it is virtually impossible to identify independent entities with functions, assets and equal risk on which the involved parties would agree. Despite adjustments to increase the comparability, differences remain. However, a sample representative of the sector would come closer to the results that third parties expect to obtain when making similar activities.

It was also noted that Latin American countries face the same twin limitations: there are few players and many of them are not obligated to disclose public information, which complicates the identification of potentially comparable companies. In this respect, we propose the building of a regional database, with access to the financial data of the main companies included, in order to share the information between tax administrations. This initiative can be promoted within the Pacific Alliance, which, as a block, can encourage best practices for Transfer Pricing.

Regarding adjustments to improvecomparability, it was concluded that the correct delineation of the parties through functional analysis is essential to identify companies similar to the tested party (Action 8-10 BEPS Project) and, if applicable, to perform the corresponding business or functional adjustments. The methodological approach of financial or capital adjustments is also questioned (accounts receivable, payment and inventories) to the point that an independent third party would not be willing to get a return on his investment in countries such as Latin Americans equal to the one reached in a developed country. In conclusion, it is not sufficient to adjust the effect of these accounts for obtaining approximate returns and we subscribe to an alternative methodology that aims to add a premium covering the country and sector risk; however, other formulas can be discussed.

Finally, we identified other elements that directly affect the comparison; thus, we concluded that the inclusion of companies with recurring losses should be evaluated case-by-case, passing through the comparability analysis filter, showing evidence that the losses reflect the market conditions. Similarly, to avoid litigation, Latin American tax administrations should explain normatively the specific circumstances where the application of multiple years of the comparable companies is useful for the statistical purposes of the determination.

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# APPLICATION OF THE GENERAL ANTI-AVOIDANCE RULE IN CHILE

**Isaías Cattaneo Escobar and Jorge Burgos Arredondo**

## SYNOPSIS

The purpose of this bibliographic study is to analyze the material element of the taxable event in Chile, beginning with a theoretical analysis following the implementation of the general anti-avoidance rule in 2015, presenting this anti-avoidance standard as an interpretive rule in tax legislation; next, we will discuss the manners of interpreting the doctrine and jurisprudence, prior to the entry into force of this standard; finally, the supremacy of the substance over the form in the material element of the taxable event is described as a principle of tax law.

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**Content**



The following article analyzes the material element of the taxable event, starting with its theoretical analysis after the implementation of the general anti-avoidance rule in 2015; next, we will discuss the ways of interpreting the doctrine and the jurisprudence regarding the application of the material element of the taxable event in Chile, prior to the entry into force of this standard; Finally, we will examine legal examples, distinct from the general anti-avoidance rule, where we interpret with respect to what is to be understood, applied to the material element of the taxable event.

## 1. THE MATERIAL ELEMENT OF THE TAXABLE EVENT DEPENDS ON THE NATURE OF THE BUSINESS

As of September 30, 2015, Chile began applying a new legal standard, known as "general anti-avoidance rule"[1], through the inclusion, with regard to the topic of this article, of articles 4° bis, 4° ter and 4° quater to the Tax Code[2], consequence of the entry into force of Act N ° 20.780 in 2014.

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1. *In this publication, all references to laws and codes are references to Chilean legal texts. The same with the mentioned institutions.*
2. *Tax Code: "**Article 4° bis**.-Tax obligations established in the laws that determine the taxable events, will be born and will be payable pursuant to the legal nature of the events, acts, or performed business, whatever the form or name given by the parties and regardless of the vices or defects that could affect them.*
*The tax authority must consider the good faith of the taxpayer. Good faith on tax matters is to recognize the effects that the lawful activities or business or their aggregate, according to the form that has been decided by the parties.*
*There is no good faith if, via such activities or legal business, separated or grouped, the taxable events established in the relevant tax laws are avoided. This means that the avoidance of the taxable events takes place in cases of abuse or simulation established in articles 4° ter and 4° quater, respectively.*
*In cases that a special normative is applied to prevent the avoidance, the legal consequences legal are governed by this provision and not by Articles 4° ter and 4° quater.*
*The tax authority has competence to prove the existence of abuse or simulation under the terms of articles 4° ter and 4° quater, respectively. For the determination of abuse or simulation, the procedures in force are established in articles 4° quinquies and 160 bis.*
***Article 4°** ter.-Taxable events contained in the tax laws may not be avoided through the abuse of legal forms. This mean that there is abuse in tax matters when, to avoid total or partially the realization of the taxed event, or to reduce the taxable income or the tax liability, or to defer or deviate the birth of the obligation, by activities or legal transactions that, considered individually or together, do not produce relevant results or legal or economic effects for the taxpayer or a third party, that would be different from the mere tax effect referred to in this subsection.*
*The reasonable choice of behaviors and alternatives referred to in tax legislation is legitimate. Accordingly, the single circumstance that the same economic or legal result is can be obtained with a variety of legal acts and would derive in a different tax burdens shall constitute abuse; or that the legal act of legal forms chosen does not generate tax effect, or generate them either reduced or deferred in time or at a lesser rate, provided that these effects are a consequence of the tax law.*
*The tax obligation emanating from the taxable events established by law shall be enforced in case of abuse.*
***Article 4° quarter** - Acts or business that include a simulation will also constitute avoidance. In these cases, taxes are applied to the business actually performed by the parties, independently of the simulated acts or simulated business. This means that a simulation takes place, for tax purposes, when legal actions or business are produced to conceal the configuration of the taxed event or the constitutive elements of the tax liability, or the true tax amount, or date of the event."*

In the following article, we will focus on the resulting impact from the incorporation of such standard on how is to be understood the material element of the taxable event.

It is necessary to indicate that the topic of this article is not to analyze the concepts of avoidance, abuse, simulation or other similar.

- **The material element of the taxable event.**

If we want to understand the implications of the general anti-avoidance rule regarding its application to the material element of the taxable event, we must start with a brief review of what is understood by material element and the role of the taxpayer's will in the generation of the taxable event.

First, we must remember that the Tax Law is a branch of the Public Law, in the sense that it does not correspond to a relationship between equals, where the taxpayer decides freely against a counterpart (the Tax Administration), but it corresponds to a legal vertical relationship (legal tax relationship) between the State and the taxpayer, by which the legal obligation to comply with the tax is generated, by virtue of the Ius Imperium of sovereignty, according to the contributive capacity of the taxpayer.

To impose taxes under the rule of law, the elements that compose the tax (taxable event, rate, taxpayer and taxable base) must be established by law.

With respect to the taxable event (or tax type), let's briefly remind that it consists of 2 elements: (Hensel, 2004, p.175) a material element[3], so-called factual generator of the tax liability established by law[4], and a personal element, that is, the persons or entities[5] that have the potential of generating that taxable event[6].

The will of the taxpayer at the time of determining if there is a taxable event is not determinant, nor to determine its elements, since these are born by law. This corresponds to the public nature of the tax law, which operates in a field different from the events generated by the parties, which is the sphere of the private law. A consequence of this is, for example, that the possible (civil) nullity (civil) of the taxpayer's acts has no relevance at the time of determining their tax effects.

Fernando Sainz de Bujanda (Bujanda, 1975, p.199) states it as follows: "For the birth of the tax liability, the taxable event has always a pure factual nature, given that the will of the individuals who performed the said event will be operational to produce certain legal effects (those wanted by the subjects), but not to give rise to the taxable event, which is caused exclusively by the law."[7]

This is effective even when what is described as the material element of the taxable event is a legal act, since the tax effects (of Public Law) that are created as consequence of the said legal act (of private law) are dictated by law, without that the will of the taxpayer is determinant for the birth of the tax obligation. For example, the seller can decide or not to perform a given contract (eg. Sale-purchase), but cannot decide if tax effects are generated or not in said contract, nor their content (e.g. the material element of the taxable event is verified in the Value Added Tax[8]).

3. *Also called "objective aspect of the event generating the tax" or "object of taxation". HENSEL, Albert, tax law (publishing legal Nova thesis, Rosario Argentina, 2004), p. 175.*
4. *Example: obtaining income, in the Personal Tax ("Complementary Global Tax" in Chile).*
5. *When in this text mention a person, unless contrary indication, it is understood in a concept broad, i.e., any person or entity indicated by the personal element of the taxed event.*
6. *Example: Individuals with domicile or residence in Chile, in the Personal Tax.*
7. *Sáinz de Bujanda, Fernando, " La relación jurídico tributaria. Su nacimiento. Lecciones De Derecho Financiero–", Cap. XII, en Notas de Derecho Financiero. (Tome I, Volume 2°, Madrid, 1975), p 199.*
8. *In Chile, article 2° N ° 1 of the Value Added Tax Act.*

Now, here is where the new Chilean general anti-avoidance rule takes special relevance, because it may be debated on how to understand the material element of the taxable event, if it lies on legal forms used by the taxpayer or whether it lies about the real nature of such acts, facts or business. In this regard, the first paragraph of article 4 bis of the Tax Code is presented as standard interpretative guide on this issue:

“Tax obligations laid down in the laws that set the taxable events, will be born and will be payable pursuant to the legal nature of the facts, acts or conducted deals, regardless any form or name that the parties have given, and regardless the vices or defects that could affect them.”

This clarifies the question of the field of application of the material element of the taxable event, no longer about the form of the acts, but on their substance: their legal nature.

- **Economic activity and freedom of choosing the legal form**

In order to understand the legislative change, we should look at the bases of the institution.

From our point of view, the law in itself is a form of organizing us peacefully in society, born as a need of limiting one’s individual freedoms to coexist peacefully with the freedom of others.

In this context, the private law was born as a form of regulating the horizontal relations between pairs, such as the family relations or the economic activity of each individual or entity (more usually the object of the Tax Law, since it denotes contributory capacity) according to the individual free will.

This freedom to exercise an economic activity in the form considered pertinent is enshrined in the Political Constitution of the Republic of Chile in its article 19 N° 21:

“The Constitution guarantees to all persons:” 21° the right to develop any single economic activity which is not contrary to morality, public order or national security, respecting the laws and regulations in force.”

Thus, the economic activity[9] of each person is represented in legal acts, and can carry both the desired economic activity (as long as it is not expressly forbidden) as well as through any legal form allowed for such activity. (For example, the taxpayer that meets with the requirements established in the article 14 ter, letter a) of the Income Tax Law (simplified regime of taxation), could choose between this form and the general taxation regime described in the article 14 of the law[10].

Now, the principle that it is legitimate to perform freely any licit economic activity and that it is lawful to organize such economic activity by any of the procedures allowed by the law, is echoed by the new anti-avoidance rules, which indicate that “the reasonable choice of behaviors and alternatives referred to in the tax legislation is legitimate”[11] as long as they effectively correspond to the real activity of the taxpayer.

So, the taxable event is caused by the activity of the taxpayer, who can use the legal form that he considers pertinent, while specific tax consequences may result from each form.

In this way, if the legal form used by the taxpayer corresponds effectively to the real activity “the single circumstance that the same economic or legal result can be obtained with one or another legal form and would derive in an increased or decreased tax burden will not constitute an abuse; or if the one or several legal form or legal

9. *Economic activity can be developed in a factual way through facts or business (set of facts).*
10. *Another example, if an economic activity through a competition of capitals is exerted by autonomy of will, can be organized as a limited liability company (articles 424 et seq. of the Commercial Code) or Société par actions (Law N ° 18,046).*
11. *Article 4° ter subsection second of the Tax Code.*

act performed do not generate any tax effect, or generate a reduced amount or deferred in time, they do not constitute an abuse, as long as these effects are a consequence of the tax law."[12]

In this sense, if a legal act is performed according to the true nature of the activity, it generates a taxable event according to that particular legal act and not another.

The Internal Revenue Service in its Regulation N° 65 from July 23, 2015 (hereinafter "Regulation 65/2015") indicates the following:

"In this perspective, given that the effects of the acts are those emanating from their specific nature, it is legitimate for taxpayers to choose between the different forms, instruments or mechanisms subject to the consequences that the tax laws provide, even if the mean employed, according to the effects of the applicable tax laws, may have as the consequence of not generating any tax effect, or generating one, or a reduced one, or deferred in time."

The law states that otherwise, if such "acts or legal business that, considered individually or together, do not produce results or legal or economic relevant effects for the taxpayer or third party, different from the mere tax effects"[13], they should be classified as abusive acts, i.e., are viewed as avoidance[14]; this since "form or denomination that the parties had given" to such acts do not match "the legal nature of the facts, acts or business"[15].

In this case, the law indicates that "the required tax obligation is the one resulting from the taxable facts established by the law"[16].

In this regard, not only legal acts, but also to "facts" and "economic activities"[17] are the base of interpretation, makes it clear that the legislator seeks the factual substance of the taxable event and not exclusively the form of the legal acts used by the taxpayer.

In summary, it is legitimate to organize the business in the legal form desired by the parties, if they correspond to the fact, act or business really performed by the parties; at the same time, it is not legitimate to use "abnormal" legal forms[18] for the activity actually performed.

- **Taxable event and freedom of the taxpayer**

As noted, the taxpayer has no choice or freedom[19] with respect to the taxable event, since this is generated by law[20], according to the real nature of the business operation performed.[21]

12. *Article 4° ter second sub-paragraph of the Tax Code*
13. *Article 4° ter first sub-paragraph of the Tax Code.*
14. *Article 4° ter third sub-paragraph of the Tax Code.*
15. *Article 4° bis third sub-paragraph of the Tax Code.*
16. *Article 4° bis first sub-paragraph of the Tax Code.*
17. *Business considered as fictitious.*
18. *Role no. 17.586-14. Supreme Court. Twenty-seventh day of July of two thousand fifteen.*
19. *Guiding principles of private law.*
20. *According to the nature of public law.*
21. *The Internal Revenue Service provides an example as follows, in its Circular 65/2015: "It is possible to illustrate this with the following examples. It is well known that the legislator of the income tax has provided that salaries, wages and other remuneration paid on the occasion of dependent work, i.e., that subject to an employment relationship, are affected by the flat tax of second category. The elements of this taxable event are determined by that legislation, that set clearly to the taxpayer (dependent worker), the taxable base (in general, the remunerations paid), the respective tax and a progressive rate, and that obviously the legislator has established a higher tax rate for those who obtained higher remuneration according to the established segmentation. However, if the taxpayer, by abuse of legal forms or simulation, organizes its activities in such a way that the fixed or variable remuneration for dependent personal services, are perceived by a company or other legal person or entity that, for example, it taxed according to the first category income, taxing them with the proportional rate of this tax ", the tax authority could evaluate the application of the NGA if the antecedents justify it, as if the taxpayer would be violating the taxable event of second category."*

Thus, if the taxpayer use of any lawful legal form[22] to seeks to prevent the birth of a taxable event, or attempts to show that this occurred at a different time or intends to pretend it was for an amount other than the actual amount[23], in order to obtain a tax saving, he or she is performing tax avoidance[24].

We use the phrases "avoid to show", "tries to show" and "aims to appear" since nothing that the taxpayer may do can avoid the birth of the taxable event[25] according to the real nature of the business activity, the taxable event is created by law, independently of the acts of the taxpayer. So, despite the avoidance actions, the taxable event is always generated.

Thus, judicial decisions (in case there is no specific anti-avoidance rule) or administrative acts (in case there is a specific anti-avoidance rule in force) that disclose an act of avoidance are not constitutive of the taxable event, but are merely declarative of it.

The Regulation 65/2015, expresses this in the following manner:

"It should be noted that the commented legislation supports the legitimate right of taxpayers to organize their taxable activities, acts or business in autonomy of will and with the contractual freedom permitted by law [*sic*], considering that not all tax advantage, achieved by the taxpayer, constitutes an avoidance; to find avoidance, it is essential that there is an abuse of legal forms or acts simulated against the taxed events provided by tax legislation. The legitimate right of option, in this sense, cannot be an excuse for the determination of the tax obligations by taxpayers, in a manner different than those provided for in the law."

This way, for determining the avoidance nature of the activity, it is irrelevant if it was performed before, simultaneously or subsequently to the completion of the taxable event, which occurs automatically by law according to the real nature of the business activity[26].

- **Presumption of the real activity and interpretative nature of the anti-avoidance rule**

Now, given that we are in a State of Law, citizens manage their activities via legal acts. In this sense, legal acts used by taxpayers allow to presume what their real activity is. So, provided that the taxpayer is acting in good faith, the legal forms used will correspond to the real nature of the activity or event.

In this sense, the law establishes the following simple legal presumption: "The service should presume bona fide of the taxpayer. The bona fide principle in tax matters supposes to presume the effect resulting from the acts or legal activities or their plurality, according to the way in which these have been convened by the taxpayers."[27]

I.e., the recognition of bona fide is a general principle of law, therefore it is presumed by law

22. *If the form chosen is not lawful, we would be in presence of outright tax evasion, independently of the considerations about the taxable event.*
23. *If the avoidance act attempt to pretend that economic quantification in question is lesser than the real, we are actually facing an attempt to modify the taxable base, not the taxable event.*
24. *The Internal Revenue Service defined avoidance, in its Regulation N° 65 of 23 July 2015 "as that conduct seeking to leave unapplied the tax law through the abuse of legal forms or simulation."*
25. *Or the real amount, in the case of the tax base.*
26. *For example, in order to avoid certain monthly tax, a taxpayer performs the following lawful operations:*
    *Month 1: Change society to other corporate structure of reduced taxation.*
    *Month 2: The service is provided and payment is received.*
    *Month 3: The society is reverted to its old corporate structure.*
    *In this example the taxable event is produced, by law, in the month of the service and its payment, so all the acts indicated would be of avoidance (prior, simultaneous or subsequent to the same), since it could be proven that such operations do not correspond to the true nature of the activity.*
27. *Article 4° bis second paragraph of the Tax Code.*

that the form in which the taxpayers have held their legal acts or business or a plurality of them corresponds effectively to the nature of their activities[28].

However, the same law reminds that this principle not is absolute: “There is no good faith if by one or many of such acts or legal business, the taxable events established in the corresponding legal tax norms are avoided.”[29]

Then, if the taxpayer avoids (seeks to hide the birth of the taxable event, or attempts to show that it occurred at a different time or intends to make appear that it was for a different amount than the actual amount, in order to obtain a tax saving) he or she is no longer acting in good faith; Therefore the law will consider that the form in which taxpayers have concluded one or many of their legal acts or business of them does not correspond to the real nature of their business, by applying “the tax obligation emanating from the taxable events as established by law”[30], according to the “business actually performed by the parties’[31].

In this sense, the nature of the anti-avoidance standard is to be an interpretive rule, not an operational standard, since it does not indicate any taxable event, but it provides tools to interpret the acts of taxpayers in order to correctly identify the taxable event.

What will vary however, will be the way in which it will be evidenced that this presumption does not correspond to the reality, i.e. if there is avoidance, according to the existence or not of specific anti-avoidance rules[32]:

- If a particular anti-avoidance standard is in force: it may demonstrate that the form in which the taxpayers have performed one or many of their legal business does not correspond to the real nature of the business, through the means delivered by each standard in particular, through the corresponding administrative legal act[33] (liquidation, transfer, resolution, etc.).

- If there is no specific anti-avoidance standard: It is via judicial decision that it is possible to evidence that taxpayers have performed one or various of their actions or business which do not correspond to its true nature, and that there is abuse or simulation.

This is stated by the Internal Revenue Service in its Regulation 65/2015 as follows, referring specifically to the general anti-avoidance rule:

“1. Article 4 bis is based on the recognition of bona fide in tax matter, what would amount to say that the service, in principle, must respect the legal tax effects of the acts or contracts concluded by the taxpayers and according to the forms in which they have been carried out;

1. “However, the service can object to those effects, when that good faith is distorted according to what the law describes, i.e.,

28. *The Internal Revenue Service in its Regulation 65/2015 indicates: “The principle of bona fide radiates its strength in the whole legal system, since it is a base of the legal order and manifests itself of different ways depending on the considered legal area.” In tax matters, bona fide supposes to admit and presume, for the tax authority and for the taxpayers, all of the effects arising from the activities or legal actions carried out by the control authority as well as by taxpayers, whatever form or denomination that the parties have given. What determine the birth and effectiveness of tax obligations established in the laws as taxable events is the legal nature of the events, acts or business performed more than the contractual forms or denominations that the parties have attributed to them.*
    *In the same sense, the simulated acts or abuse of legal forms are contrary to the bona fide, so that the imperative tax involves the recognition of what belongs to the Act or operation concerned in accordance with their legal nature, regardless of its appearance or denomination or the intention pursued by taxpayers.”*
29. *Article 4° bis third sub-paragraph of the Tax Code.*
30. *Article 4° ter final paragraph of the Tax Code.*
31. *Article 4° quater of the Tax Code.*
32. *Article 4° bis second part of the paragraph third and fourth subsection of the Tax Code.*
33. *Subject to jurisdictional control by the appropriate courts.*

in case of abuse or simulation, considering also the effects produced by the abusive or simulated acts, which intend to leave without effect the taxable events established by law".

- **Legal certainty and principle of legality**

We understand that one of the objectives of the general anti-avoidance rule is to give priority of the substance over the form of the acts of the taxpayers, to protect the principle of legal certainty: certainty that facing the same business[34], the same taxation is applied, that the material elements of the taxable events are always interpreted according to their real nature, and not according to the will of "astute"[35] taxpayers.

In addition, the avoidance acts not only seriously damage the principle of legal certainty but also the principle of legality, as they seek to change the legal tax rates only for the avoiding taxpayers, as well as breaking the principle of equal distribution of taxes, i.e. the same taxation to all taxpayers for the same taxable event.

The aforementioned Regulation 65/2015 of the Internal Revenue Service states it as follows:

"The establishment of this GAAR (general anti avoidance rule) also demonstrates the concern of the legislator to safeguard the constitutional principles of tax legality and equality in the distribution of the public charges, contained in article 19, number 20, of the Political Constitution of the Republic. Safeguarding the principle of legality implies that the application of taxes must be in accordance with the legal taxable events, and cannot be at the mercy of taxpayers, i.e., the taxes are mandatory, and no one can escape their application through avoidance acts. At the same time, the respect of this principle is that neither the Administration nor the judiciary can create a law acting as legislator, so that the essential function of anti-avoidance rules, both general and special, is precisely to safeguard the compliance with the taxable events as established by the law, avoiding that taxpayers prevent their implementation by avoidance behaviors. Moreover, the principle of equality in the distribution of public burdens supposes to ensure that taxpayers pay tax as the legislator has considered appropriate. To achieve these objectives, the legislator has defined two types of behaviors that can be considered avoidance, these are: the abuse of the legal forms and the simulation."

## 2. WAYS TO UNDERSTAND WHAT GENERATES THE MATERIAL ELEMENT OF THE TAXABLE EVENT BEFORE THE ENTRY INTO FORCE OF ARTICLES 4° BIS, 4° TER AND 4° QUATER OF THE TAX CODE

Prior to the entry into force of articles 4° bis, 4° ter and 4° quater of the Tax Code, there was discrepancy between national doctrine and case law with respect to what generate the material element of the taxable event, being understood in a first period that this was exclusively based on the legal acts performed by the taxpayer, to then begin to understand that this was generated due to the nature of the activities, business or acts performed.

a. The material element of the taxable event is generated exclusively on legal acts.

In a first stage it was considered that the material element of the taxable event was determined exclusively based on the legal forms used by the taxpayer.

This is how over the years, it was interpreted that the Legal Chilean Tax order was governed

34. *Established by law (taxable event).*
35. *Role no 4038-2001 Supreme Court.*

by the principle of the form over the substance; i.e., if the acts were performed according to the legally required forms (requirements and forms established by law), there was no tax contingency.

In that sense, the Supreme Court in 2003, acting on avoidance in the case of the Bahía Blanca Real Estate[36] indicates the following:

"(18º) That the tax authority, in this case, has confused two legal concepts that show a notorious difference: one of illegal tax evasion, with avoidance, which consists of cunningly avoiding something, which does not have to necessarily be against the legal dispositions, especially if the law provides and delivers tools to the taxpayer, as it is here the case, to pay taxes on a corresponding legitimate measure, which is not how they have been paid".

In this decision, even though it does not concern directly what must be understood as the material element of the taxable event, it is safe to indicate that what is understood rests exclusively on the legal acts performed by taxpayers, independently of the real nature of the activities carried out.

In addition, it is also possible to detect a doctrine majority that understood the taxable event by regarding exclusively the legal acts. In this regard it should be indicated that there is little national doctrine on what mean the material element of the taxable event[37]; however, it is possible to clearly understand the national positions by examining their approach to avoidance.

Thus, there are those who argue that avoidance "consists in avoiding by lawful means that a determined taxable event is performed, through the use of legal concepts"[38]. For Professor Klaus Tipke (2005), "the avoidance is not immoral and, in his opinion, is recognized in the States of Law that respect freedom"[39].

Also, Valenzuela (2005) estimates that what the taxpayer wants to avoid is the birth of the taxable event, preventing the birth of the tax liability. So, in view of this trend, the avoidance is lawful inasmuch as it is based on the constitutional principles of the legality of the tax and the economic freedom and it is admitted that the law authorizes taxpayers to arrange their business, pay less tax, provided that in the organization of this form of compliance, no behaviors are developed of fraud or abuse of the law, etc."[40]

Indeed, the tax attorney Franco Brzovic (Brzovic, 2008) points out that "in Chile, avoidance does not legally exist. People pay taxes or evade them. Avoidance is not is sanctioned in the Chilean law and that is why the different Governments that have tried to solve the issue on topics where they estimated that there is a tax avoidance, had that resort to the Congress with a bill (...) basically, the tax engineering intends to determine the moment when the taxpayer is going to pay taxes. It is a matter of time opportunity in the payment, not of evading taxes"[41].

I.e., the doctrine considered that, (Alesandri, Mansilla, Orezzoli and Salgado, 2005, p.173), in the hypothesis of the material element of the

36. *Role no 4038-2001 Supreme Court.*
37. *The references indicated below do not purpose to be encyclopedic and comprehensive collections on the matter, but try to illustrate the existing positions. In this sense, only representative samples of the issue have been chosen.*
38. *Manual de Consultas Tributarias. Diciembre 348. Internal Revenue Service. p. 142. 2005.*
39. *Manual de Consultas Tributarias. OB. cit p. 142.*
40. *Ibid.*
41. *Franco Berzovic, August 2008, talk about tax planning, College of engineers of Chile AG. Quoted by Katia V. Villalobos Valenzuela in the article "Boundary between the circumvention and the tax planning applied to a case of corporate reorganization". P. 2. (Reading material year 2013 of the postgraduate course in master in taxation Faculty of Economics and business, University Chile's tax law class taught by Professor Jaime García).*

taxable fact relying exclusively on the form of legal acts, the "legislator is forced to"[42] anticipate and provide expressly for all cases that would exist under a particular taxable transactions, and must create a new law that generates the taxable event: a specific anti-avoidance rule[43].

Now, despite the fact that the indicated authors do not refer directly to what must be understood as the material element of the taxable event, it is not risky to indicate that they would understand that depend exclusively on the legal acts performed.

Professor Jaime García (Garcia, 2005, p.11-12) is particularly clear on this issue: "It must be clearly distinguished between evasion and avoidance. In the first case, the taxable event was born by force of law, i.e., there is a duty to pay tax, and the taxpayer has failed to comply. In the case of avoidance on the other hand, the taxable event does not exist, and precisely the purpose of the avoidance behavior is to prevent its birth, by unlawful means."[44]

In the previous quote, it is clear that the emphasis of the author, regarding to what apply the material element of the taxable event, is with respect to the legal form of the acts and not on their substance, because it indicates that when acts of avoidance happen, the "taxable event does not exist".

b. The material element of the taxable event results from the substance of the business, events or acts.

Recently, a second stage in the jurisprudence has started to appear, aimed to understand that the material element of the taxable event is configured according to the nature of the business and not exclusively according to the legal form chosen by the taxpayer.

Below are given examples of this criterion, collected from various courts of the country, where the claim was rejected, by giving priority to the substance or economic reality against the forms of the business:

- "But the circumstance of changing the name of a contract does not change anything of what the parties executed or execute, nor, can it be claimed to establish a taxable event different from the one which is really took place;" "both from the will of the parties as from the practical implementation of the contracts, it is clear that is the taxable event of transportation of passengers has been configured, and not another."

The previous decision was not ratified in the first instance, however, the minority vote expressed the following:

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*42. ALESSANDRI Amenabar, Andres; MANSILLA Cazorla Alex, OREZZOLI Franceshini Nicolas, SALGADO Olcese, Jorge. VI. Tax Anticircumvention rules. P. 173. TAX REFORM. Thomson Reuters. "It law tax has evolved through them years of way reactive, because as them contributing by means of various subterfuges legal van finding forms for avoid the configuration of the made taxed or decrease the load tax applicable to a determined operation, the legislator is sees forced to dictate new standards of control for do facing practices" ", and thus obtain an effective enforcement of the tax law by taxable persons of the tax."*

*43. This not is in accordance with the form of interpret the made taxed concerning the Fund on the form, as there the made taxed always exists, being the standard anti elusive (particular) a standard interpretative concerning the real made taxed.*

*44. Garcia ESCOBAR, Jaime, "La naturaleza jurídica de la elusión tributaria ", pp. 11 and 12, online in: https://www.cde.cl/wps/wcm/connect/96e82fa1-45c1-4ea4-b372-e56ead41e8b1/9.pdf?MOD=AJPERES consulted on April 27, 2015 16:05 hrs.*

"In this sense, as it is well known, both exemptions and taxable events are determined by law in regard to the contributory capacity provided in the standard, and it does not correspond that individuals, nor even under the exercise of free will, skillfully chose one or other form only to obtain a tax advantage."

- Another example is the decision dated on December 16, 2013, of the Appeal Court of Concepción[45], in case N° 50-2013, "Commercial Caracol limited with Internal Revenue Service", which stated the following in its second paragraph:

  "It can be concluded that the sole purpose of the claimant to draw this payment procedure that he calls "agreed deposits", or at least the main objective, was avoiding or lowering the tax burden, which incidentally is the same procedure performed in the payment by concept of agreed upon deposits made to partners and legal representatives of the company [xxx] limited" being particularly eloquent in this regard the coincidence of dates in which the acts that would have guaranteed such payments were held or executed.

  […] In relation to the above, we should bear in mind that in a recent decision in cause role 3-2012 on the Court of appeals of Arica, we find the following: "in this way, the corporate reorganization that the claimant has made does not obey to a legitimate business reason justifying it, i.e., which the Anglo-Saxon jurisprudence has named "business purpose test" This is, planning is acceptable to the extent that has a different commercial or economic purpose than the single goal of avoiding a tax and, as a result, the activity had the sole purpose to avoid the payment of taxes".

  This ruling was confirmed by our Exc. Supreme Court dated on July 23, 2013 in case role 5118-2012.

## 3. GENERAL PRINCIPLE OF THE CHILEAN TAX LAW PRIOR TO THE GENERAL ANTI-AVOIDANCE RULE: MATERIAL ELEMENT OF THE TAXABLE EVENT IS ACCORDING THE NATURE OF THE BUSINESS

Despite the fact that the general anti-avoidance standard demonstrates that the law considers the material element of the taxable event as resulting from the real nature of the business, this is not the first standard that is inspired by this principle.

For instance, the Chilean tax legislation highlight rules that recognize the material element of the taxable event about the reality of the business, which is manifested through legal fictions, rating of taxable bases, limitation of deductible expenses, alleged withdrawals, loans to partners or shareholders or requirement of a legitimate business reason.

Then some legal examples of the application of this principle:

- **Article 21 of the Income Tax Law:** In this article establishes the withdrawal of costs which are not accepted as such, for the purposes of determining the tax of companies and their owners, there is a legal presumption that certain specific disbursements were intended to benefit the partner or shareholder of the company.

  The specific anti-avoidance rule considers that what really take place is an equity

45. *Sentence confirmed by the Supreme Court, in case role 5118-2012, July 23, 2013.*

increase of the individual partner or shareholder, who should pay the final taxes as a result of the effective disbursement of money by the company.

- **Article 64 of the Tax Code:** Since the year 1975 already, the article 64 of the Tax Code empowers the control authority to correct the values given by the parties in business of goods and services, when these were not consistent with market values.

  This specific anti-avoidance rule does not combat avoidance with respect to the taxable event, but regarding the tax base; in other words, it applies when the legal act corresponds to the reality of the business, event or act, but with an incorrect amount.

- **Article 41 E of the Income Tax Act:** In 1998[46], a special anti-avoidance rule is implemented for business between related companies, seeking to correct the modification of prices of goods or services where these are not in accordance with the principle of Arm's Length and seek to reduce the income tax payment at the source.

- Article 2 N ° 1 and 2 of the Value Added Tax Act, which already states since 1976[47] the following:

  "Article 2.-for the purposes of this law, unless the nature of the text implies another meaning, will be considered:"

  1°) As "sale", all agreement, regardless the name given by the parties, which serve to transfer for a price the domain of personal property, personal real estate, excluding the grounds, or a share of such property or property rights constituted over them, as, similarly, any act or contract that will lead to the same end or that the present law consider as a sale.

  2º) by "service", any activity or provision that a person performs for another and for which is received an interest, bonus, fee, commission or any other form of remuneration, provided that it comes from the exercise of the activities included in the No. 3 and 4 of article 20 of the Income Tax Law."

The preceding paragraphs recognize that the material element of the taxable event must be understood as the activity or act effectively carried out, regardless of the form or designation chosen by the taxpayers.

Finally, since the year 1964 (still in force and relevant for this article), there is a anti-avoidance standard of special application, allowing to re-qualify legal acts performed in accordance with the nature of avoidance acts; here is the original text of article 63 of Law 16.271 on tax on Inheritance, Allocations and Donations[48]:

"The Internal Revenue Service will investigate whether the obligations imposed by the parties by any contract are effective, if really these

46. *Originally in 1998 this article was in 38 of the Income Tax Law.*
47. *Even if some elements of the legal text have been modified with the years, as for example the taxation of the estate, they are not relevant for this analysis.*
48. *Current text: **"Article 63."** The Internal Revenue Service may investigate if the obligations imparted to the parties by any contract are real, it these obligations have been fulfilled, or if what a party give under an onerous contract is proportional to the current market value at the date of the contract, of what is received as counterpart. If the Tax Administration prove that these obligations are not effective or have not been fulfilled, or that one of the parties give according to the onerous contract is notoriously disproportionate by comparison with the marked Price for the counterpart, and that such acts and circumstance have as a purpose to cover a donation and anticipated transfer of assets or heritage, the authority will tax the said business at the corresponding tax rate.*
   *The verification that the declared amount was not really incorporated to the assets of one of the contractor will be considered as a sufficient antecedent for the exercise of the taxing power referred to in the previous paragraph; in case of contracts signed between parties among whom one or various are ab intestat inheritors.*
   *The tax cancellation in compliance with this article does not affect the legal qualification of the contract for non-tax reasons."*

obligations have been met, or if what a party according to a contract against payment relates to the current market price of the counterpart at the date of the contract.” If the service finds that these obligations are not effective or they have really failed, or that what a party gives e under an onerous contract is significantly disproportionate in relation to the current market price of the counterpart, and such acts and circumstances have intended to conceal a donation or payment on account of inheritance , the judge will dictate a grounded resolution liquidating the tax that corresponds in conformity to this law and will request the competent judge to rule on the competence of the tax and it application final of its amount. The service request will be processed in accordance with the summary procedure.

The proof that the declared amount has not entered the assets of the interested party to the contract will serve as a sufficient antecedent for the enactment of the resolution referred to in the previous paragraph, in the case of contracts concluded between persons of whom one or more will inherit ab intestato from the other or others.

The judicial resolution that determines the tax according to this article will not import a decision on the legal classification of the respective contract for other effects which are not tax-related.”

The quoted standard indicates clearly that the avoidance act[49] has “intention to conceal” a donation or payment on account of inheritance, i.e., that the taxable event always existed, despite the fact that formal legal actions of the taxpayer did not configure it. I.e., it recognizes that the material element of the taxable event is created in the real business made by the taxpayer and not exclusively in the legal form presented.

In this way, in our opinion, it is possible to indicate that, already at least since 1964, considering that the material element of the taxable event applies with respect to the real nature of the business is an inspiring principle of the Chilean tax law.

Thus, the arrival of the general anti-avoidance rule maintains uniformity in the Chilean tax legislation, to enshrine this principle in the written law.

Therefore, we can only conclude that the principle of the substance over form has always existed, only that had not been explicit, but as an element that underlies the tax legislation, inspiring different special anti-avoidance provisions.

49. *The previous article of the Regulation (article 62) already in 1964 legally recognized the existence of “avoidance”: “Ii is presumed, also, the* ***intention of avoiding*** *the payment of the contributions established by this law, in the case of assets not mentioned in the inventory and that the heirs have distributed among themselves.” The highlight is added.*

## 4. CONCLUSIONS

1. The material element of the taxable event in Chile lies on the substance of the business of the taxpayer, being expressly embodied in the Chilean general anti-avoidance rule.

2. The principle of primacy of the substance of over the form of the business is a guiding principle of the tax legislation, at least since 1964.

3. The general anti-avoidance rule implemented in 2015 is consistent with the principle of primacy of the substance over the form.

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# THE "CSR TAX REGISTRY" AND THE REQUIREMENT FOR TAX INFORMATION IN THE SOCIAL BALANCE REPORT

**Marcelo Eduardo Domínguez**


## SYNOPSIS

This article analyzes the control of tax compliance within the framework of Corporate Social responsibility (CSR). Currently, the multiple tax information of operations and assets systems provide for an effective systemic control of tax behavior, and allow for granting tax incentives for social-environmental investments. Within the context of greater international transparency in the Treasury-taxpayer relationship, the creation of the "CSR Tax Registry" is proposed, in order for tax administrations to request the companies that voluntarily enroll therein to provide, a "Tax Annex" to their Social Balance Report.


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**Content**



Social responsibility must be developed by the State, the Citizens and the Companies.

- The **State** must intervene in social aspects, applying public policies that consider these aspects, ensuring education, health, work and social inclusion[1].

- The **citizens** request social responsibility from the position of consumers or users, and also from the position of taxpayers.

The following dispositions are requested from the **companies**[2]:

1. Personnel policies that respect the rights of the company’s employees and promote their development. Fair remuneration, training, elimination of gender discrimination, etc.

2. Transparency and good corporate governance. Continuous public information and obligation to avoid conflicts of interest.

3. Fairness with the consumer. The products must be of good quality, have reasonable prices and, critically, the products must be healthy.

4. Active environmental protection policies. They include the conversion of enterprises to clean environmental standards, and collaboration to the global agenda of environmental issues.

5. Integration to the main issues of common welfare. Private companies must collaborate in public policies, in strategic alliances with the society. The goal is not that the company replace the public policy, but it must be a constant and creative partner.

6. Avoid practicing a dual code of ethics. There must be coherence between the social responsibility discourse and its implementation.

- **Companies** have started to consider that they should assume a “social responsibility”, complementing their purpose of obtaining profits with other objectives of social nature.

With the concept of “Corporate Social responsibility” (CSR), respect for ethics, people, community and the environment is included by organizations in the course of their daily business activities and in the making of strategic decisions, pointing to honest and committed ways of doing business[3].

The official apparition of the CSR concept took place during the World Economic Forum held in Davos in 1999, where an important global compact on Social responsibility was agreed

1. *FERRÉ OLIVE, Edgardo H. - “Tributos, Responsabilidad Social y Administraciones Tributarias” - Revista de Adm. Tributaria CIAT/AEAT/IEF N°. 36, Enero 2014, pág 44 a 56.*
2. *KLIKSBERG, Bernardo - “Primero la Gente: Una mirada desde la ética del desarrollo a los principales problemas del mundo globalizado”, Ediciones Deusto, 2007, Capítulo 12 “El rol de la responsabilidad social empresaria en la crisis”, página 314.*
3. *WAINSTEIN, Mario y CASAL, Armando. “El medio ambiente en la auditoría financiera”, Errepar, Profesional y Empresaria (D&G), Tomo VII, Junio de 2006*

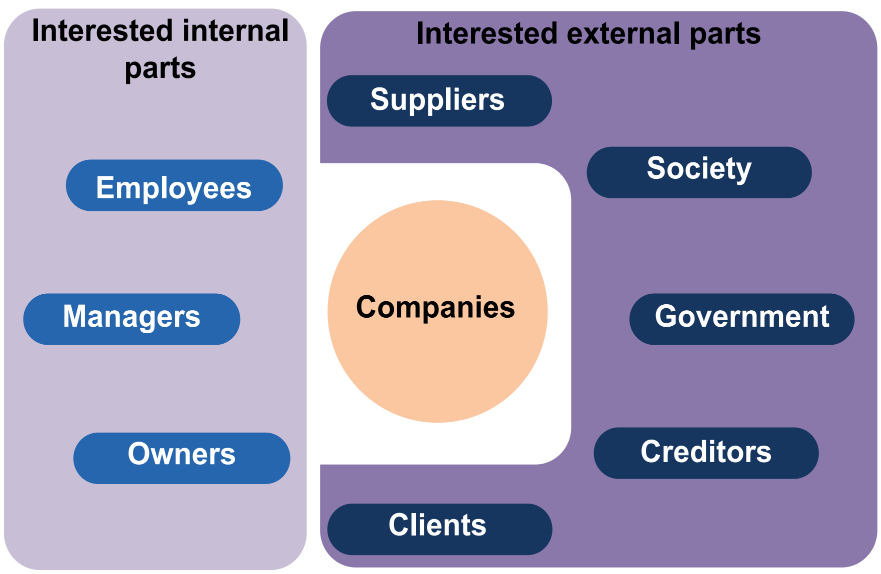
upon. In this respect, the European Commission has published on 18 / 7 / 2001 the Green Book, entitled "Promoting a European Framework for the Corporate Social Responsibility"[4].

In this sense, a company with a commitment to social responsibility should address the following aspects:

- Compliance with laws
- Ethical standards
- Transparency of information
- Improvement in the quality of relationship with employees, customers and suppliers
- Respect for the environment
- Commitment with the development of the society in which the company is present.

To develop CSR in the relationship with the State, customers, suppliers, and the community in general, the company should provide information on its activities and their immediate or future social and environmental impact (the "Social Balance Report"). This Balance reflects the evolution of the management and dialogue with **interest groups** ("Stakeholders"). The solutions to the problems of sustainability will be effective if they are fair and equitable for all the groups involved, including the future generations and the others species[5].

**Interest groups – CSR**




**Source:** Employment portal of municipality of Cádiz - https://www.ifef.es/

4. *In Spain, the Royal Decree 221/2008 creates the State Council in charge of CSR policies and 2/2011 sustainable economy Act, States need to promote CSR (Art. 39).*
5. *COSTANZA, Robert en "Ecological Economics: Reintegrating the study of humans and nature", Ecological Society of América, Ecological Applications, Vol. 6, N° 4, páginas 978 a 990, 1996.*

Therefore, through the “Social Balance Report” a description of responsible management of the organization in social, environmental and economic fields can be presented in a detailed and transparent manner, and satisfy the “Stakeholders’ needs for information”.

The aspects related to tax compliance and tax incentives for corporate CSR are considered hereafter.

## 1. CORPORATE SOCIAL RESPONSIBILITY AND TAXATION

### a. Tax compliance as a CSR requirement

As general concept, it can be highlighted that socially responsible companies are those which duly comply with their tax obligations. I.e., these companies do not seek to minimize their taxes through aggressive fiscal planning or through the use of regimes offshore. In this regard, the European Commission has indicated that aggressive tax planning damages the principles of corporate social responsibility[6].

The minimization of taxes affects the State and suppose an unfair behavior compared to the rest of citizens, who not only should pay higher taxes because of corporate tax evasion, but also see how states must cut spending on social investments. The use of tax havens is a socially irresponsible practice, and has been one of the main causes of the current economic crisis, especially in the financial sector[7].

Given that the minimum tax threshold is adjusted to the financing of public goods needed by the community, i.e., it is “the meeting point between the common good and the interests of private parties”, and if the minimum tax is circumvented through any program, scheme or business strategy, the values of the Social Balance Report are broken by excess of private interest[8].

The CSR, before the state, implies full compliance with tax obligations, social security and the proper implementation of state subsidies. Tax minimization hurts not only the State but also the fair competition and the citizens in general, since they must pay more taxes due to the corporate circumvention[9].

When a company is not socially responsible (because it does not comply with their tax obligations, or because it operates with tax havens to minimize its taxes), this creates a serious breach of its social contract with the State, which maintains the Social Balance Report. Non-compliant businesses must not get away with these behaviors[10].

Socially responsible business planning is not an option for a higher taxation, but it requires taking the tax option that report a greater benefit to the company and the stakeholders. I.e., the strict fiscal criteria are not decisive in planning, while criteria for social impact are more decisive[11].

6. *European Commission CSR in “Communication on a renewed strategy of the EU for 2011-2014 on CSR”, COM (2011) 681 final, Brussels, on 25-10-2011.*
7. *RUIZ GARIJO, Mercedes in “more of a decade of Corporate Social responsibility. “When its legal regulation and the establishment of fiscal incentives?” Basque Journal of Social economy - social Ekonomia Euskal Aldizkaria-Gezki, N ° 7, 2011, page 33.*
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11. *SÁNCHEZ HUETE, Miguel Ángel en “Hacia una planificación fiscal socialmente responsable. La planificación ultrafiscal”, Quincena fiscal: Revista de actualidad fiscal, número 7, 2010.*

If one admits that the State is not primarily a tax collector but a resource manager for social welfare, taxes are just the essential instrument for the public administration. The tax burden that every company must support constitutes its required contribution to the social construction[12].

Therefore, avoiding tax commitments means escaping from the required contribution to social coexistence. Democracy is linked to taxes and the way they are distributed. Paying taxes is a sample of democratic health... If there is democracy, fair, progressive and sufficient taxes are paid. If it is not the case, the democracy is weak[13].

As a result of tax evasion and avoidance, countries fail to raise the amounts that could be used to combat poverty and stimulate development. The Network for Tax Justice in Spain estimates that, because of the low or null taxation on the funds placed in offshore centers, governments of the whole world lose a collection amount greater than the estimated cost for reducing by half the world poverty.

**b. The trend to evade taxes and the role of tax havens**

There is a widespread trend in search of loopholes to pay the least possible tax amount, which is qualified with the expression "optimization of the fiscal situation". But the concept of optimization is assimilated to evading obligations with the State, taking advantage of all the possible options to pay less. I.e., "optimizing" means paying less and thus the contribution to the society is "minimized".

Avoidance, unlike evasion, is to avoid paying certain taxes via legal mechanisms or legal procedures. While evasion is a crime, avoidance may be not considered as such, but their effects are similar.

Evasion is related to illegal possession of funds, while avoidance is related to the optimization of the tax burden on funds obtained legally. If the origin of the funds is illegal because they proceed from tax evasion, the income that they generate will be part of that tax evasion (These are the cases for assets not declared in the country of residence of the investor that generates income).

On the other hand, if the origin of the funds is legal, but then they are transferred to low or nil taxation jurisdictions, we will deal with tax avoidance (these are cases of money declared in the country of residence of the investor, but that then its profitability remains in off-shore investment companies).

Both tax evasion and avoidance can be related with the diversion of funds to "tax havens". The alternatives are as follows:

- **Investment in "areas of low taxation":** In territories that tax benefits and income from capital by non-residents in a way significantly lower than the rest of the revenue.

- **Investment in countries with "tax loopholes":** These are the tax systems that, taxing regularly the benefits of the companies and the incomes of the capital, contain certain specific regimes that allow a reduced or null taxation for those same incomes under certain conditions.

- **Investment in "pure tax havens"**: Offshore territories that are home to "mailbox companies", seeking legal and fiscal advantages due to lack of transparency.

12. *REVISTA DIALOGOS PARA LA ACCION RSC* - *Obligaciones Fiscales de las Empresas y Responsabilidad Social Corporativa* - *JUNIO 2014* -
13. *KRUGMAN* - *Observatorio de RSC, Informe del 2009.*

The OECD sets 3 key factors to determine whether a jurisdiction is a tax haven:

1. If the jurisdiction does not impose direct taxes on “non-residents”, or allows them to benefit from tax rebates, even though they do not develop activities in the country.

2. If there is lack of transparency with regard to identifying the holder of the invested funds.

3. If the laws or administrative practices do not permit the exchange of information for tax purposes with the residence countries of the international investors.

The most important feature of the tax haven is given by strict laws of banking secrecy and personal data protection. It is common for details of shareholders and directors of companies not listed in public records that are in the custody of their legal representative, the so-called resident agent (registered agent).

These characteristics have led these countries, often very small in extent and population, have managed to accumulate a quarter of private wealth around the world, according to the IMF. Historically they have been accused of sheltering ax evaders, terrorists and drug traffickers that hide their identities behind offshore companies, ciphered accounts, trustees, foundations, or bearer shares.

Companies domiciled in tax havens have an instrumental or financial nature; or carry out their activity in third countries (for example, company domiciled in Delaware, whose actions are societies of Panama or BVI, and carry out their activities in third countries). Tax havens remain as expression and bastion of hidden businesses, dirty money and secrecy that prevents to know if the economic flows that they protect come from the drug trafficking, traffic of persons, traffic of weapons or fraudulent tax evasion[14].

Ultimately, tax evasion means destabilization of revenues of the State, which has negative repercussions on the whole society, given that formal companies must pay more taxes to offset the taxes evaded by informal enterprises. I.e., if a company eludes paying a fair and proportional share of its profits, this causes that the tax burden is distributed among the rest of the companies that pay their taxes, while all companies benefit from the public policies and from the advantages of operating in the same market.

**c. Tax control based on local and international systemic information**

The current business environment is characterized by the use of internet and new technologies that increase the risk of evasion or tax avoidance. For example, the growth of e-commerce has caused “holes” in the volume of revenue of some States, given that the companies responsible for the turnover of online shopping are located in tax havens.

The need to adapt national and international tax regulations, and sign bilateral and multilateral agreements for the exchange of tax information are attempts to face the changes occurring in the economic activity and the movement of capital.

But beyond the good intentions of regulation forwarded by the G20 and OECD, circumvention and evasion are still present in the world, which is the result of a shared responsibility between the State and the companies in each country:

- The responsibility of the State arises from the lack of effective systemic tax regulation. This allows the unwanted “loopholes” in taxation, and prevents an adequate tax control, and...

- The corporate responsibility stems from the lack of ethical response to the gaps arising from the legislation in force, and deficiencies in the control.

14. *JIMÉNEZ VILLAREJO, Carlos - Fiscal Jefe de la Fiscalía General de España en Diálogos para la Acción - Observatorio de la RSC - Revista de Junio/2014 – Página 10.*

Now, given that it is utopian to leave on the initiative of private companies the payment of taxes as a CSR policy, it is the state that should promote CSR in tax matters.

The base line is that Governments must reduce possibilities for evasion and avoidance. Tod do this, they must remedy the regulatory gaps in the legislation of each country and in the international conventions, and international agreements for the exchange of information must be implemented, through which each country could detect the activities of its own residents abroad (including in tax havens).

From the broad national and international tax control of activities and assets, each country should encourage CSR policies, so companies that carry out activities in their territory would better comply with the essential objectives of:

- Not evading or using the various possibilities of tax avoidance to achieve low or zero taxation on funds obtained in their country of residence.

- Not taking advantage of the lack of regulation, or of lax regulation in other countries, to design a tax structure that facilitates avoiding their tax obligations.

- Not respond exclusively to the interests of shareholders, which obeys to the logic of paying less taxes for gaining more profit; but consider the interest of all citizens of the countries where companies operate.

Each country's public policies are essential to avoid the "inequalities" that occur between companies with similar contributory capacity. In this regard, it would be desirable for the tax administrations to promote public policies that comply with the following premises:

1. They should provide the correct measurement of the contributive capacity in the country where the income is generated. The taxable bases, applicable aliquots, retention scheme to external beneficiaries, the regime of credit for taxes paid abroad, etc. must be harmonized regarding the criteria of nationality, residence and territoriality of the producing source.

2. They should avoid that tax reductions, or tax incentives, motivate the capital investments in another country, instead of maintaining the capital in the country where it was generated. For this purpose, it is necessary to define internal rules that promote reinvestment of profits and international agreements that combat the transfer of funds to tax havens and, in addition to the "double taxation", must avoid "double non-taxation".

3. They should clarify the spaces of confusion in their internal legislation and ensure the continuous flow of information of tax interest within the country and abroad. When compliant companies lose competitiveness because the state does not control the non-compliant companies, this has a negative effect for all countries.

All members of the society must become aware to contribute to their social development. It is imperative to associate unequivocally that paying taxes is contributing to equity and social cohesion. Therefore, CSR policies should include clear state rules as a requirement to achieve the effective commitment of the tax obligations and their control.

## 2. CORPORATE TRANSPARENCY AND TAX INCENTIVES

### a. International tax rules on corporate transparency.

The traditional anti-avoidance rules designed to combat the double imposition being insufficient, states resort to international cooperation through bilateral and multilateral agreements of information exchange.

These international control measures are very necessary in terms of international equity, since the proclaimed ‘business engagement’ with the economic development of the country in which companies operates, is not always compatible with the simultaneous “business pressure” to obtains subsidies or tax exemptions, and the possible “business shelter” which involves investing in tax havens.

Some of the current measures of exchange of information between tax authorities, are: 1) the automatic exchange of financial information of OECD and the FATCA law of the United States; (2) the Multilateral Agreement for the exchange of information “Country-by-country”; and 3) the spontaneous exchange of Rulings; The main features of these international efforts, are as follows:

1. Through multilateral agreements for the automatic exchange of financial information from OECD and FATCA, attempts are made to relate the balances, interests, dividends and sales of financial assets, with the operational information in the tax returns of the country of residence.

2. In addition, through the “Country-by-Country” report, the measures aim at preventing the tax evasion derived from transfer pricing. Multinational enterprises provide information relevant to their country of residence on the taxes paid and the benefits obtained in each country in which they operate. To provide information by country includes: 1) sales and purchases, in the Group and outside it. (2) Labor costs and number of employees. (3) Earnings before tax, 4) Taxes paid to each State in which the group operates.

3. For their part, the States that sign agreements with preferential regimes (tax rulings), must provide certain information to other States involved, by means of a mandatory system of spontaneous exchange. This information is related to the presence of subsidiaries and partially owned companies in tax havens (due to low or null taxation, and lack of transparency).

These information systems are necessary for the purpose of detecting possible irresponsible tax practices. They allow evidencing the effective tax rate of the company in the different countries, and fundamentally, the coherence between their tax strategy and their corporate social responsibility can be evaluated.

### b. Corporate transparency as a requirement for competitiveness.

Groups of multinational companies use existing corporate, financial and tax structures in each country, as well as the network of DTCs, to optimize their tax burden. But the current requirement of international transparency forces them to report their operations and assets.

The problem of providing information is not only related to tax control, but with the uncertainty about the use that tax administrations will make of their data, which can hamper business competition.

The requirement of information should be regulated with the administration’s responsibility for the use of the data received, in order to reduce the fear that private relevant information could be disclosed to competitors. The rules on tax responsibility in the handling of information would help to the companies to understand that the transparency required from them is compatible with a loyal competition business, and that such transparency would improve the image of the company to employees, suppliers, customers, banks, etc.

Transparency is the necessary condition for a responsible management of companies. A country gains value when a fair and transparent entrepreneurial competition exist, and when citizens know how the State and the companies are operating.

Not knowing how the state will exactly use or interpret the information cannot be an excuse for not delivering it. Hiding information from the State may be a way to hide bad practices. But in order for companies to lose their fear to provide information, the State must guarantee the confidentiality of that information, and use it only for the purpose for which it was requested.

Ultimately, the exercise of transparency should not be regarded as dangerous for business practice, because of possible exposure of internal "secrets". Transparency must be a factor of competitiveness of companies, especially on tax issues. If one accepts the idea that... "Lesser transparency means more corruption and more fraud", models of transparency applicable to all companies who actually practice CSR must be designed.

Knowing that some companies are bigger than some states, the fact is that many companies take advantage of the weaknesses of the States. Business information is needed help with CSR policies, and States should take the initiative to obtain direct information from the companies, rather than learning it from corporate scandals and leaks of information of tax interest.

Finally, the public sector has an important responsibility due to its role model and example of transparency, which should encourage private companies.

### c. The need to grant tax incentives to CSR policies.

To promote CSR in taxation by alluding to the mere "ethical commitment", is not sufficient. The State should encourage CSR policies, accepting the logic of the private reasoning... "I adopt CSR practices because of the benefits they bring."

Of course, it is not appropriate to have public policies of reducing tax obligations to boost the mere voluntary compliance of those same tax obligations. The purpose must be granting tax incentives to CSR policies which, while in some aspects can result in a transient drop in tax revenue, should be quickly and widely compensated through a more integral tax compliance.

Some CSR rules represent also a saving of public expenditure, because fewer public resources are needed to meet the demands of the citizens in the areas where the company operates. In addition, if the "CSR Tax registry" is created as a requirement to provide tax incentives, it could have as a consequence that fewer public resources would be needed to control these companies.

It is positive to provide tax benefits for social activities that could facilitate the duties of the State[15]. If CSR policies and contributions of companies contribute to less public spending, it is logical to support them with a tax incentive that distinguishes them from other companies that do not show the same social commitment in tax matters.

15. *AVI-YONAH, Reuven S. en "Corporate Social Responsibility and Strategic Tax Behavior", Symposium on Tax and Corporate Governance, Munich, December 2006, and co-organized by the International Network for Tax Resarch (INTR), the Max Planck Institute for Intellectual Property, Competition and Tax Law and the German IFA branch, página 26.*

In terms of the tax incentives to provide, while they may be direct (subsidies) or indirect (tax benefits), the latter are more effective instruments to promote CSR in the form of deductions or exemptions, since subsidies are less reliable, because they depend on annual budgets.

The application of tax benefits such as deductions or exemptions must be made taking into account that CSRs are not a reward for good behavior, they must show a higher dedication to legal and social obligations of the company. I.e. the company should not be considered as CSR only because it respects the labor rights of their workers or comply with their tax obligations.

In addition, the tax benefits tax for the protection of the environment in particular can affect the tax competition between the States. Therefore, the environmental problem is a global issue, requiring global solutions... “It requires the involvement of the maximum possible number of countries”[16].

The biggest risk of tax incentives is that they give rise to actions looking more like marketing than to real awareness of the responsibility of the company in social welfare[17]. But this reality should not be a reason for not granting them.

Tax incentives should be granted to whom perform additional business activities that meet a general interest, such as green investments, concrete improvements to labor conditions, or social benefits in favor of the community in which the company develops its activities (social assistance, basic health care, basic education, etc.).

In definitive, considering the extra-fiscal purpose of taxes, the State can develop and promote CSR strategies. I.e., taxes can also be used to prevent environmental or social assistance public expenditures, extra-fiscal phenomenon which has been called “third generation contribution”[18].

The momentum of the CSR must not be an excuse or pretext for the State to transfer the promotion of values and social rights to private hands[19]. The promotion of entrepreneurship in actions of general interest should not assume the desire of the State to “outsource” a public service, but that CSR must be considered in terms of “controlled complementarity”.

In this regard, the State only seek that public activity should be complemented without losing tax control, admitting also the business logic of maximizing profits, and without losing sight that there are public functions that cannot be developed by enterprises[20].

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16. *PATÓN GARCÍA, Gemma, en “Incentivos fiscales ambientales, y responsabilidad fiscal empresarial” – UCLM Cátedra Santander RSE-Rae2013/Pensar - Resumen.*
17. *GARCÍA CALVENTE, Yolanda “El derecho financiero y tributario ante la Responsabilidad Social de la Empresa”, en “La Responsabilidad Social Empresarial: un nuevo reto para el Derecho”, Ediciones Marcial Pons, España, 2009, página 37.*
18. *GARCÍA LUQUE, Elisa en “La actividad financiera del estado social globalizado” (la prevención de gastos públicos y el tributo de tercera generación), REDF, N° 131, 2006, pág 5016. PATÓN GARCÍA, Gemma, en “Incentivos fiscales ambientales, y responsabilidad fiscal empresarial” – UCLM Cátedra Santander RSE- Rae2013/Pensar - Resumen.*
19. *SÁNCHEZ HUETE, Miguel Ángel “La responsabilidad social y su fomento a través de normas tributarias”, en “Ética y Responsabilidad ante la crisis”, María Ángeles Arraez Monllor y Pedro Francés Gómez (Eds. Lits.), Ediciones Sider S.C., Spain, May 2010, page 161.*
20. *FRIEDMAN, Milton in “The Social Responsibility of Business is to Increase its Profits”, The New York Times Magazine, September 13, 1970.*

## 3. THE SOCIAL BALANCE REPORT AND THE "CSR TAX REGISTRY"

### a. CSR measurement through the Social Balance Report

The CSR is based on a list of good behaviors arising from internationally accepted indicators to measure and report. Thus, through the guidelines proposed by the Global Reporting Initiative (GRI) for Sustainability Reports, companies can report annually their economic, environmental and social performance[21].

CSR indicators are aiming at the "ethical investor", i.e., the investor who evaluates the negative or exclusionary conditions and does not invest in companies that operate in activities considered socially, environmentally or morally harmful, as well as the one who evaluates the positive conditions to invest in companies with good practices in terms of CSR evaluated by specialized indexes[22].

Usually, the Social Balance Report provides a "memory of sustainability", from which guidelines and principles set out in the Guide for the preparation of sustainability reports drafted by the GRI would be taken. These reports inform on work conditions and employment, social assistance programs, etc. They also report environmental entrepreneurs, such as the Green trade policies, natural capitalism, the impact of global warming, etc.[23].

The granting of "tax incentives to CSR", should invite beneficiary companies to accompany their Social Balance Report with a Tax Annex, in which specific investments in environmental and social activities, collective interests of society are covered (annual investments made to improve the environment, working conditions, community social assistance, etc.).

The Tax Annex to the Social Balance Report should include the annual tax contributions (taxes, fees and contributions), subsidies and tax benefits obtained during the year, and specific investments in social and environmental programs with their corresponding tax incentives.

The purpose of the Tax Annex is reverting the complex current cycle in which the companies that benefit from public resources through grants or tax benefits, and also plot strategies of tax evasion or avoidance, sometime with high presence in tax havens. This paradoxical situation leads to have the companies that benefits from public investment policies as sources of relevant income, are endangering those same public policies by their low contribution to public resources and obtain subsidies and tax benefits. It seems that these companies are acting against their own subsistence.

To express the issue in another way, there is an obvious risk that, through policies and public procurement, incomes from employees, self-employed, SMEs, retirees, etc. (i.e., those who have effective tax burden), are transferred to large companies with lower effective tax burdens, but with greater access to government procurement and public subsidies.

Companies claiming to be socially responsible and committed to the development of the communities where they settle and operate,

21. *NÚÑEZ, Georgina "La responsabilidad social corporativa en un marco de desarrollo sostenible", CEPAL, Naciones Unidas, Serie Medio Ambiente y Desarrollo, 72, Noviembre 2003, Chile.*
22. *MORENO IZQUIERDO, José "Responsabilidad Social Corporativa y Competitividad: una visión desde la empresa", BBVA, 2004. c., en "Harvard Business Review on Green Business Strategy", Harvard Business School Press, U.S.A., 2007.*
23. *In Argentina the law 25.877 of the year 2004 established that companies that occupy more than 300 workers must present the Social Balance Report with labor information.*

cannot assume commitments with society and the environment and, at the same time, take advantage of the weaknesses of the tax system to pay less taxes through a strategy of tax avoidance or evasion.

This reality should be reflected in the Tax Annex to the Social Balance Report, which, besides containing the information on payments to the State during the year (taxes, rates and contributions), should contain information on subsidies and subventions in the country where they operates and their activities in “tax havens.

It is necessary to supplement the social and environmental information, with regard to the tax issue. States have a powerful ability to generate and develop the social model they envision, but if they do not take good care of their tax policy, that model of society will be at risk.

**b. International transparency as a requirement for tax control**

In recent years, States have progressed in being informed on results, taxes and exemptions that multinational business groups attribute to each country in which they develop activities (transfer pricing, “country-by-country” reporting, reports of rulings, etc.). Likewise, the states have progressed in the reporting of information on financial investments abroad by their own residents (automatic exchange of financial information promoted the FATCA Act of the United States and later by the OECD).

This requirement of business transparency must be accompanied by transparency in the Tax Administration, especially when agreements are signed with national or international companies in which they receive greater benefits than the other taxpayers, under the pretext of promised investments that would be source of work.

The tax administration should keep clear rules in tax matters, particularly caring for equity and equality in the distribution of the tax burden, since “internal tax havens”, are very difficult to control.

In addition, the national tax administrations must operate in a coordinated manner to prevent territorial tax imbalances. It is necessary to implement urgently BEPS action 15, referring to a global agreement between states in matter of double taxation, through which competitiveness and investment are promoted in developing countries.

This Global Agreement should contemplate the information on operations with tax havens, which concentrate the highest income per capita derived from bank secrecy, corporate secrecy and tax secrecy (numbered accounts, offshore companies, bearer shares, etc.).

Without a global agreement that allows knowing the extra-territorial investments of the residents of a country, public policies in social and environmental matters are affected. The global transparency implies that public information and private information coincide and are verifiable. This intersection of public and private information must include the details of the corporate tax burden and tax benefits received by companies.

In addition, the responsible management of the tax administrations is the engine to promote equity and tax transparency in the private sector. The lack of coordination between State agencies and the concealment of information, generates non-competitive elements and enables public and private corruption.

The responsible use of international information by tax administrations should lead to compel multinational companies to complete the Tax Annex to the Social Balance Report, taking into account as follows:

1. The evaluation of the impact on the local company, the tax variations in jurisdiction where related companies are located.

2. The consistency of the information provided locally and the one published abroad (e.g.: financial statements, tax returns, documentation of transfer prices, etc.)

3. The identification of the situations that may generate questions from the tax authorities when the "country by country report" is presented. For example, when lower margins are reported in relation to other companies of the group performing similar activities, or when the external entity which operates the local company obtains high profits with few activities or people, or with low level of taxation.

4. The review of the policy of fixing transfer pricing and the evaluation of the application of alternative methodologies starting from the information of the external taxpayer. For example, the existence of detailed information of the group opens the possibility of applying new methodologies, such as the Profit Split method.

5. The business risk management, evaluating whether the tax planning of the company is vulnerable to BEPS. To mitigate these risks, there is a possibility of making advance pricing agreements with the tax administration, on the criteria of transfer pricing fixation.

This new international context faced by taxpayers should be reflected it in the Tax Annex to the Social Balance Report. The amount and level of detail of the information to provide requires a standard mode of information directed to the different tax administrations.

**c. Tax Registry of socially responsible companies**

The starting point for the public control of the corporate social responsibility is a "CSR Tax Registry", from which the State can grant tax incentives to registered enterprises carrying out environmental investments, and control the tax compliance of those companies.

I.e., with the information that emerges from the Tax Annex to the Social Balance Report, tax administrations may evaluate the permanence of companies in the CSR Tax Registry, and the continuation or the suspension of tax incentives[24].

The proposed "**CSR Tax Registry"** would have 3 purposes:

I. Granting tax incentives to companies voluntarily enrolled in the register, which will be maintained as long as the companies are not suspended or excluded by the tax administrations.

ii. The openness the registered companies to possible "complaints" on operations that could disclose tax noncompliance by themselves or by third parties (these complaints require of the identification of the plaintiff and the company denounced must have access to the file).

iii. The requirement for the registered companies to complete the Tax Annex to the Social Balance Report, with information on the tax burden, the tax benefits obtained, and discharge from the web complaints received.

To achieve these objectives of "information and control", the state should adopt the following regulations:

24. *In Argentina, the Tax Administration (AFIP) through the RG 3.424 / 2012 and 3,642 / 2014, established the voluntary registration of companies in the CSR Registry. The aim is to overview corporate commitments to the community, which demonstrates responsible behavior in social, economic and/or environmental aspects (including tax compliance). The registration incentive is only the publication of the company with CSR in communicational programs of the AFIP.*

**i. Granting tax incentives to companies with CSR**

The benefits granted to companies voluntarily enrolled in the “CSR Tax Registry”, would be as follows:

- The deduction in the **income tax** of expenditures for the development of programs, plans, and/or implemented projects in the field of CSR, even in the case of durable goods.

- The exemption in the Tax on Assets of movable and immovable goods intended for programs, plans and/or projects implemented in the CSR projects.

- The computation in the consumption tax (ex. VAT), of the tax credit arising from expenditures on programs, plans or projects implemented in the CSR field, which should be reported in a special section of the tax return.

These tax benefits would be reported in the Tax Annex to the Social Balance Report submitted to the tax administrations.

In countries with Federal Government structure, the national Government should invite the sub-national governments to establish tax incentives for companies that voluntarily enroll in the “CSR Tax Registry”.

**ii. Controlling the tax compliance of CSR companies**

The web reports system of tax breaches by companies that voluntarily enroll in the “CSR Tax Registry” would admit employees, customers, suppliers and banks that relate to registered companies as claimants.

These claimants, prior to identify themselves and divulgate the reason that leads to inform a potential tax breach of the registered company, choose one of the following web options:

**1. Options for the “employees” of the registered employers:**

a. No receipts of salaries issued,
b. Real dates or real payment amounts are not reported on the receipts of salaries,
c. The total amount of remuneration was not deposited on the employee’s bank account.

**2. Options for “Clients” of the registered providers:**

a. Fiscal invoice not delivered for the sale or service,
b. There is no debit or credit card system for the payment of operations with end consumers,
c. The price of the good or services is reduced if the payment is in cash.

**3. Options for “suppliers” of registered clients:**

a. The purchases are paid with cash or checks from third parties.
b. They request the issuance of purchases invoices under the names of third parties and not to under their legal name.
c. They seeks the issuance of invoices for values higher than the price offered, in order to request the refund of over-priced items.

**4. Options for “Banks” that operate with registered companies:**

a. They declare that they do not operate with end consumers, but receive cash deposits on their accounts.
b. They deduce checks of third parties which have not issued sales invoices
c. They withdraw in cash money from their accounts.

The discharges of web complaints would be reported in the Tax Annex to the Social Balance Report submitted to the tax administrations.

In countries with Federal Government structure, the national State should provide access to web complaints, to the sub-national tax administrations that grant tax incentives to participants in the “CSR Tax Registry”.

**iii. Request the Social Balance Report with Tax Annex from companies with CSR**

The Social Balance Report that corresponds to the professional technical standards, would be formed by the following 2 parts[25]:

1. The **sustainability report**: Through which the guidelines and principles established in the Guide for the making of sustainability reports made by the Global Reporting Initiative (GRI) are attended

2. The **Statement of Economic Value Generated and Distributed**: Through which the compensation of the following social groups involved in the processes inherent to the activities of the company is reported:

    - Employees’ remunerations.
    - Remuneration to management and executive staff.
    - Payments to the Treasury (taxes, fees and contributions).
    - Retributions to third parties’ capital.
    - Retributions to owners.
    - Withheld earnings.
    - Others.

The Tax Annex to the Social Balance Report required by the tax administration to companies registered in the “CSR Tax Registry”, would contain the following information:

- **Tax benefits to the activity:** In case of have received State benefits, information on direct state help (subsidies and grants received in the country of operation), and indirect (exemptions and rebates derived of internal regulations of each country, and benefits from the application of DTCS, and for operating with companies linked to “tax havens”) would be added to the information on “payments to the State” (taxes, fees and contributions).

- **CSR Tax incentives**: In case of having made purchases and expenses intended to the development of programs, plans and/or projects in the CSR program, the tax rebate derived from the deduction in the income tax, of the exemption from the tax on assets, and of the computation of the tax credit on the consumption tax would be reported.

- **Disclaimer for complaints**: In case of having received “web complaints” from employees, customers, suppliers or banks, the discharge from these complaints would be reported. The reasons by which, to the criterion of the company denounced, the plaintiffs could have posted their complaints would also be repormed (prior labor or commercial relationship, etc.).

In countries with Federal Government structure, the national State should invite the sub-national state administration that, after their analysis of the Tax Annex to the Social Balance Report, they should issue their opinion about the permanence of the company in the “CSR Tax Registry”.

25. *In Argentina, since 2013 the technical resolution 36 of the ARG on Social Balance report is applied.*

## 4. CONCLUSIONS

The current international context is characterized by a decrease in the collection of the income tax on corporate revenue.

The funds that are not declared in the country of residence of their beneficiary, have their origin in the fact that private companies have eluded their tax obligation, either through the lack of registration of revenues, or by reporting non-existent expenditures (operation related to overpricing of sales). In both cases there is a tax evasion by the companies, and the funds generated by the "unreported income" and "non-existent payments" are intended for the marginal circuit, which obscures the privately management, and also public management.

Regardless of periodic options for reporting non-declared funds, the states should adopt structural solutions such as encouraging CSR policies in tax matters. It requires the granting of tax incentives, and also the control of the tax compliance with tax with the provision of information on the groups of interest.

From the proposed "CSR Tax Registry", States can grant tax benefits to companies that voluntarily enroll, and control their tax compliance.

In order for the companies to remain registered in the registry to the effects of receiving the tax benefits, they must present to the administrations a "Tax Annex" to the Social Balance Report, in which can report their social and environmental interest, and file responses to any web complaints about tax breaches by their employees, customers, suppliers and banks.

The information contained in the CSR Tax Registry will be very useful for an effective local and international transparency, and in the public and private scope. Based on that, tax administrations and administrative courts may use more efficiently the multiple resources of the State to combat tax evasion and corruption.

Through the system of "web complaints" proposed on behalf of "groups of interest", tax administrations can even identify the possible collusion between companies, public officials and banks, regarding tax evasion and money laundering. It is not possible to fight the tax evasion and the corruption in a country without a political decision from the top level of Government in this sense, and without the active participation of banks as information agents.

Therefore, in addition to requesting from the banks information on investments from the residents and nonresidents, and about fund transfers towards or from tax havens, the banks should "denounce" the deposits and withdrawals of large amounts in cash. Moving money in cash is incompatible with CSR, and the lack of State control in this regards causes tax evasion by residents and third-parties, public and private corruption, and money laundering from illicit operations.

In short, the promotion of CSR in tax matters corresponds to the State, which should evaluate the adoption of the following measures:

1. Granting tax benefits to the companies that voluntarily adhere to the "CSR Tax Registry" which implies the commitment to submit annually a Social Balance Report with an Annex containing information of tax interest, and

2. The control of the CSR Tax registry membership, based on the evaluation of the Tax Annex to the Social Balance Report, which will contain responses to web complaints about possible tax violations sent by employees, customers, suppliers and banks.

From these public measures, the voluntary enrollment in the “CSR Tax Registry” is related to the concept of business convenience in a broad sense. That is, even though the decision to enroll in the registry has a strong ethical component, the fact of having to provide tax information in standardized format, and being exposed to web complaints by stakeholders, is basically related to the economic component of the decision.

Therefore, the success of the CSR Tax Registry not only depends on the granting of the tax incentives to social-environmental investments, but also requires others economic benefits such as: (1) the granting of special regimes of financial assistance for the payment of taxes, (2) that being listed in the registry should be a requirement to act as a state provider, (3) access to more favorable condition to obtain bank financing, (longer-term return, lower interest rate, etc.), and (4) other similar economic measures, which involve a clear economic benefit to companies that enroll in the CSR tax registry.

The success of the CSR Tax Registry also depends on the commitment of tax administrations to make an objective and responsible analysis of the web complaints received, and the responses in the Tax Annex to the Social Balance Report. The lack of public transparency and tax arbitrariness in the analysis of tax compliance by companies registered in the CSR Tax registry would lead companies to renounce to the economic benefits even when they are implementing CSR policies.

In short, the creation of the Fiscal Registry of socially responsible companies, the granting of economic benefits, and the strict control of their tax compliance, are basic measures to promote CSR in tax matters.

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# THE MYTH OF BANKING SECRECY BEFORE TAX AUTHORITIES: THE CASE OF BRAZIL

**Efigênio de Freitas Júnior**


## SYNOPSIS

This paper shows how access to the banking data of taxpayers by the Brazilian tax authorities operates. It presents two programs of international automatic exchange of financial information, the FATCA, implemented by the United States, and the CRS, developed by the OECD, which demonstrate the importance of access to the banking information by the tax authorities without judicial authorization as a measure to fight against tax fraud, foreign exchange evasion and money laundering. In this new paradigm of taxation, the so-called Global Treasury, fiscal isolation of nations, entrenched in their unmatched sovereignties has come to an end; hence, there is talk of the myth of banking secrecy before the Treasury.


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**Content**



Bank secrecy has always been a controversial subject, especially in relation to access by tax authorities to the financial operations of the taxpayer without the intervention of the judiciary. Recently, the issue has gained relevance again because of two programs that have impacted strongly the world scene: i) the Foreign Account Tax Compliance Act - FATCA (law of tax compliance of accounts overseas), program implemented by the US for the purpose of exchanging bank data between them United States and more than 110 countries around the world, and ii) the Common Reporting Standard - CRS (Common Standard of Reporting), a program similar to the FATCA, implemented by the Organization for Cooperation and Economic Development (OECD), with the support of the G-20, which allows the exchange of financial information between the signatories of the Multilateral Convention on Mutual Administrative Assistance Regarding Tax Information, a sort of Global FATCA.

In Brazil, the problem was finally decided by the Federal Supreme Court in February of 2016. To better understand the context in which the resolution initially took place, we make a historical review of bank secrecy in the Brazilian legal system. We then demonstrate how access by tax authorities to banking information of taxpayers in the form of systemic and basic access works; we list the relevant points of the FATCA and the CRS; then, we highlight the main foundations of the decisions of the Direct Unconstitutionality Motions Nº 2.390, 2.386 and 2.397 2.859 and Special Appeal Nº 60.1314 whichi, after 15 years, proclaimed under the influence of the international commitments undertaken by Brazil (FATCA and SRC), the legality of the Complementary Act 105/2001 and related decrees.

Finally, after some criticism, we pointed out that in the era of Global Treasury, new paradigm of taxation, fiscal transparency and the exchange of information, the measures to combat tax fraud, foreign exchange evasion and money laundering, take up increasingly more space. Indeed, upon the declaration of constitutional of access by the tax authorities to the bank data without reservation of jurisdiction, the Brazilian Constitutional Court allowed Brazil to stay aligned with the major jurisdictions of the world economy.

In this new scenario there is no room for the financial transactions of taxpayers to remain invisible to tax authorities, whether internally or externally, that is why we affirm that banking secrecy before.

## 1. HISTORY OF BANKING SECRECY

Since ancient time discretion and secrecy were part of banking activity, given the fact the intermediation of credit always required mutual trust between banker and customer. In this context, secrecy emerged in banking activity spontaneously, on the basis of the "need or condition for the regular exercise of the granting of credit"; but later it became a "true obligation for banks." (Covello, 2001, p.19).

Nelson Abrão, given the difficulty of historical research to recognize a specific date for the origin[1] of the concept points out that the "secret emerged in the early stages of banking activity, which, in its discretionary nature, cannot be separated from it, barring under exceptional circumstances laid down by law, when the aim is to protect public order and common good". Also according to the author, the backdrop of banking secrecy is its "mystical connotation", which marked the origin of banks, which were started "within the temples" due to "an activity emanating from the gods themselves, represented by its priests[2]." Banking activity[3] had such mystic nature in its origins that it should have "a sacred character", so much so that the expressions "sacred" and "secret" keep lexical similarity and ontology. (Abrão, 2014, p. 88-89).

Among the many theories[4] that try to explain the legal basis of bank secrecy are the theory of the Constitution or fundamental law that holds that banking secrecy has a legal basis on the fundamental right to inviolability, either to privacy or intimacy[5] (article 5, paragraph X of the Federal Constitution - CF/88)[6], or the confidentiality of the data (article 5, (paragraph XII, CF/88) (Carvalho, 2014, ps. 37-38). It maintains, moreover, that, although there is not an absolute right, banking secrecy, for not having a constitutional basis, may only be restricted by a judicial decision, i.e., tax authorities could only access bank information of the taxpayer following a judicial authorization.

1. *Nelson Abrao notes that the code of Hammurabi, King of Babylon, includes the more ancient reference to banking secrecy, which allowed the "bankers to unlock their files in case of conflict with the customer." Indeed, is it inferred, in contrast, that in different circumstances the bank was obliged to keep the secret. (Abrão, Nelson (2014). Banking law. (15. ed.). Sao Paulo: Saraiva. p.89).*
2. *Chinen also suggests that the origins of banking secrecy, "as well as its evolution, mix up with the banking institutions, dating back to the Mesopotamian civilizations" and one of their features was the religious aspect. (Chinen, Roberto Massao (2005). Banking secrecy and the treasury: freedom or equality. Curitiba: Juruá. 21).*
3. *According to Nelson Abrão, there is a "consensus that the banking activity, as a specialized profession, emerged in Greece. But, even so, not entirely disconnected from its threshold in the temples, its origin: those of Delphi [...]. Bankers, in addition to promoting safe protection of the values of their clients, drafted negotiable instruments and provided guidance to their business, thanks to the knowledge they possessed of legal texts ". (Abrão, Nelson (2014). Banking law. (15. ed.). Sao Paulo: Saraiva p. 89)..*
4. *For theories on the basis of banking secrecy check in: Covello, Sérgio Carlos. (2001). The banking secrecy: with special emphasis on civil protection. (2. ed.). Sao Paulo: University Bookstore of Law. p. 113-164; Roque, Maria José Oliveira Lima (2001). Banking secrecy & right to intimacy. Curitiba: Juruá. p. 87-95; Barbeitas, André Terrigno (2003). Banking secrecy and the need for weighting the interests. Sao Paulo: Malheiros. p. 16-18; Carvalho, Márcia Haydée Porto de (2014). Banking secrecy in Brazil – limitations, competence and conditions for its loss. (2. ed.). Curitiba: Juruá. p. 36-38; Chinen, Roberto Massao (2005). Banking secrecy and the treasury: freedom or equality. Curitiba: Juruá. p. 24-29; Quezado, Paulo & Lima, Rogério. (2002). Banking secret. São Paulo: Dialética. p. 22-30; Gomes, Noel. (2006). Banking secrecy and tax law. Coimbra: Almedina. p. 19-24; Hagström, Carlos Alberto (2009). Comments on the law of banking secrecy: Complementary law n° 105, of January 2001. Porto Alegre: Sérgio Antônio Fabris Editor. p. 49-70.*
5. *Criticisms of this theory are based on the fact that the rights of individuals are fully valid and cannot be waived and banking secrecy involves exceptions, in addition to the fact that the holder may renounce it. It is also alleged that secrecy in banking activity arose before the notion of personality. In the time of slavery, the slave, who was not considered a person, was guaranteed he right to secrecy regarding banking transactions; which proves that secrecy emerged in order to offer protection to banking activities and not to the person or intimacy. (Roque, Maria José Oliveira Lima (2001). Banking secrecy & privacy. Curitiba: Juruá. p. 94). Chinen also refers to the subject in the theory of the right to privacy. (Chinen, Roberto Massao (2005). Banking secrecy and the treasury: freedom or equality. Curitiba: Juruá. p. 29).*
6. *Constitution of the Federative Republic of Brazil (1988). Brasilia: Federal Senate.*

## 2. ACCESS TO BANKING INFORMATION BY BRAZILIAN TAX AUTHORITIES

In Brazil, Complementary Law N° 105 of January 10, 2001[7] defines banking secrecy as the duty of financial institutions to keep the confidentiality on their active and passive operations and services rendered; it lists the financial institutions subject to said obligations; and affirms, among other hypotheses, that it does not constitute a violation of secrecy:

i. the exchange of information between the financial institutions for registration purposes; (article 1, § 3º, I-. Information for private purposes);
ii. the disclosure of confidential information with the express consent of the interested parties; (art. 1, § 3º, V);
iii. that the Executive Branch controls the criteria according to which financial institutions must report to the Federal tax administration, financial transactions carried out by the users of its services (art. 1, §3 th, VI c/c Article 5 – information of interest to tax authorities);
iv. examination of the bank details of the fiscal agent of the tax administrations in the cases and conditions specified (art.1º, § 3, VI c/c Article 6 - information of interest to tax authorities)

The access of tax authorities to information on the financial transactions of taxpayers can occur in two ways:

i. systemic access - mode in which only the Secretariat of Federal Revenues may access, through the system, the monthly total amount managed by the taxpayer - not including the identification of the origin or the nature of the expenses - according to the information regularly provided by financial institutions; (art. 5);
ii. basic access - mode in which that the tax authority of the Federation, the States and municipalities, through certain requirements (established administrative process or ongoing tax procedure, obligation to examine the banking information, among others), request bank information - bank statements, for example-, directly from financial institutions; (art. 6).

### 2.1. Systemic access

Article 5 of the Complementary Law 105/2001 dealing with systemic access, authorizes the Executive Branch to regulate the criteria under which the financial information will be transmitted by financial institutions exclusively to the Secretariat of Federal Revenues; it establishes that such information is limited to identifying the holder of the operation and the global amount managed monthly, prohibiting the inclusion of any provisions that allow to identify the origin or nature of expenses made (art. 5º, § 2º). In case of detection of signs of failure, inaccuracies or omissions, or the commission of any tax irregularity, the Tax Administration is allowed to request the information and documents it may need, as well as to perform the audit in order to investigate the facts (art. 5, art. 5º, § 4º)[8]. Finally it establishes that the financial information

7. *Complementary law N° 105 of January 10, 2001. It governs the secrecy of the operations of financial institutions and regulates other provisions. Consulted on Jan. 7, 2016, http://www.planalto.gov.br/ccivil_03/leis/LCP/Lcp105.htm*
8. *After detecting anomalies due to the crossing of other information contained in systems of the Brazilian Secretariat of Federal revenues, especially of revenues annually declared by individuals and legal entities, the competent administrative authority may initiate an investigation of selected taxpayers, and may request [...] the information and documents it may need, which gave support to these global amounts moved as well as perform inspection or audit for the correct determination of the facts. Saraiva Filho, Oswaldo Othon Bridges (2008). The banking secrecy and the tax administration (Complementary Law n°105/2001; INRFB N° 802/2007). Tax Law Forum Magazine, 6(34), 1-65. P. 10. This involves the power and control of verification, since the tax authorities may request (demand, being authorized by law, the provision of a service or the delivery of a good addressing, under certain circumstances, the public interest) and not simply request (request, require any right claim in a trial;). Dias, Roberto Moreira. (2005). Burden of proof after the Complementary Law 105/2001 and bank deposits. Tax and Public Finance Magazine, 13(64), p. 22-29.p. 26.*

transmitted to the tax administration of the Union will be kept under tax secrecy[9] (article 5, § 5º).

**Complementary Law nº 105 of January 10, 2001.**

> [...] Article 5º T**he Executive Branch shall regulate, even with respect to the frequency regarding the value limits, the criteria according to which financial institutions shall inform the tax administration of the Union, about financial transactions made by users of its services.** (Regulation)
>
> [...]
>
> § 2º information transferred under the heading of this article shall be limited to reports relating to **the identification of holders of transactions and monthly total amounts moved, prohibiting the inclusion of any element allowing to identify their origin or nature of the expenses they have incurred**.
>
> [...]
>
> § 4º After the reception of the information in this article, in case of signs of failure, inaccuracies or omissions, or the commission of tax irregularities, the competent authority may request the information and documents it may need, as well as perform an inspection or audit to properly investigate the facts.
>
> § 5º **The information mentioned in this article will be kept under tax secrecy provisions, in accordance with the existing legislation**. (boldface is ours)

Decree Nº. 4.489[10], of November 28, 2002, which regulates article 5 of the Complementary Law Nº 105/2001, provides: i) that the information relating to financial transactions must be provided continuously, in digital files, according to the specifications defined by the Secretariat of Federal Revenues (art. 2); ii) what is the total monthly amount moved in the operations specified (article 3); iii) minimum limit - R$ 5,000.00 (five thousand reais) for individuals and R$ 10.000,00 (ten thousand real) for corporations - in relation to the total monthly amount that shall be reported to the Secretariat of Federal Revenues (art. 4); iv) that the Secretariat of Federal Revenues may change the limits established in art. 4° (art. 5°).

Based on Decree nº 4.489/2002 the following statements were introduced: i) statement of operations with credit cards (Decred), whose presentation is mandatory for managers of credit cards (Ordinance SRF 341 of July 15, 2003); ii) Declaration of Information on Financial Transactions (Dimof), whose filing is mandatory for the banks of any kind, savings and loan associations, and for institutions that are authorized to perform operations on the currency market, (Ordinance RFB Nº 811, of January 28, 2008[11]); iii) e-financiera, statement covering the then existing information in the Dimof[12] and adds new data derived from international agreements signed by Brazil for the purpose of automatic exchange of financial information (Ordinance RFB 1.571, from July 2, 2015)[13].

9. *National Tax Code: Article 198. Without prejudice to the criminal law, the disclosure by Public Finance authorities or its employees of any information obtained under their trade on the economic or financial situation of taxpayers or third parties and on the nature and the status of their business or activities is prohibited. (Writing offered by Complementary Llaw Nº. 104, 2001).*
10. *Decree N° 4.489 of November 28, 2002. It regulates article 5 of Complementary Law No. 105 of January 10, 2001, concerning the provision of information to the Secretariat of Federal Revenues under the Ministry of Finance, by financial institutions and similar entities, concerning financial transactions made by users of its services. Consulted on January 7, 2016, http://www.planalto.gov.br/ccivil_03/decreto/2002/d4489.htm. See Ordinance RFB 802, December 27, 2007. Available on the provision of information in accordance with article 5 of Complementary Law Nº. 105 of January 10, 2001. Consulted on January 7, 2016, at http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?visao=anotado & idAto = 15755.*
11. *Ordinance RFB no 811, of January 28, 2008. Establishes the Statement of Information on Financial Transactions (Dimof) and other measures. Consulted on Jan 7. 2016, at http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?idAto=15765&visao=anotado*
12. *With the establishment of e-financiera the filing of information appearing in the Dimof in relation to events from the January 1, 2016 is waived (art. 12, sole paragraph of the UN RFB 1571/2015).*
13. *Ordinance RFB no 1.571, of July 2, 2015. Available on the obligation to provide information on the financial transactions of interest to the Brazilian Secretariat of Federal Revenues (RFB). Consulted the Jan. 7, 2016, at http://normas.receita.fazenda.gov.br/sijut2consulta/link.action?idAto=65746&. Sobre la implementación de e-financiera verifique la información de la Secretaría de Ingresos Federales disponible en: https://www.youtube.com/watch?v=MbvidYLykwc>, accessed on 01.02.2016.*

## 2.2. Indispensable access

Article 6 of Complementary Law N° 105/2001, which centers on the indispensable access, provides that the tax authority of the Union, States, Federal District and Municipalities may only examine the bank information when there is an open administrative process or an ongoing fiscal procedure and provided that such evidence is considered necessary by the competent administrative authority[14]. It also establishes that the results of evidence and scanned documents will be under the protection of tax secrecy provisions.

**Complementary Law Nº 105, of January 10, 2001**

> [...]
> Article 6º The authorities and tax fiscal agents of the Union, States, Federal District and Municipalities can only examine documents, books and records of financial institutions, including those related to deposit and investment accounts, when there is an **open administrative process or an ongoing fiscal procedure and these audits are considered indispensable by the competent administrative authority**. (Regulation)
>
> Sole paragraph. **The result of the aduits, information and documents referred to in this article will remain secret, according to the tax legislation**. (boldface is ours).

At the federal level, the indispensable access provided for in article 6 of Complementary Law N° 105/2001 was regulated by Decree N°. 3724 of January 10, 2001, laying down a series of requirements to the review of the financial transactions of taxpayers.

To allow direct access to bank information, initially a verification procedure[15] should be opened for the taxpayer (as defined in article 7 and subsequent provisions of Decree nº 70.235[16], March 6, 1972) and the reason why the review of financial transactions is considered to be indispensable - either as a result of a difference determined by the comparison between the global amount handled by the taxpayer (systemic access) and the amount reported to the Secretariat of Federal Revenues (income statement), or for any other reason - must include the limited role of the necessary hypotheses provided for in article 3 of Decree Nº 3.724/2001. See:

14. *Only starting from the detection of probable evidence of tax irregularities arising from the [...] exchange of information, and in keeping with the criteria of tax relevance and interest, the Brazilian Secretariat of Federal Revenues sets a verification procedure of selected taxpayers, which enables the request and examination of documents, e.g. bank statements, which gave rise to the global amounts managed, provided that the provision in article 6 of Complementary Law No. 105 of 2001 is complied with. (Saraiva Filho, Oswaldo Othon de Pontes (2008). The banking secrecy and the Tax Administration (Complementary Law N° 105/2001;) IN-RFB No. 802/2007). Tax Law Forum Magazine, 6 (34), 1-65 p. (10).*
15. *RFB Ordinance No. 1.687, of September 17, 2014, establishes that the fiscal procedures will be established after their assignment through the specific administrative instrument called a Tax Procedure Assignment Term (TDPF). The assignment of the tax procedure will be preceded by the activity of selection and preparation of the tax action, which will be impersonal, objective and based on technical parameters defined by the Secretariat of Federal Revenues and executed by Tax Auditors of the Brazilian Secretariat of Federal Revenues. The TDPF is issued only in electronic format, and the taxpayer's acknowledgment will occur in the RFB online website, with the use of an access code set in the term that formalizes the start of the fiscal procedure, by which the taxpayer may certify the authenticity of the procedure.*
16. *Decree 70.235/72, approved by the CRFB/88 as ordinary law, governs the tax administrative process - PAF of assessment and requirement of tax credits of the Union and consultation on the implementation of the federal tax legislation. Art. 7 The tax procedure begins with: I - the first official act exercised, written, performed by a competent employee, informing the taxpayer of a tax liability or his/her proposal; II - the seizure of goods, documents or books; III - the beginning of customs clearance of imported goods.*
    *§ 1° The commencement of proceedings excludes the spontaneity of the taxpayer in relation to the preceding actions and regardless of notifying others involved in violations recorded.*
    *§ 2 ° For the purposes of the provisions of §1°, the actions referred to in items I and II shall be valid for a period of sixty days, renewable successively for the same period, with any other written document indicating the continuation of work.*

**Decree Nº 3.724, of January 10, 2001**

[...]

Article 2º The fiscal procedures related to taxes and contributions administered by the Brazilian Secretariat of Federal Revenues - RFB will be executed by those who hold the actual position of Tax Auditor of the Brazilian Secretariat of Federal Revenues and will begin through the prior issuance of the Fiscal Procedure Assignment Term - TDPF, in accordance with the procedure to be laid down in the Act of the Brazilian Secretariat of Federal Revenues. (Writing offered by the Decree N° 8.303, of 2014)

[...]

§ 2º The modality of fiscal procedure referred in the article 7° and subsequent provisions of Decree N° 70.235, of March 6, 1972 is defined as verification procedure. (Writing offered by the Decree N° 6.104, of 2007).

[...]

§ 5º The Brazilian Secretariat of Federal Revenues, through the employee holding the position of **Tax Aditor of the Brazilian Secretariat of Federal Revenues, may only examine information concerning third parties, contained in documents, books and records of financial institutions and other similar entities, including those relating to accounts, deposits and investments, when there is an ongoing verification procedure and such reviews are considered to be indispensable**. (Writing offered by the Decree N° 6.104, of 2007).

[...]

Article 3º **The reviews referred to in § 5º of article 2º are only considered to be necessary in the following cases:** (Writing offered by the Decree N° 6.104, of 2007). (boldface is ours).

I – underestimation of values of operation, including foreign trade, acquisition or sale of property or rights, based on the corresponding market values;

II – obtaining loans from non-financial corporations or individuals, when the taxpayer cannot corroborate the cash receipt

III – the practice of any operations with individuals or corporations residing or domiciled in a country with favored taxation system or beneficiaries of the tax regime referred to in articles 24 and article 24-A of Law No. 9.430, of December 27, 1996; (Writing offered by the Decree N°8.303, of 2014)

IV - omission of revenue or net income derived from investments in fixed or variable income;

V – incurring in expenses or investments higher than available income;

VI – remittances overseas, on any account, through non-resident account of securities incompatible with the availability of declared valuables;

VII – provided for in article 33 of Law N°. 9.430, of 1996;

VIII – corporation on the National Register of Corporations (CNPJ), under the following conditions of status:

(a) cancelled;

(b) inadequate, in those cases provided for in article 81 of the Law N°. 9.430, of 1996;

IX – Individuals without registration on the Register of Individuals (CPF) or with cancelled registration status;

X – refusal by the holder of the account of de facto ownership or liability for the financial transactions;

XI – presence of any indication that the de facto owner is indeed a third party; and (writing offered by the Decree N° 8.303, of 2014)

XII – exchange of information, on the basis of treaties, agreements or international agreements, for the purpose of collection and verification of taxes. (Including by Decree N° 8.303, of 2014)

§ 1º does not apply the provisions of subparagraphs I to VI, when the calculated differences do not exceed ten per cent of the market or declared values, as the case may be.

§ 2º is considered indicative of posing as someone else, for the purposes of subsection XI of this article, when:

> I - the information available, in relation to the taxpayer, points to financial transactions more than ten times the disposable declared income, in the absence of the Statement of Annual Adjustment of Income Tax, the annual transaction amount was higher than that established in subsection II of § 3º of article 42 of Law N°. 9.430, of 1996;
> II - the registration form of the taxpayer, in the financial institution, or similar entity, contains:
> (a) false information regarding the address, income or equity; or
> (b) an income lower than 10% of the annual amount of the transactions.

The hypothesis of indispensability is specific and "reveals aggressively evasive behavior," and also allow that "Brazil complies with international treaties for the exchange of information in order to combat evasion, corruption, money-laundering and the financing of terrorism":

> i) fraud in international trade; ii) simulation of loans to cover up resources of dubious origin, even derived from trafficking in drugs and arms; iii) transactions with tax havens or countries which do not allow access to information concerning the social composition, ownership of property or rights or economic transactions made; iv) omission of income derived from variable income, including operations outside of the stock exchange; v) engaging in expenses or investments for an amount exceeding disposable income; vi) remittances of amounts overseas on behalf of non-residents that are incompatible with the declared amounts earned; vii) taxpayers subject to the special regime of compliance of obligations, such as, for example, companies consisting of front people; viii) non-existent legal persons in fact; ix) people physical non-existent in fact; x) refusal by the holder of the ownership right over resources kept or handled to collaborate; and xi) presence of indication of existence of front person by the de facto holder of resources (facades or proxies), in this case, characterized, objectively, by financial transactions ten times higher than income available or declared or, even, if the registration form of the taxpayer at the financial institution contains false information. (Secretariat of Federal Revenues, 2016b, p. 4)

Among the subsections listed in art. 3º we want to highlight subsection XII that deals with the "Exchange of information, on the basis of treaties, agreements or international conventions, with purposes of collection and verification of taxes." In this case, although Brazil has no immediate interest on the collection and verification of taxes, according to the sole paragraph of article 199 of the national tax code[17], said interest stems from the Treaty signed by the signatory State. Therefore, the international agreement, by virtue of its nature and mutual obligations, mainly in relation to the secrecy of the information, justifies the administrative procedure, with the subsequent access to bank information of taxpayers. The "verification made in another State would be equivalent to the verification made in Brazil, with the ensuing need for continuity," through the issue of a Tax Procedure Assignment Term. (Godoy, 2009, p.17).

Next, after the verification procedure is open, the taxpayer must be aware that he/she is under the fiscal action and must be summoned to submit details pertaining to his/her financial transactions. If they refuse to provide this

17. *Art. 199. The Public Treasury of the Union and that of the States, the Federal District and the Municipalities will collaborate with one another for the verification of the respective taxes and exchange of information, in the manner established, generally or specifically, by law or agreement.*
*Sole paragraph. The Public Treasury of the Union as set out in the treaties, agreements or conventions, may exchange information with foreign States in the interest of raising and overseeing taxes. (Included by Complementary Law N°. 104, 2001).*

information, it will be requested directly from financial institutions through the issuance of a request for information on financial transactions - RMF, which is subject to the following requirements: i) prior summons issued to the taxpayer to submit information on his/her financial transactions; ii) failure to submit or absence of express authorization for direct access to the information; iii) detailed report prepared by the Tax Auditor of the Secretariat of Federal Revenues responsible for the tax procedure or his immediate boss, which must include the origin of the proposal for issuance of the RMF showing, with precision and clarity, that this is a situation under the hypothesis of indispensability under article 3º of Decree Nº 3.724/2001. After these requirements are met, the RMF will be issued by a competent tax authority[18] other than that which drew up the report.

**Decree 3.724, of January 10, 2001**

[...]

Article 4º The competent authorities **may request the information referred to in § 5º of article 2° to issue the TDPF** (writing offered by the Decree N° 8.303, of 2014)

§ 1º The request referred to in this article shall be formalized by means of document called **Request for Information of Financial Transactions (RMF)** and shall be addressed, as appropriate, to the:

I - Chairman of the Central Bank of Brazil, or his representative;

II - Chairman of the Securities Commission, or his representative;

III - President of the financial institution, or similar entity, or his representative;

IV - Branch Manager.

§ **2º The RMF will be preceded of a summons of the taxpayer to present the information of financial transactions, necessary for the application of the procedure tax.** (Writing offered by the Decree N° 8.303, of 2014)

§ 3º The **taxpayer can answer the summons referred to in § 2º by means of:** (Writing offered by the Decree N° 8.303, of 2014)

I – **Express authorization of direct access to the information on the financial transactions from the tax authority;** or (included by the Decree N° 8.303, of 2014)

II - **Presentation of information on financial transactions, in which case he will be responsible for its accuracy and integrity, observing the applicable criminal law.** (Included by Decree N° 8.303, of 2014)

§ 4º The information provided by the taxpayer may be object of verification in the institutions mentioned in article 1°, even through the Central Bank of Brazil or of the Securities Commission, as well as the comparison with other information available at the Secretariat of Federal Revenues.

§ 5º The **RMF will be issued on the basis of a detailed report prepared by the Tax Auditor of Brazilian Secretariat of Federal Revenues responsible for the application of the tax procedure or by the immediate supervisor**. (Writing offered by the Decree N° 8.303, of 2014)

§ 6º The report referred to in the above paragraph, must include the **grounds for the proposed issue of the RMF**, which shows, with precision and clarity, that this is a situation

18. *The competent authorities for issuing the TDPF and RMF under article 7 of the Ordinance RFB No. 1.687/2014 are: General Coordinator of Verification; General Coordinator of the Customs Administration; Superintendent of the Brazilian Secretariat of Federal Revenues; Delegate of Brazil's Federal Revenues; Chief Inspector of Brazil's Federal Revenues; Inspector General; General Coordinator of Audits and Investigations; General Coordinator of Programming and Studies; Special Coordinator for Refunds, Compensation and Restitution; and Special Coordinator of Large Taxpayers.*
*"For added security, the Brazilian Secretariat of Federal Revenues established that the issuer of the order [TDPF] should hold a management position." The Fiscal Auditor is responsible for the TDPF. He will only decide based on the request for information on financial transactions if pursues one of the management duties. "Such limitations of formal order, together with the description of the material conditions that justify an opening in bank secrecy, come together to give credibility and reliability to the system." (Gramstrup, Erik Frederico (2014). Tax and banking secrecy: normative and principled fundamentals of opening secrecy. Brazilian Magazine for Constitutional Studies, 8 (28), 95-117 p. 107.*

under the **hypothesis of indispensability** laid down in the above article, subject to the principle of the reasonableness. (boldface is ours).

By having the financial transactions submitted by the taxpayer or the financial institution, upon analyzing the valuables credited to a deposit or investment account, tax authorities should ignore the amounts derived from transfers to another account of the same individual, if it were the case. Subsequently, the taxpayer must be again summoned to corroborate the origin of the other valuables accredited in his(her) account(s). If unable to corroborate the origin of resources, through valid and appropriate documentation, the valuables presented must be officially submitted, claiming presumption omission of declared income, under the terms of article 42 of law N° 9.430[19], of December 27, 1996.

**Law N° 9. 430, of December 27, 1996**
Article 42. Also defined as **omission of income or revenues** are amounts credited to a deposit or investment account in a financial institution, in relation to any holder, individual or corporation, regularly summoned, **who fails to corroborate, through valid and appropriate documentation, the origin of the resources used in these transactions**.
[...]
§ 2º The valuables whose origin have been corroborated, which had not been accounted for on the basis of the calculation of taxes and contributions they were subjected to, will undergo specific tax provisions, outlined in the existing legislation at the time they were earned or received.
§ 3º For the purpose of determining the undeclared income, credits will be analyzed on an individual basis, noting that the following **will not be considered**:
I - **income derived from transfers from other accounts of the same individual or corporation;**
II - in the case of **individuals**, without prejudice to the provisions of the preceding paragraph, those **amounting** equal to or less than **[R$ 12,000.00 (twelve thousand reais**)], provided that their sum, within the calendar year, does not exceed the amount of **[R$ 80.000,00 (eighty thousand reais)**]. (Adjusted values, in accordance with the Law N°. 9.481 of August 13, 1997)

In terms of the amounts whose origin was corroborated, but which were not declared on the basis of the calculation of taxes and contributions they were subjected to, in checking their condition as subject to the payment of tax, we are facing an omission of income itself and not a presumptive omission; in fact, payment of taxes shall occur in accordance with the specific rules laid down in the current tax law.

Complementary Law N° 105/2001 also establishes that banking secrecy must be observed for both systemic and indispensable access, i.e. banking data after being transferred to the Treasury are under the protection of tax secrecy provisions, without prejudice to the former. In this regard, the majority position of the Supreme Court of Justice[20] in judging Direct Unconstitutionality Motions N° 2.390, 2.386, 2.397 and 2.859 - which declared the constitutionality of Complementary Law N° 105/2001 - and part of the doctrine

19. *The legality of Article 42 of the Law no 9.430/96 was questioned in the Special Appeals Motion 855.649, whose overall impact was recognized on 22.09.2015.*
20. *The position of the STF will be addressed below.*

understand that, under this condition, there is no breach[21]of secrecy provisions, but rather the transfer of secrecy[22] from the financial institution to the tax administration; however, the law does not make a distinction between transfer of secrecy provisions and breach of secrecy provisions[23].

The breach of secrecy occurs when the data - bank or tax data - are accessed by persons not authorized by law, judicial decision or without authorization from the taxpayer, i.e., when the data are breached. Note that in the aforementioned art. 1º, § 3º, VI, the law lists the cases that not constitute a breach of bank secrecy, including, the provisions of the article 5° and 6°. If in such cases there is no breach of secrecy provisions, it can, therefore, be inferred that there would be no violation of secrecy provisions, but rather a transfer.

It just so happens that part of the doctrine, on the other hand, understands that the term transfer of secrecy would be a "manifest sophism, because this transfer to Federal Revenues gives rise to the unlawful breach of secrecy provisions." (Reale & Martins, 2005, p.13). This doctrinal trend asserts that the Treasury's access to bank information of the taxpayer without prior judicial authorization is unconstitutional.

Below we will see two measures listed as real milestones in terms of banking secrecy before the State Treasury.

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21. *According to De Placido, 'breach,' "in the fluent language, in application of the Law, is interpreted also as a breach or failure to comply with one's assumed duty" and "secrecy" is the secret that must not be breached. Silva, de Placido and (2009). Reference. In: P. Silva. Legal Vocabulary. (28. ed. pp. 1135-1289). Rio de Janeiro: Forense.*
22. *In this same sense: Saraiva Filho, Oswaldo Pontes Othon. (2011). Banking and tax secrecy related to the tax administration and the attorney general's office. In: O. O. P. Saraiva Filho & V. B. Guimarães, (Coord.). Banking and tax secrecy: homage to Legal Expert José Carlos Moreira Alves. (pp. 17-83). Belo Horizonte: Forum. p. 35; Santi, Eurico Marcos Diniz (2011). Secrecy and tax law: transparency, control of legality, right to the prove and the transfer of banking secrecy to the tax administration under the Constitution and the Complementary Law n. 105. In: O. O. P. Saraiva Filho & V. B. Guimarães, (Coord.). Banking and tax secrecy: homage to Legal Expert José Carlos Moreira Alves. (pp. 17-83). Belo Horizonte: Forum. p. 596-597; Justice Cármen Lúcia (Special Appeal no 389.808/PR, ruling 15/12/2010. Justice Rapporteur Marco Aurelio. Electronic Daily of Justice, May 9, 2011, p. 233); Justice Dias Toffoli (Special Appeal no 389.808/PR, p. 231); Justice Ellen Gracie (Injunction Nº 33/PR, ruling on 24.11.2010. Justice Rapporteur Marco Aurélio. Electronic Daily of Justice, February 9, 2011, p. 63).*
23. *An example in which the term 'breach of secrecy' was used correctly: Law 9.296, of July 24, 1996, Art. 10. It constitutes a crime make the wiretapping of telephone, computer or telematics communications, or to violate the secrecy of confidentiality in justice, without judicial authorization or for purposes unauthorized by law.*

## 3. THE FOREIGN ACCOUNT TAX COMPLIANCE ACT - FATCA (USA) PROGRAM

The Foreign Account Tax Compliance Act (foreign accounts tax compliance Act) is a system of declaration of information which aims to identify financial accounts of U.S. persons[24] (US accounts) maintained outside the United States by financial institutions around the world in order to increase transparency and avoid tax evasion in the United States[25].

In light of budgetary difficulties, tax evasion by US taxpayers[26] using goods and assets in foreign entities, but not declared to the US Treasury - UBS case[27] - and to enhance fiscal transparency, the US Congress on 18.03.2010 enacted the Employment Incentives Act (The Hire Incentives to Restore Employment Act, or Hire Act) which established a set of measures to encourage the creation of jobs in the U.S. The aforementioned law states that foreign financial institutions (Foreign Financial Institutions – FFI) from around the world must identify the accounts of US persons (individuals and corporations) – US accounts – and report them to the US Treasury (IRS - Internal Revenue Service), in an automatic fashion. The FFI's that fail to cooperate or that do not provide accurate information may be taxed at 30% on any payment of interest, dividends, rents, wages, salary, awards, annuities, compensation, remunerations, emoluments and other fixed income or variable or periodic annual income, earnings and revenues, if said payment came from sources within the United States.

The legislation was included in Chapter 4, sections 1471 to 1474, of the US Tax Code of 1986 (Internal Revenue Code), referred to as the Foreign Account Tax Compliance Act (foreign accounts tax compliance Act), better known as FATCA.

During the FATCA regulation the U.S., with the common goal of intensifying cooperation in the fight against international tax evasion, agreed to sign bilateral intergovernmental agreements (Intergovernmental Agreement - IGA) with France, the United Kingdom, Spain,

24. *Citizen of the U.S. or person residing in the U.S., a corporation or company organized in the U.S. or based on U.S. laws or from a U.S. State, or a trust ("Trust") if (i) a U.S. Court of Justice had authority in the field of the legislation applicable for issuing orders or rulings on substantially all matters related with the administration of the trust ("Trust"); and (ii) one or more persons from the U.S. had authority to control all important decisions of the trust ("Trust") or of the assets of the deceased person who is a citizen or resident of the United States.*
25. *The law of the US bank secrecy act (Bank Secrecy Act) already established, domestically, a rule similar to the FATCA, the FBAR - Report of Foreign Bank and Financial Accounts (report of foreign financial and banking accounts) - report used in the prevention/fight against financial crimes that must be delivered to the IRS by persons of the U.S. that have accounts outside the U.S. whose value added in the calendar year may exceed US$ 10,000. The competence to investigate certain crimes was delegated, in 2003, by the Financial Crimes and Enforcement Network (FinCEN) to the IRS. Although similar, the fundamental difference in relation to the FBAR is that the FATCA has information from foreign financial institutions - FFI. Accessed on May 9, 2016, at https://www.irs.gov/pub/irs-utl/IRS_FBAR_Reference_Guide.pdf. Also check in Coelho, Carolina Reis Jatoba. (2015). Banking secrecy and global governance: the incorporation of the FATCA (foreign account tax compliance act) in the Brazilian legal system in the face of the international regulatory impact. Federal Revenues Magazine: Taxation and Customs Studies, 1(2), 83-122. p. 102.*
26. *Estimates point to an international tax evasion in the U.S. (international tax gap) between US $40 billion (2002) and US $70 billion (2004) per year. It is estimated that the international tax gap, mainly by individual taxpayers, could be significantly higher than the total tax gap for corporations whose estimate in 2001 was US$29.9 billion. Guttentag, Joseph & Avi-Yonah, Reuven (2005). Closing the international tax gap. In: M. B. Sawicky (Ed.). Bridging the tax gap: addressing the crisis in federal tax administration. Washington: Economic Policy Ins. p. 101-102. The international tax gap occurs, in part, because the United States does not withhold taxes on passive income (such as interest) paid to foreign entities; on the other hand, if U.S. taxpayers channeled their investments towards a foreign entity and fail to report them in their tax returns, they shall fail to pay taxes they are legally forced to pay. Gravelle, Jane G. (2015). Tax Havens: International Tax Avoidance and Evasion. Congressional Research Service. p.1.*
27. *The case of the UBS Bank, according to Faria and Rocha, reportedly revealed that many wealthy Americans may not be complying with their tax obligations" – they were hiding investments in accounts located in Switzerland, Cayman Islands, Singapore, and Hong Kong in order to avoid taxation. Faria, Wilson Rodrigues; Rocha, Alessandra M. Gonsales. (2013). The international fight against tax evasion: how FATCA can affect the Brazilian financial institutions. Banking Law Magazine, 16(59), 381-392. p.382. After a long negotiation, the UBS and the IRS signed a settlement in which UBS paid a $780 million fine to the IRS, and also presented financial data of 4.450 customers suspected of evasion.*

Italy and Germany[28], under the argument that an intergovernmental approach would facilitate compliance, would simplify the practical implementation, and would reduce the costs of FFI's. It was the beginning of an inter-governmental agreement model, subsequently divided into two models[29] - model 1 and model 2 - that would be replicated to other interested countries, as well as the idea of a European FATCA, which would end up becoming a global FATCA, also known as GATCA[30].

In accordance with the IGA model 1, signed by the countries mentioned above, the FFIs transmit the information of the US accounts to the Tax Administration of the partner jurisdiction[31] wherever it may be located and they, in turn, transmit it to the IRS automatically. The exchange of information under this model can be with or without reciprocity of treatment.

Under the IGA model 2, the partner jurisdiction undertakes to encourage and allow that the FFIs, located in their jurisdiction, report directly to the IRS the data on the US accounts, as well as the aggregate information of holders of preexisting US accounts that did not allow the sending of data[32]. Under this model, therefore, the jurisdictions do not have access to the financial data of their taxpayers living overseas[33], since there is no exchange of information between the authorities tax.

Under both models of IGA, the procedures of due diligence (due diligence) to verify whether specific accounts can be characterized as US accounts, is a responsibility of the FFIs.

The FATCA entered into force on 01.07.2014, date on which the FFI's should have already registered on the web page of the IRS/FATCA and obtained their GIIN (intermediate global identification number) number for purposes of identification in negotiations financial. The FFI's whose jurisdictions have signed the IGA model 1, shall presume compliance, i.e., in accordance with the FATCA.

The inclusion of the FATCA in the Brazilian legal system took place through the approval of the legislative Decree N°. 146, of June 25, 2015, enacted by the Decree of the Executive Branch No. 8.506, of August 24, 2015.

The concept of financial institution[34] subject to the FATCA is quite broad and includes custody institutions, deposit entities, investment companies or specific insurance companies[35].

The United States will inform Brazil only about information relating to financial accounts of Brazilian residents, while the data reported by Brazil to the United States shall include accounts of U.S. residents and citizens. This is because the United States, as well as the Philippines and

28. *Joint statement of the United States, France, Germany, Italy, Spain and the United Kingdom on the intergovernmental agreement on the fulfillment of the FATCA. U.S. Treasury Department. (2012). Joint statement from the United States, France, Germany, Italy, Spain and the United Kingdom regarding an intergovernmental approach to improving international tax compliance and implementing FATCA. Checked on April 14, 2016, at https://www.treasury.gov/resource-center/tax-policy/treaties/ Documents/FATCA-Joint-Statement-US-Fr-Ger-It-Sp-UK-02-07-2012.pdf..*
29. *The Internal Revenue Service. (2016). FATCA Information for Governments. Checked on April. 13, 2016 in https://www.irs.gov/Businesses/ Corporations/FATCA-Governments..*
30. *GATCA is the informal nomenclature of the global FATCA, also known as - Automatic Exchange of Information - AEOI (automatic exchange of information). OECD (2016). Automatic Exchange of Information. Accessed on May 10, 2016, at http://www.oecd.org/.*
31. *The partner jurisdiction is the jurisdiction that has an agreement in effect with the US for the implementation of the FATCA.*
32. *Regarding the US accounts whose holders do not allow the exchange of information, the IRS partner might make a request to the partner jurisdiction for more specific information.*
33. *By 04/2016, 112 jurisdictions had already signed the IGA: 98 had*
34. *For the purposes of the FATCA, Brazilian financial institution means (i) any financial institution whose headquarters are located in Brazil, with the exception of their subsidiaries abroad, and (ii) all subsidiaries located in Brazil from a financial institution whose headquarters is located in Brazil.*
35. *Decree no 8506/2015 - IGA, article 1, "g" - "k".*

Bulgaria, are among the few countries that exercise jurisdiction of residence over their residents[36] and also on their citizens. In other words, in these countries resident or non-residents[37], as well as foreign residents, are subject to the income tax on the basis of their world income (worldwide) (Arnold & Mcintyre, 1995, p. 19).

The information that must be reported by the Brazilian tax authorities[38] to the IRS[39] is basically the account information and account holder information, financial institution identification and gross total amount, interest, dividends, earnings, credited to account, including:

> (1) name, address, US TIN number[40] for each US individual or corporation who is the account holder and, in the case of entities that are not US-based entities, after the registration of the due diligence procedures described in Annex I, is identified as one or more Controlling Persons that are Individual or Corporation of the US, name, address, US TIN number (if any) of the aforementioned entity and each US individual or corporation;
> (2) the account number (or functional equivalent information, in the absence of account number);
> (3) the name and identification number of the Brazilian Reporting Financial Institution;
> (4) the balance or account value (including, in the case of Insurance Contract with Monetary Value or Annuity Contract, the Monetary Value or salvage value) at the end of the relevant calendar year or other period of delivery of adequate information; or, in the event that the account has been closed during the year, immediately prior to closing;
> (5) in the case of any Custody Account:
> (A) the gross total amount of interest, the gross total amount of dividends and the gross total amount of other income related to assets under custody in the account, in each case paid or credited to the account (or in connection with the account), during the calendar year or another period of delivery of adequate information; and
> (B) the total gross income of the sale or salvage of the property paid or accredited in the account during the calendar year or another period of provision of appropriate information with respect to which the Brazilian Reporting Financial Institution has acted as custodian, broker, representative or agent of the Account Holder;
> (6) In the case of any Deposit Account, the gross total amount of interest paid or credited to the account during the calendar year or another period for the provision of appropriate information; and
> (7) In the case of any account not described in subparagraph 2 (a) (5) or 2 (a) (6) of this article, the gross total amount paid or credited to the account holder in relation to the account

36. *In accordance with the jurisdiction-based taxation of residence, there is a link between the country and the person who earned the income. Under this methodology, the people are taxed on the basis of their worldwide income (worldwide), i.e., domestic income and foreign income, without reference to the source of income (jurisdiction of origin). The countries that exercise the jurisdiction of residence do so only for the income of individuals and corporations that are their residents: hence the term jurisdiction of residence. Countries such as the United States, Philippines, and Bulgaria, are the exception to the jurisdiction of residence, because they cover both their residents and citizens. Arnold, Brian J. & Mcintyre, Michael J. (1995). International tax primer. Cambridge: Kluver Law International. p. 19. See also Department of the Treasure (2015). Tax Guide for U.S. Citizens and Resident Aliens Abroad. (Publication 54). Consulted on April 22, 2016, at https://www.irs.gov/pub/irs-pdf/p54.pdf. and Department of the Treasure (2015). U.S. Tax Guide for Aliens (Publication 519). Checked on Apr.22, 2016, at https://www.irs.gov/pub/irs-pdf/p519.pdf.*
37. *Said structure follows a contentious criterion of tax residence used in the United States; If an US citizen moves to Switzerland for 10 years, for example, he will still be obliged to file his income taxes in the United States, regardless of his physical residence; such a situation is very different from most of the countries of the world, where the criterion of tax residence is usually based on the physical residence after a certain period of time (typically 6 months to a year). Alvarez, Michael Zavaleta; Speer, Andrew & Godoy, Jarek Tello. (2013). Cross-border control: problems of the FATCA and proposal for Latin America. Americas Tax Law Magazine, 4(7),159- 235. p. 167.*
38. *Article 2 (a) of the IGA - Decree no 8.506/2015.*
39. *In accordance with article 3 of the IGA, the US will report all information concerning 2014 to Brazil from the first Exchange, which took place on 09/2015. Brazil, in turn, will gradually report the information concerning 2014 and 2015, and in a complete manner for 2016. The expectation of exchange of information among countries is up to nine months after the calendar year referred to in the information provided.*
40. *Number equivalent to the CPF/CNPJ.*

for the calendar year or another period for the provision of appropriate information regarding the Brazilian Reporting Financial Institution, whether a debtor or obligor, including the total amount of all salvage payments made to the Account Holder during the calendar year or another period for the provision of appropriate information.

Although the information to be reported by the US[41] to the Brazilian tax authorities may have the same nature as that which must be reported to the IRS, it just so happens that the level of detail is less than that required by US tax authorities:

(1) name, address and Brazilian CPF/CNPJ of any person who is resident in Brazil and holder of an account;
(2) the account number (or functional equivalent information, in the absence of the account number);
(3) the name and identification number of the US Reporting Financial Institution;
(4) the gross amount of the interest paid on the Deposit Account;
(5) the gross amount of US-source dividends paid or credited to the account; and
(6) the gross amount of other US sources of income paid or credited to the account, provided that it is subject to the obligation to provide information contained in Chapter 3 of the section A or Chapter 61 of section F of the US Federal Revenue Code.

With a view to identifying the US accounts that must be reported to the IRS, the Brazilian financial institutions must perform the due diligence, according to the terms of Annex I to the IGA, which establishes procedures and parameters of specific values for individual accounts (individuals), entity accounts (corporations), preexisting accounts (accounts existing as of 30.06.2014), and new accounts (accounts open after 01.07.2014).

The review procedures which must be observed are: i) the electronic investigation of data; ii) the investigation of the physical records; iii) the the investigation of the relations manager; iv) the procedures against the laundering of money, AML (Anti-Money Laundering), and those adopted by the financial institutions on getting to know your customer (KYC- Know Your Customer) or for other regulatory purposes; v) specific procedures specific for the FATCA.

The US accounts identified are transmitted by financial institutions to the Brazilian Secretariat of Federal Revenues, through the declaration of e-financiera, which they send to the IRS.

In accordance with the US Department of the Treasury, the myth that US citizens who live overseas would renounce their US citizenship under the responsibilities and burdens resulting from the FATCA was created. For the US Treasury, there is no need to talk about myths, because the fact is that the FATCA provisions do not impose new obligations on US citizens living abroad; given the fact that the obligations of withholding at the source under FATCA fall on financial institutions that make payments to the FFI's, and the obligation of due diligence and reporting data falls on the FFI's.

On the other hand, the US Treasury adds, US taxpayers, including US citizens living abroad, are required to comply with the tax laws of the United States. Therefore, the individuals that use offshore accounts to evade their tax obligations may, with justified reason, fear that the FATCA may identify their illicit activities. Meanwhile, the decision to give up their US citizenship does not

41. *Article 2 (b) of the IGA - Decree no 8.506/2015.*

exonerate these people of their preceding tax obligations in the US; this may create additional obligations in the US for certain citizens and residents who renounce their US citizenship or residence[42].

Myth or fact, the reality is that the FATCA has caused a growing increase in the number of people renouncing their US citizenship since its implementation.[43]

## 4. AUTOMATIC EXCHANGE OF INFORMATION BASED ON THE COMMON REPORTING STANDARD (CRS)

The intergovernmental agreements (IGA - Model 1) signed by the five main European countries (United Kingdom, France, Spain, Italy and Germany) with the US to exchange bilateral information automatically under the scope of the FATCA, as mentioned above, acted as catalysts so that the OECD and the G20[44] will implement a similar model around the world.

In 2013, during the meeting of the G20 in Moscow[45], in accordance with the aspirations of the countries of the G8[46] and the G-20, the OECD presented a model of automatic exchange of information whose regulation is the Common Reporting Standard (SRC) (Common Standard of Reporting). This model, similar to FATCA, developed by the OECD together with the G20, defines the standard of financial information to be exchanged, the rules of due diligence and presentation of reports, as well as a technical platform. (OCDE, 2013, p. 38).

In July of 2014, the OECD published the report Standard for Automatic Exchange Financial Account Information[47], which includes the Common Reporting Standard (CRS) and the Multilateral Convention Model Among Competent Authorities (Multilateral Model Competent Authority Agreement - MMCAA)[48].

The implementation of this model of exchange of information in Brazil, as well as in the main economies of the world, depends on of the following procedures: i) signing of the Multilateral Convention on Mutual Administrative Assistance Regarding Tax Matters, that allows the automatic exchange of information among the signatory jurisdictions; ii) signing of the Multilateral Competent Authority Agreement (Multilateral Competent Authority Agreement), document that incorporates the CRS.

42. *Stack, Roberto (2013). Myth vs. FATCA: the truth about treasury's effort to combat offshore tax evasion. Consultado el 22 abr. 2016, en https://www.treasury.gov/connect/blog/Pages/Myth-vs-FATCA.aspx>.*
43. *Newlove, Russel (2016). Why expat Americans are giving up their passport. Checked on Apr., 2016, at http://www.bbc.com/news/35383435; Mullen, Jethro (2016) Record number of Americans dump U.S. passports. Checked on Apr. 20, 2016, at http://money.cnn.com/2016/02/08/news/ americans-citizenship-renunciation/; Bosley, Catherine & Rubin, Richard. (2015) A record number of Americans are renouncing their citizenship. Checked on Apr. 20, 2016, at http://www.bloomberg.com/news/articles/2015-02-10/americans-overseas-top-annual-record-for-turning-over-passports.*
44. *The countries that make up the G20 are: South Africa, Germany, Saudi Arabia, Argentina, Australia, Brazil, Canada, China, South Korea, United States, France, India, Indonesia, Italy, Japan, Mexico, United Kingdom, Russia, Turkey and the European Union member countries.*
45. *OECD. (2013). Secretary-General Report to the G20 finance ministers and central bank governors. Paris: OECD. Accessed on May 25, 2016, at http://www.oecd.org/g20/topics/taxation/OECD-tax-report-G20.pdf.*
46. *The countries that make up the G8 are: United States, Japan, Germany, United Kingdom, France, Italy, Canada. (Russia, then member of the G8, was suspended after the reunification of Crimea).*
47. *<?> OECD. (2014). Standard for automatic exchange financial account information. Paris: OECD. p. 29 and 215. Accessed on May 23, 2016, at http://www.oecd.org/ctp/exchange-of-tax-information/standard-for-automatic-exchange-of-financial-account-information-for-tax-matters-9789264216525-en.htm.*
48. *The Model of Agreement of the Competent Authority may be multilateral (Multilateral Model Competent Authority Agreement - MMCAA), signed by the jurisdictions that are parties of the Multilateral Convention, or bilateral (Model Competent Authority Agreement - MCAA). In this study we will address only the multilateral model; model adopted by Brazil.*

The Multilateral Convention on Mutual Administrative Assistance in Tax Matters, signed by all members of the G20 on November 3, 2011 in Cannes Summit was approved by Legislative Decree n. 105 of April 15, 2016, deposited with the OECD on June 01, 2016 with effect on entry into force on October 1, 2016, promulgated by Decree 8842 of 29 August 2016 and, currently, has 103 jurisdictions[49] participants, among them several tax havens.

The Convention addresses the five main methods of administrative cooperation among Member States on tax matters and, especially, pertaining to this study, the automatic exchange of information (art. 6).

> i) **Exchange following a request**, i.e., a communication by the requested State of information relating to a particular case, requested in a manner expressed by the requesting State (article 5);
> ii**) Automatic exchange**, i.e., the systematic transmission of information on certain items of income or capital by one Party to the other Party (article 6);
> iii) **Spontaneous exchange**, that is, the communication of information obtained in the course of the review of the situation of a taxpayer, or other circumstances, which may be of interest to the recipient State (article 7);
> iv) **Simultaneous tax audit**, that is, the communication of information obtained in the course of a review carried out simultaneously on each of the interested Parties, on the basis of an agreement between two or more competent authorities, on the tax situation of one or more persons, which has for these States common or additional interest (see article 8);
> v) **Tax audit overseas**, i.e., obtaining information under the presence of representatives from the tax administration of the requesting State during a tax audit carried out in the requested State (article 9)[50]. (OECD, 2011, p. 30, the boldface is ours)

The CRS is the standard that defines due diligence procedures to be observed by financial institutions in order to identify accounts and financial information to be reported. Such procedures are crucial, because they help to ensure the quality of the reportable information.

Under this standard, the jurisdictions obtain a report from the financial institutions and automatically exchange financial information pertaining to all the accounts of the report with partners in treaties, as appropriate, identified by financial institutions on the basis of common reporting rules and the due diligence. The term "**financial information**" means interest, dividends, account balance, income from certain insurance products, the proceeds of the sale of financial assets and other income generated with respect to the assets held in the account or payments related to the account. The term "**reportable accounts**" means accounts of individuals and entities (which includes trusts and foundations), and the standard includes the requirement to verify passive entities to inform the relevant controlling persons. (OECD, 2103, p. 38, the boldface is ours).[51]

The procedures of due diligence, outlined in sections I to IX of the Common Standard on Reporting and Due Diligence for Financial Account Information are similar to the procedures of the FATCA and seek to identify them types of accounts that must be informed to the Treasury and subsequently reported. (OCDE, 2014, p. 29-61)

49. *Check at OECD (2016) Convention on mutual administrative assistance in tax matters. Consulted on Sep 05, 2016, at https://www.oecd.org/ctp/exchange-of-tax-information/convention onmutualadministrativeassistanceintaxmatters.htm.*
50. *OECD. (2011). Convention on mutual administrative assistance regarding tax matters. Accessed on May 10, 2016, at http://www.oecd.org/ctp/exchange-of-tax-information/POR-Amended-Convention.pdf.*
51. *See also: Rocha, Sergio Andre. (2015). International exchange of information for tax purposes. Sao Paulo: Quartier Latin. p. 121-123.*

The CRS was finalized and approved by the OECD and the G20 in 2014. Subsequently, the process of commitment among the members of the Global Forum[52] got underway, and it currently has 96[53] jurisdictions committed to implement it in 2017/2018, with a view to ensuring an automatic exchange of effective information among the partners. Brazil pledged to exchange information based on CRS in 2018.

The exchange of information under the FATCA and CRS is quite similar. In both models the exchange occurs automatically, the type and nature of the information to be provided and due diligence procedures are virtually the same, except for the fact that under the FATCA data to be reported refer to residents or citizens of the United States; the Treaty is bilateral in nature (IGA - model 1) and there is the possibility of withholding at the source for revenues from the US, in case of non-compliance by the financial institutions. Meanwhile, under the CRS the Treaty is Multilateral in nature, the information to be reported refers only to residents of the respective jurisdictions and the hypothesis of withholding at the source does not exist.

In the area of the European Union, the measures provided for in the CRS are contained in the Directive 2014/107/EU[54] of December 9, 2014 that modified the Directive 2011/16/EU[55] concerning the automatic exchange of mandatory information in the taxation area.

The Multilateral Competent Authority Agreement (MCAA), whose legal basis is article 6 of the Multilateral Convention, shows the CRS for national legislation and establishes the international structure that allows the international exchange of financial information. In jurisdictions where there are other instruments for the exchange of information (bilateral treaty, for example), competent authority agreement (CAA), which in this case shall be bilateral, will have the same function. (OCDE, 2014, p. 13, 215)

The MCAA provides details about the information to be exchanged among the jurisdictions, and also lists the jurisdictions in which there will be no reciprocity in the exchange of information, i.e., the jurisdictions that will report information to the signatories to the Convention of the residents of the country of destination, but who have no interest in receiving information on their residents (Annex A). (OECD, 2014, p. 13, 218).

Information to be exchanged among the jurisdictions, such as name, account information and account holder, identification of the financial institution, and the gross total amount of interests, dividends, income accredited in such accounts, in essence, is the same as FATCA member countries shall have to report to the United States, with the exception of the fact that in the context of the Multilateral Convention only information of residents shall be exchanged. Please see:

The information to be exchanged is, in relation to each account to be informed of any other jurisdiction:

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52. *Global Forum on Transparency and Exchange of Information for Tax Purposes. Accessed on April 8, 2016, at http://www.oecd.org/tax/transparency/about-the-global-forum.*
53. *Check in OECD (2016). CRS by jurisdiction. Consulted on May 23, 2016, at http://www.oecd.org/tax/automatic-exchange/crs-implementation-and-assistance/crs-by-jurisdiction/#d.en.345489.*
54. *Directive 2014/107/EU of the Council of December 9, 2014, amending Directive 2011/16/EU in regards to the automatic exchange of mandatory information in the field of taxation. Accessed on May 23, 2016, at http://eur-lex.europa.eu/legal-content/PT/TXT/PDF/?uri=CELEX:32014L0107&qid=1464049971883&from=EN.*
55. *Directive 2011/16/EU of the Council of February 15, 2011 on administrative cooperation in the field of taxation and which repeals Directive 77/799/EEC. Checked on May 23, 2016, at http://eur-lex.europa.eu/legal-content/PT/TXT/PDF/?uri=CELEX:32011L0016&qid=1464051590433&from=EN.*

a) name, address, TIN number (equivalent to the CPF/CNPJ), date and place of birth (for individuals) of the reportable person who is the account holder; name, address, TIN number, date and place of creation, in case that the account holder is a corporation and is calculated, using procedures of due diligence, that one or more of their controlling persons are reportable persons,
b) the account number (or its functional equivalent, in the absence of an account number);
c) the name and identification number (if any) of the reporting financial institution;
d) the account balance or amount (including, in the case of a contract of insurance with monetary value or annuity contract, the value in cash or the salvage value) at the end of the relevant calendar year or another appropriate period of reporting or, if the account has been closed during that year or period, the closing of the account;
e) in the case of custody accounts:
i) the total gross amount of the interest, dividends and other income with respect to the assets held in custody in the account, in each case, paid or accredited to the account (or related account) during the calendar year or another period to provide adequate information;
ii) the total gross income from the sale or salvage of financial assets paid or credited in the account during the calendar year or another period for the provision of adequate information with respect to which the reporting financial institution acted as a custodian, agent, trustee or other representative of the account holder;
f) in the case of a deposit account, the total gross amount of interest paid or credited to the account during the calendar year or another period to provide adequate information;
g) in the case of any account that is not described in section e) or f), the total gross amount paid or credited to the account holder in relation to the account during the calendar year or another period for the provision of appropriate information in relation to which the reporting financial institution is obliged or is indebted including the total amount of the salvage payments made to the Holder of the account during the calendar year or another period to provide adequate information. (OCDE, 2014, p. 218-219).

In Brazil, the MCAA, which has been signed by 84 jurisdictions[56], it should be signed soon by the Secretary of Federal Revenue, the competent authority appointed for such (Decree 8,842 / 2016, § 2º).

Information will be exchanged within a period of nine months after the corresponding calendar year, as in the FTCA, and shall be subject to the rules of confidentiality and guarantees provided for in the Convention; and also, if necessary, to the guarantees laid down in the respective domestic legislation that may be specified by the competent authority. The aforementioned authority shall notify the Secretariat of OECD about the breach of confidentiality, failures in safeguards, sanctions and corrective measures applied. (OECD, 2014, p. 219-220).

After the implementation of the automatic exchange on the basis of the CRS, we will have a kind of Global FATCA (GATCA)[57]. In this new model, the jurisdictions will have access to the information of the financial accounts of their residents in the partner jurisdictions without it being necessary to enter into a bilateral treaty with each State, as occurs in the FATCA, since they are signatories of the Multilateral Convention. It just so happens that the CRS standard optimized exchange of information provided for under the FATCA.

56. *OECD (2016). Signatories of the multilateral competent authority agreement on automatic exchange of financial account information and intended first information exchange date. Consulted on Sep 05, 2016, at http://www.oecd.org/tax/automatic-exchange/international-framework-for-the-crs/ MCAA-Signatories.pdf.*
57. *See note 31*

## 5. THE FEDERAL SUPREME COURT AND THE BANK SECRECY

The legality of the Complementary Law No. 105/2001 concerning access to bank data of taxpayers by the tax authorities, without the intervention of the Judicla Branch, was discussed by the Federal Supreme Court for the first time in 2010, in the motions of Injunction N°. 33/PR, linked to the Special Appeal No. 389808/PR without overall impact[58], handed down on 15.12.2010.

In the motion of Injunction 33, Justice Marco Aurelio, Rapporteur, deferred the injunction to prevent, until the final ruling on Special Motion N° 389.808 is handed down, providing banking information to the Secretariat of Federal Revenues, and the non-use of the information so obtained. The Supreme Court Plenary, however, by 6 votes to 4, denied the endorsement to the injunction granted under the AC-33.

However, upon analyzing the merits of the Special Appeal N°. 389.808, in most of the judges present, by 5 votes against 4, prevailed the view that access by the Treasury to the bank information of taxpayers without a judicial authorization is unconstitutional; and this also configures an offense against fundamental rights - privacy, privacy and confidentiality of the data - provided for in paragraphs X and XII of article 5 of the CF/88.

It turns out that upon characterizing art. 6° of Complementary Law N°. 105/01 and Decree N°. 3,724/01 as unconstitutional, through the aforementioned ruling, the Court failed to heed the requirements of art. 97 of the CF[59] and art. 173 of the Internal Regulation of the Federal Supreme Court that require an absolute majority of their members – in this case, six votes – to declare the unconstitutionality of the law or regulatory act of the Public Power. As Leal pointed out, the ruling handed down, in disagreement with the Constitution and the Internal Rules of the STF, "both public order provisions, which should have been known officially," has to do with the decision failing to state the "appropriate precedent to pacify the matter and reveal the criteria of the Federal Supreme Court on the matter." (LEAL, 2013, p.18, 14)[60].

On 24.02.2016, after 15 years of promulgation of the law, Motions of Unconstitutionality nº 2.390, 2.386, 2.397 and 2.859, as well as Special Appeal No. 60.1314 were decided, with overall impact, questioning the legality of the State Treasury's access to bank information of taxpayers, without the intervention of the Judicial Branch (LC 105/2001, articles 11º, § 3º and 4º, 3º, § 3º, 5º and 6º; Decree No. 3.724/2001; Decree N°. 4.489/2002)[61].

58. *Overall impact: procedural instrument included in the Federal Constitution of 1988, through the Constitutional Amendment No. 45, allowing the Supreme Court selecting the extraordinary resources that examine, in accordance with the relevant legal, political, social, or economic criteria. Once verified the existence of overall impact, the Supreme Court examines the merits of the question and determined the affected resources, the colleges will declare handicapped other resources dealing with the same dispute or decide them by applying the asserted thesis. (arts.) 1035-1039 of the law nº 13.105, of 16 March 2015. (Code of Civil procedure - CPC).*
59. *CF: article 97. Only by the vote of an absolute majority of its members or of the members of the respective special body may the courts declare the unconstitutionality of a law or normative act of public power.*
60. *Failure to comply with the above requirements was embargo of the Declaration of national finance and the Attorney General of the Republic still awaiting judgment up to the present.*
61. *Not yet published statements. See Supreme Federal Court (2016, feb. 22-26). Informativo no 815. Accessed 10 may 2016, in http://www.stf.jus.br//arquivo/informativo/documento/informativo 815.htm and Supreme Court (2016, mar 04). Informativo no 816. Retrieved 10 may 2016, of http://www.stf.jus.br//arquivo/informativo/documento/informativo816.htm.*

The plenum of the STF, by majority vote - 9 to 2 - decided that access to bank information of taxpayers by the State Treasury does not represent a breach of bank secrecy, but rather the transfer of the secret from the banking sphere to the taxation domain, both protected against access by third parties. In light of the legal duty of the tax administration to preserve the secrecy of the data, one cannot talk about offense to the Federal Constitution.

The Magistrate Ruling on the Special Appeal, Justice Edson Fachin, defended the constitutionality of the provisions under the following grounds: i) the non-absolute nature of banking secrecy, which must give space to the principle of morality, in the cases in which banking transactions represent illegal acts; ii) the LC 105/2001 is in line with the commitments undertaken by Brazil under international treaties with a view to expand fiscal transparency and enable the exchange of tax information, in order to fight illicit acts such as money-laundering and tax evasion; iii) the identification of the assets, income and economic activities of the taxpayer by the tax administration gives support to the principle of contributory capacity (art. 145, §1º, CRFB/88), which, in turn, suffers risks when limiting the hypothesis that authorize their access to bank transactions of taxpayers; iv) Public Power did not move away from constitutional parameters upon creating specific requirements for the request for information by the tax authorities to financial institutions, while also maintaining the secrecy of taxpayer's financial information, transferring the duty of keeping secrecy from the banking sphere to the taxation domain; v) article 6 of LC 105/2001 is specific upon enabling the review of the documents, books and records of financial institutions only if there is an open administrative process or ongoing fiscal procedure and these reviews are considered indispensable by the competent administrative authority, and, in addition, the single paragraph of this legal provision establishes that the results of the reviews, information and documents referred to in this article are preserved in a confidential manner, in compliance with the tax legislation.

The Justice Presiding Over the Direct Unconstitutional Motion, Justice Dias Toffoli, pointed out the following underlying principles: i) the practice provided in LC 105/2001 is common in many developed countries and the declaration of unconstitutionality of the challenged provision would be a setback to the international commitments made by Brazil to combat illegal acts, such as money-laundering and tax evasion, and to curb the practices of criminal organizations; ii) the provisions challenged do not violate the fundamental right, mainly in terms of privacy, because the law does not permit the violation of bank secrecy, but the transfer of that secrecy from the banks to the State Treasury; iii) the challenge to the guarantee of banking secrecy does not occur with the simple access to the data information of taxpayers, but with the eventual disclosure of these data; v) the confluence between the fundamental duty of taxpayers of paying taxes, whose base is the social solidarity, and the duty of the tax authorities to tax and oversee correctly, which requires the adoption of effective means of combating tax offenses.

Justices Marco Aurelio and Celso de Mello's view was defeated, as they interpreted the legal provisions being challenged as understanding that there is no possibility of direct access to banking information by public entities, even going as far as to prohibit the exchange of information. This may occur in light of the hypothesis provided for in the final clause of paragraph XII of article 5 of the CF, for purposes of criminal investigation or criminal prosecution.

The position of Justice Gilmar Mendes should also be pointed out; he also went along with the majority, but cast his vote only on the RE 601.314, and the ADI 2859, since he was unable to participate in the ruling of the ADIs 2.390, 2.386 and 2.397, due to his performance as attorney general of the Union. The magistrate, who voted completely differently on the RE 389.808, in this manner resorted to arguments used by Justice Ellen Gracie (vote won in 2010 vote) when the decision on that event was handed down. According to Gilmar Mendes, the instruments provided for in the contested law lend effectiveness to the general duty to pay taxes, not being isolated measures in the context of the performance of finance authorities, who have specific prerogatives and powers to enforce this duty. She also emphasized that the inspection of baggage in airports is not disputed, although a procedure is quite invasive, but is a measure necessary and indispensable so that the customs authorities can supervise and collect taxes.

In the end, the Justice Presiding Over the Direct Motions of Unconstitutionality observed the views of other justices to explain the understanding of the Court on the application of the law in the sense that States and Municipalities can only obtain the information specified in article 6 of LC 105/2001 after the regulation of the matter, analogously to Federal Decree 3.724/2001, and shall contain the following guarantees: i) thematic relevance between obtaining the bank information and tax being collected in the established administrative procedure; ii) after notifying the taxpayer of the opening of the process and about all other acts; iii) making the request for access subject to a high-ranking official; existence of electronic security systems that are certified and with access record; iv) establishment of effective instruments of verification and correction of deviations.

## 6. CONCLUSIONS

In the process of incorporation of measures to combat tax fraud, tax evasion, money laundering, in which fiscal transparency and exchange of information occupy a prominent place, Brazil is moving side-by-side with the world's largest economies, taking into account its participation in both the FATCA and CRS, among others[62].

In this scenario, Brazil is "integrated into the more sophisticated actions of the new paradigm of taxation, that is, the 'Global Treasury.' Fiscal isolation of nations, entrenched in their inalienable sovereignty, came to an end. Another 'iron curtain' that the world watches collapse" (Torres, 2015, p. 2)[63].

The Global Treasury ensures the elimination of the differences in treatment between those who pay their taxes and nonfilers, aiming at the expatriation of resources or sophisticated means of organizing assets overseas. This concept is in line, therefore, with the "era of transparency and tax compliance. (Torres, 2015, p. 2).

62. *Brazil is also cooperating in the plan of action BEPS - Base Erosion and Profit Shifting (Erosion of the Base and transfer of benefits) developed by the OECD to combat erosion of the tax base and the transfer of profits to low tax jurisdictions.*
63. *Heleno Torres says that "in times past, as everyone knows, the legal systems were characterized by the territoriality of the Administrations of the States, even for the little relevance of their activity economic with international focus." Even the acceptance of foreign rulings with tax applications and the granting of exequatur requests in tax matters were admitted. Torres, Heleno Taveira (2015). Brazil innovates to comply with sophisticated practices of the Global Treasury system. Legal Consultant. Checked on Mar. 10, 2016, at http://www.conjur.com.br/2015-jul-08/consultor-tributario-brasil-inova-aderir-praticas-sistema-fisco-global.*

In this context, although the FATCA may at first appear as a typical imperialist rule, what happens is that the most important countries in the world (currently 113 jurisdictions have already joined the program), following the path of the US, have embraced the cause in the fight against countries that still insist on maintaining banking secrecy regarding treasury authorities. The rule does not purport to conduct an investigation of the accounts of taxpayers, but only verify that the amount of financial assets abroad match the amounts declared to the tax authorities. Therefore, taxpayers, whether Brazilian (resident) or US (citizen or resident), who have any financial assets abroad that is compatible with the amounts reported on their tax returns will not be affected by FATCA.

Even if the tax position taken by the US is questioned, we must conclude that such a measure prompted greater fiscal transparency worldwide. The impact was si great that the OECD, along with the world's leading economies (G20), developed a standard (CRS) whose implementation at the global level is supported by 82 jurisdictions, in which the exchange of information will occur in 2017 / 2018. It should be noted that under this model, there is no expectation of withhnolding of 30% in the event of noncompliance, involving only an exchange of information automatically. This demonstrates the increasing interest of jurisdictions in measures to combat tax fraud, tax evasion, money laundering, in which the access of tax authorities to financial information of taxpayers, internally and externally, is of fundamental importance.

In these new models of information Exchange, there is no need to talk about jurisdiction reservation, since the financial information, endorsed by the Federal Supreme Court, is protected by bank secrecy; once transmitted to tax authorities, it is protected by tax secrecy, without prejudice to the former.

We are not saying that bank secrecy should not exist; no, what should not exist is bank secrecy before the tax authorities. After all, saying that access by tax authorities to bank information, without the intervention of the Judiciary, "violates privacy is a bit contradictory when compared with the obligation to file income tax returns, declaring assets and income imposed on taxpayers, whether individuals or corporations"(Giannetti, 2009, p 7592.); hence we talk about the myth of banking secrecy before the tax authorities.

It is important to highlight that if financial transactions, whether in domestic accounts or offshore accounts, match declared income and are in keeping with the tax laws, taxpayers do not need to worry because any discrepancies found shall be fully justified since there were no movements breaching tax legislation.

If the Federal Supreme Court had ruled tax authorities' access to bank information unconstitutional without regard for jurisdiction, we would anticípate the following consequences, among others:

> i) in the field of FATCA, financial institutions would have to obtain the express consent from customers[64] (US accounts) to report information to the Brazilian tax authorities in order to transmit it to the IRS. In the case of refusal by the customer, we would have the following scenarios: a) the financial institution would cancel the customer's account, contracts, etc.; which could lead to civil consequences for breach of contract; on the other hand, depending on the type of customer, it may be irrelevant for the bank lose him/her; b) the financial institution would not comply with the rules of FATCA and assume the risk of withholding of 30% of

64. *In accordance with art. 1º, §3º, V, of Complementary Law No. 105/2001, disclosing confidential information with the express consent of those concerned does not constitute a violation of the obligation to maintain secrecy.*

> the amounts derived from US source, which would place it in unfavorable conditions to compete in the international market, facing restrictions or increased costs to operate with financial institutions participating in the FATCA. (Coelho, 2015, p. 87).
>
> ii) In the area of CRS, it would show that the country moves in the opposite direction of the largest economies in the world; it would prevent Brazil from receiving information from abroad that may constitute tax crimes; it would leave the country in an extremely delicate position in the international arena, since the jurisdictions referred to in the Brazilian[65] list of countries or dependencies with favored taxation and privileged tax regimes (Cayman Islands, Bermuda, Barbados, Liechtenstein, etc.) would join the model.

Finally, it is in this global scenario that we affirm that bank secrecy before the tax authorities is a myth. If in the recent past bank secrecy was already questioned, with the implementation of new measures of transparency under this new paradigm of taxation, there is no need to speak about its existence; always remembering that such data once transferred to the tax authorities will always be protected by tax secrecy.

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65. *Check Ordinance RFB No. 1,037, of June 4, 2010.*

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# NATIONAL AND INTERNATIONAL CHANGES IN TAX ENVIRONMENT: AN OPPORTUNITY TO PROMOTE THE CONTROL OF THE INHERITANCE TAX IN CHILE

**Claudia Cecilia González Torres**



## SYNOPSIS

This article presents a synthesis of the situation of the Inheritance Tax in Chile and the difficulties that the use of avoidance schemes by taxpayers implies for its examination, as well as the collection of data related to the assets of the deceased, especially those located abroad. Considering that the financial and tax-related information is made transparent through the normative changes included in the Tax Reform Law in Chile and via global initiatives such as BEPS and the Multilateral Convention on Mutual Administrative Assistance in Tax Matters of the OECD, we are facing a favorable scenario for developing the control of the Inheritance Tax.


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**Content**



The vast majority of people wonder what will happen to their family and their property after their death. They feel great uncertainty about the effects of the decisions that their heirs can take, about the possible conflicts that sharing the inheritance could create between them, or whether to leave or not a written "last will". In addition, some taxpayers, regardless of the segment to which they belong, they believe that taxes related to the succession represent a certain injustice and should be avoided in any ways; or at least they use some formula to obtain the lowest possible payment for such costs, decreasing, thus, the economic impact on the family. In this regard, bearing in mind both the regulations of the inheritance tax as its administrative features and consulting specialized advisors on the subject, taxpayers with more resources try to "preserve their heritage" using complex tax planning schemes. These include, among other mechanisms, the transfer of revenues via companies of various types, and "fictitious" sales of assets "between living persons", both intended to conceal the true nature of operations, as well as the possession of assets and investments abroad to hinder the audit for lack of information. Nevertheless, there is a global trend towards greater transparency of data and the correction of gaps in the legislation. This is reflected in the Chilean Tax Reform, the development of the BEPS project and the effects of the OECD's Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This trend creates a valuable opportunity to carry out preventive actions and drive forwards the control of the tax related to inheritance.

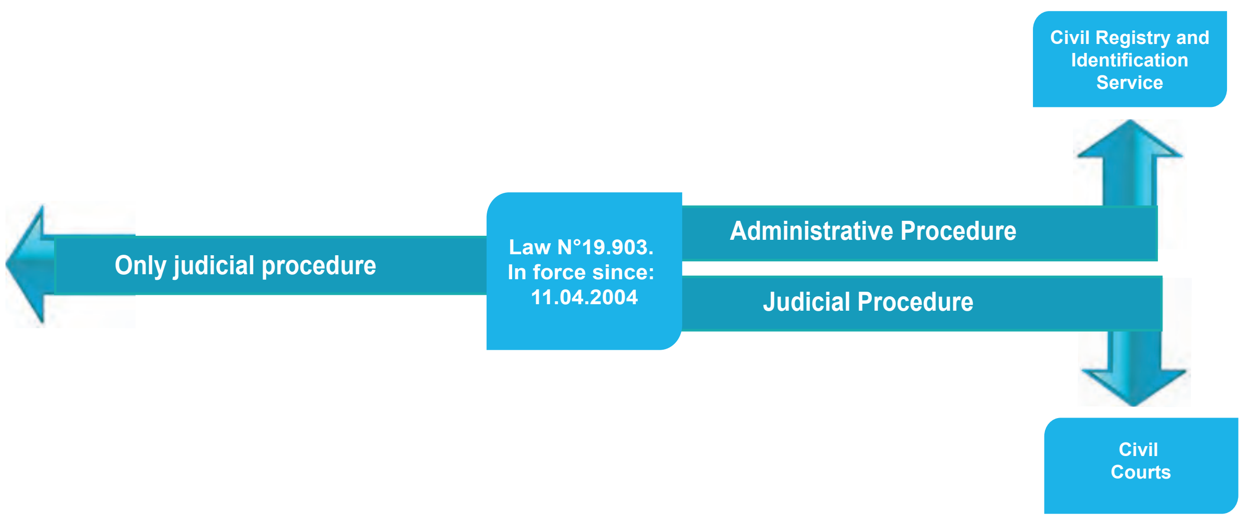
## 1. BRIEF EXPLANATION OF THE NORMATIVE FRAMEWORK OF THE INHERITANCE TAX IN CHILE

This tax was established by Law N° 16.271 on Inheritance, Allocations and Donations[1] and must be analyzed in conjunction with the provisions of the Third Book of the Civil Code: "On the succession by cause of death, and on donations inter vivos" (Art. 951 et seq.).

Unlike others taxes that are declared "directly" after the fact that generates the tax obligation, in this case, prior to the tax presentation, it is required to define who will be the heirs of the deceased through a procedure called "effective possession", which is performed in other state institutions, and with distinct procedures whether the inheritance procedure is testate or if it is intestate[2]. This is reflected in the following chart:

**Graph 1**

**PROCEDURE FOR GRANTING THE EFFECTIVE POSSESSION OF HERITAGE**




**Source:** By author

1. *Even though the legislation includes the regulation of donations (those granted previous filing a specific procedure called "Insinuation" in courts), this work will mainly refer to inheritance (hereditary successions).*
2. *In Chile, since the entry into force of Law N ° 19.903 of 2004, the institution in charge of defining the heirs in the case of intestate inheritance are the Civil Registry and Identification Service and the Civil Courts of Judicial System for the tested legacies. For more detail it is suggested to consult the following provisions: Law N ° 19.903/2003 on the procedure for granting the effective possession of the inheritance and adaptations of the civil and tax procedural rules on the matter; Code of Civil Procedure, Fourth Book, Title III: "Of the procedures initiated by succession due to cause of death" and Regulation N° 237/2004 on the processing of the effective possessions, and the National Registry of Testaments.*

Only after the process is validated, the taxpayer(s) (heirs or assignees) are in conditions of presenting the corresponding Tax Statement on the Inheritance, according to the instructions contained in Tax Instructions N° 19 of 2004 and N° 06 of 2005, both issued by the Internal Revenue Service[3].

This administrative element, prior to the implementation of the tax, creates an additional difficulty to the process, taking into account that the law establishes a period of two years from the date on which the assignment is deferred (usually the day of decease) to declare and pay.

## 2. CURRENT SITUATION OF THE TAX: OPPOSING VIEWS

Each year, around 90,000 people decease in Chile, a fairly regular number in recent years. However, the collection of the tax to the heirs of these deceased presents large variations[4] in the different periods, as shown in the following table:

**Table 1**

**Tax Revenue from Inheritance Tax**

| | Year 2009 | Year 2010 | Year 2011 | Year 2012 | Year 2013 | Year 2014 |
|---|---|---|---|---|---|---|
| Inheritance | 199,173 | 35,296 | 28,921 | 66,164 | 44,696 | 28,208 |

( (In millions of pesos))

**Source:** By the author, based on data provided by the Process Control and Management Department of the Control Sub-Directorate of the Internal Revenue Service

It must be taken into account that the majority of submissions across the country are exempted, approximately 84.3%[5], whereby revenues detailed in the table are calculated on the remaining 15.7% (which includes the returns with payment and those whose obligation was prescribed[6]).

This tax is considered of redistributive character; however, it generates conflicting viewpoints in relation to its use, since many perceive it as unfair and even propose its complete elimination. Within these conflicting views, we find the following:

3. *Tax Instruction SII N ° 19 / 2004: Instructs on the procedures for the tax determination and payment regarding assignments by cause of death and donations; Tax Instruction SII N ° 06/2005: Replaces tables for the application of the tax rates for inherited assignments and grants contained in Tax Instruction N ° 19, 2004 available at www.sii.cl4.*
4. *It is necessary to consider the influence of different variables, such as amount of the inherited assets that it will form the basis of the tax, the number of heirs (affecting the assigned amount and the rate within the progressive scale), in a term of 2 years from the decease, so the heirs presented the statement and payment, heirs who declare after term expiration, resources for the control of this tax, type of tax planning applied by the originator when he was alive, tax segment of the deceased, etc.*
5. *Percentages based on the consolidation data obtained from the Internal Tax Service Regional Departments.*
6. *Reduce this percentage in particular is an objective to generate preventive control measures..*

a. **Inequity:** In summary, the argument is that those who have access to advice, and who usually have more resources, can plan the succession and so, to equal heritage, the hereditary amounts will differ, which will result in different tax amounts. In other words: “The problem of horizontal equity and collection lies in that only upper middle and middle class pay heritage taxes, since the majority of high wealth individuals use schemes to avoid this tax, while low-income individuals are exempt”. (Transtecnia Informative Bulletin, November 2009).

b. **Contrary to the spirit of family entrepreneurship:** According to the AEF[7] “The current inheritance tax seriously affects the performance and survival of small and medium-sized family business that often have to be sold in order to pay” (Mujica, 2011)

c. **It is considered double taxation:** Opponents indicate that their assets have already paid taxes at the time they were acquired (because they associated them with income or increments of assets which were subject to income tax in the past and that they were used to obtain such property).

d. **Low collection:** This argument implies that tax revenues provided by the Inheritance Tax are lower than what is collected by other taxes.

In this regard, the author of this article has a different vision and agrees with the ideas expressed by Francisco Saffie in the publication called “The Inheritance Tax as a principle of Justice *”, which refutes the previous points:

a. Regarding equity: “... In Chile the inheritance tax regulation is explained better according to the **principles of Justice**... therefore, it is far from being understood as one that is applied on the wealth (“heritage”) of the predecessor in title... the inheritance tax becomes necessary while in a political community there is some kind of right to inheritance or some authority to assign as part of the right to private **property... the purpose of the tax... is not the possession of a certain wealth throughout time (a stock), but the fact that there has been a transfer which, from the point of view of Justice, should not have taken place, i.e. that which occurs between the predecessor in title, and a heir.** So,… the tax is applied on the cash amount allocated to the heir, and is obliged to pay it… does not tax wealth ... but rather the increase in equity that represents the amount allocated to the heir i.e. the flow (not the stock) that the legacy transfer suppose... **“Planning the legacy”, is a deficiency of regulation and not a reason to show that the tax is unfair.** On the contrary, if the institutional regulation of the inheritance tax is left void by the schemes developed by certain legal advisers with current legal standards, it is **time to ask ourselves what is needed to ensure compliance”**(Saffie, 2012)

b. Family enterprise: “... **If a family decides to carry out economic activities, this does not justify a special tax treatment or legal treatment.** “Both the company (“family business”) and their partners, have ceased to act as a family to adopt trade relations **governed by the social and the commercial law...”** (Saffie, 2012)

c. Related to the so-called double taxation: “...” “For the same reason, in order **to not apply a tax twice on the same fact, as set out in article 17 N° 9 of the law on income..., the acquisition of property via succession by cause of death does not constitute income.”** ( Saffie, 2012)

7. *AEF corresponds to the Association of Family Businesses of Chile, organization founded in 2008.*

d. Collection: "... The fact that the tax collect little revenue can be interpreted as a result of a **problem of regulation... It could be the result of evasion** ("tax avoidance" or "tax planning") and therefore it says nothing with regard to the elimination of the tax... Secondly... the question is: what is the reference used to measure the efficiency of the tax? The efficiency or inefficiency of the inheritance tax as a measure of assessing the regulation will depend on the theory of Justice on which the analysis is based..." (Saffie, 2012)

## 3. TAX SCHEMES USED TO REDUCE OR AVOID THIS TAX: REGULATORY ISSUE OR CULTURAL CHARACTERISTIC?

In some cases, considering the economic segment of the deceased and relatives, we can observe that, once the 2 years period post-mortem has passed, the heirs or assignees do not present the inheritance tax return or, if they do, they report a sub-valued estate. This behavior can be explained by lack of knowledge of the legislation in the poorest sectors, or a cultural factor, in which there is a belief in some segments of taxpayers, that paying less tax is positive. Considering the environment, these situations would basically require tax education and specific corrective control measures.

However, greater efforts should be directed mainly to detect those "astute" manoeuvers that use those who are advised and that, generally, represent taxpayers with higher assets, since they indicate the aspects that should be improved in the regulations.

The detected schemes include:

**a. Those involving disposal of assets by an act inter vivos that decrease the inheritable assets**

- **Purchase of shares or equity:** This option includes the capital increases effected by subscription of shares, with a value freely determined by the parties, which is subscribed and paid by the children of some partner or their spouse in order to dissolve the participation of the parents in the company, and thus leave a minor heritage to deliver at the time of their death. This income can start with small percentages and then go increasing to acquire greater participation with charge to the utilities to be obtained from this company or from others, in which they have invested. To justify the economic capacity that allows such initial acquisition of titles, the term purchase ("compra a plazo") is general used, which is also paid with the profits generated.

- **Life annuities contracts:** This "resource" refers to a contract between private individuals and not to a fee agreed with an insurance company. It allows selling an asset in return for a regular income, renouncing to the property of the good, and is normally signed in favor of who pays the price.

- **Creation of Foundations:** The assets of a person are "donated" to create a private foundation as a separate legal entity, without partners or shareholders, seeking to achieve the goals pre-defined by the founder.

- **Insurance contracts:** An agreement is signed with an insurance company, in which a monthly income is guaranteed, for which people makes "cash" by selling assets and transferred it to the common fund in the company. It is possible to leave as heir anyone who is appointed as beneficiary of the "pension" for the entire period guaranteed by the policy, thus solving the family "succession" and the "tax" problems, since this income is exempt of tax.

**b. "Simulated" sales**

- **"Blank" documents:** The owner, as a preventive measure, leaves the document of transfer of shares signed, but without completing the date. Subsequently it shall be filled by the heirs, dating the sales on the day before the death.

- **Sales of goods at a lower amount:** Through contract, a lower price is set so that the future heirs can justify their acquisition before a possible process of investments revenue control. Usually these heirs do not have a taxation that show sufficient income as to pay in cash, therefore a "forward sale purchase with facilities" is performed; however, they may also prefer to have the property title immediately, which has led to the use of "Bills of Exchange with the aim of novation" and "Payable document on sight in name of the seller".

- **"Bare ownership" sale in a real estate:** Commonly used to transfer a property to the family, selling the "disposition" but keeping the "usufruct" (use & enjoy). This legal fiction allows the death of the beneficiary to dissolve the usufruct, leaving the absolute property to the bare owner.

**c. Non-inclusion of assets located abroad in the asset inventory of the deceased.**

- **Omission or concealment of assets located abroad:** According to article 1 paragraphs 2 and 3 of law N° 16.271, assets located abroad must be included in the inventory of the deceased to determine the tax, and for foreigners' successions, possessions located abroad are added only when they have been acquired with proceeds from Chile.

- This information presents some difficulty and requires time, situation that is exploited by some taxpayers.

- Transfers of assets through confusing corporate structures abroad: To increase the complexity in obtaining of information, cases were observed where a foreign company acts as society controlling the family company or even where the partner does not acts with its Chilean ID but has a foreign ID number, which allows to make investments that are difficult to follow (How could one request data from a specific tax administration if in first instance we ignore that partner has assets located in that country?). The creation of off-shore companies can also be included here.

- **Use of foreign instruments uncommon in the country:** As an example of this, and although it is currently known, one can mention the use of a trust that protects the family assets.

The schemes of the letters a) and b) require greater efforts of internal control, but those in letter c) are signs that these planning often are beyond borders, spreading over a globalized world and that is fundamental to have a fluid and permanent tax information with other countries.

## 4. OBTAINING INFORMATION RELATED TO ASSETS ABROAD TO DETERMINE THE GOODS OF THE DECEASED: A COMPLEX TOPIC

Chile has different conventions in force[8] to avoid double taxation, which focus mainly on the Income Tax. This means that, although they contain provisions for the exchange of information, the data requested must be related with that tax[9].

The same thing happens with other agreements associated with other taxes such as international transport conventions or those related to the VAT tax.

This, coupled with the impossibility of exchanging antecedents with countries without Convention, and especially those who have a preferential tax regime, has contributed to hinder the global knowledge of goods that an individual could possess around the world, impeding the control that must be made with regard to inheritance and donations.

And assuming that the object of the request is related to the income tax of the deceased[10], anyway, there are administrative constraints in the process, such as for example the fact that the application must be linked to a tax control in process, to the accreditation of a specific transaction or receipt of income from abroad, or that no special process should be asked for the foreign tax administration, all of which would prevent requesting massive, constant and advanced automatic information allowing to analyze the situation of the taxpayer before the beginning an audit.

## 5. CHILEAN TAX REFORM AND CONTROL OF SUCCESSIONS: POSITIVE NEWS

On September 26, 2014 was enacted Act N° 20.780, which was complemented with Act N° 20.899, on February 1, 2016. Most of the regulations are focused towards other types of taxes, however, 3 key points relate to the Inheritance Tax and will affect its control:

### 1. Repatriation of assets:

Article 24, transitory provision, which focuses on voluntary and extraordinary system to declare income or assets that remained abroad works to ensure transparency to part of the operations generated prior to 2014. “The repatriation Act compels to deliver a significant amount of highly relevant information, which many people has not yet had time to collect all those antecedents... people who will use the incentive of repatriation will avoid the problem to future generations, since once the grace period expires, if an heir would like to enter those resources, they will be taxed at the ordinary rate” (Alonso, may 2015). This article allows to declare these undeclared assets through a flat tax replacing all other taxes, including the Inheritance Tax.

8. *For more details of the agreements in force it is suggested to check the Web site of the Internal Revenue Service. http://www.sii.cl/pagina/jurisprudencia/convenios.htm*

9. *At least in the case of Latin America, the main models used for exchange agreements (article 26 of the OECD Model Convention, CIAT Model of Information Exchange Agreement, etc.) with the exception of the OECD Model on Exchange of information in Tax Matters, did not consider the Inheritance Tax.*

10. *In Chile, the DL 824 / 74 creates the fiction of that “the deceased continues live” in terms of the Tax on Income, i.e., the succession can keep presenting the tax return of the deceased, with the same tax role, until 3 additional years after the death, considering as first year the one of the death, according to article N ° 5 of the law..*

Notwithstanding this, the knowing what type of investments were “hidden” will improve the definition of what antecedents need to be requested abroad for all those who did not disclose it, and probably have this kind of goods, and this is not only for those who meet the requirements of the article but especially for those who have owned these investments from the year 2014 onwards.

**2. General anti-avoidance rules:**

The reform introduced the General anti-avoidance rules in articles 4 bis, 4 ter and 4 quater, which aim at preventing and control avoidance behaviors by taxpayers, warning conducts which enabled them from using undue tax advantages.

These rules complement the special or preventive standards contained in the laws of Inheritance and they typify certain behaviors, supporting their control. Among them, we can mention the following:

a. **Article 17:** Assets product of a transaction are recognized in favor of individuals that sustain rights to inheritance, are estimated as acquired by succession by cause of death. Also includes the assets transfered as a life annuity to persons who, at the date of the denunciation of the inheritance, are heirs of the Annuitant, provided that the instrument has been signed within the five years preceding the date of the death of the deceased.

b. **Article 43:** Transfers of shares signed by a person who has died prior to the date of application cannot be presented, unless this has been previously authorized by the Service.

c. **Article 63:** Gives to the Service power to investigate whether the obligations imposed on the parties by any contract are effective (if they really took place or if what a party gives under an onerous contract keeps proportion with the current price at the date of the contract). If it is established they are not effective or have not been fulfilled, or that a party gives is disproportionate, and such acts have had intended to conceal a donation and advance on account of inheritance, the Service will cancel them and will charge the appropriate tax.

   Other preventive rules are available in other legal codes, especially in the Law on Income Tax (L.I.R), and can also be applied to support audits on Inheritance Tax such as:

d. **Article 33, N°. 1, letter f), of the L.I.R.:** In the case of subscription of shares effected at one price lower than their nominal value, by individuals who have an interest or are linked by kinship with existing shareholders, and this makes that the company records accounting losses by this concept, this loss must be added to the taxable income of the first tax rate.

e. **Article 70 of the L.I.R.** “Justification of investments”: If those who got a title prior to the death of the deceased do not justify where they obtained the resources to acquire the assets, the Service could assume that they obtained them with undeclared income.

**3. Inheritance Tax as credit:**

Profits from real estate selling over 8000 UF must pay Income Tax, however, the adjusted amount of Inheritance Tax which affect the property in due course can be used as credit.

## 6. THE "ACTION PLAN AGAINST THE TAX BASE EROSION AND PROFIT SHIFTING (BEPS)": INDIRECT CONTRIBUTION TO THE CONTROL OF INHERITANCES

The BEPS Plan is a project of the OECD[11] and G20 that adopts measures against the use and exploitation of differences in the international regulations by multinational companies with the sole purpose of lowering or moving profits to places of lower taxation. The working standards have focused on 4 points: Prevent "improper" use of tax agreements (especially treaty shopping), standardization of information allowing to calculate better the transfer pricing, transparency (joint audits and spontaneous exchange of information) and dispute resolution. Countries joining BEPS agreements will begin to have them in force in 2017.

And if BEPS is related to companies revenues (Income Tax) how could collaborate in the control of the Inheritance Tax?

An aspect of great importance in the Inheritance Tax is the valuation of the assets that make up the estate at the time "to defer it to others". So far, the implementation of articles 46 letters e) and f) and 46 bis, relating to assets abroad[12], societies shares including the amount of intangible values and goods without rule of valuation that use the current local value, generate additional complications to the audit.

In spite of the information standard induced by BEPS is oriented to support the calculation of transfer prices, it opens up opportunities to learn, for example, intangible assets of companies abroad, which will allow better assessing the value of the succession. In the same way, having a spontaneous exchange of information could help us to keep up-to-date the antecedents of partners abroad, avoiding possible sub-statements of assets by the heirs.

## 7. THE IMPACT OF THE MULTILATERAL CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS OF THE OECD: STEPS TOWARDS THE GLOBAL INFORMATION

Taking into account that economic and commercial relations are changing and affecting different types of taxes, the OECD has highlighted the importance of developing an instrument that will allow more tax assistance between States, which, in turn, consider the various existing taxes and standardize their relevant aspects.

This Convention on assistance was signed by Chile on October 24, 2013 and is currently awaiting enactment, which will allow us to have access to data from the year 2017. It is of great interest for Chile, as it will allow access and exchange of information for tax purposes with more than 80 countries[13], many of which had not any existing agreement or convention with Chile, and also with some jurisdictions of low or null taxation (known as "tax havens"), what will allow enhance the control of evasion schemes that use investments in locations abroad.

This "Pact" includes the different types of exchange of information in its articles 5 to 11 (request, automatic, spontaneous, simultaneous

11. *Various reports on the subject were consulted, available in the Web site of the OECD*
12. *Successions of foreign property situated abroad are only included if they were purchased with resources proceeded from Chile.*
13. *The number of countries subscribed should increase by the initiative of the Global Forum on Transparency and Exchange of Tax Information.*

audits, technical assistance for tax recovery, notifications, assistance in the recovery of tax debts, etc.) and allows declarations and reservations. In our country, it was noted, for example, that taxpayers will be informed prior to submit antecedents in cases of exchange of information and that the Convention applies only on taxes contained in the Income Tax Law, the VAT Law and the Inheritance, Allocations and Donations Tax Law. Chile also reserves the right to not accept notifications or transfer of documents from the counterparts through mail to persons in the territory of Chile. Chile reserves the right to not provide assistance in the collection of taxes or fines with regard to taxes of any kind.

For the control of the inheritance tax, this Convention allows, for the first time, obtain specific background for this tax that will improve the audits in the matter both in the determination of the estate and the valuation of assets on the basis of known avoidance schemes and the detection of new corporate structures aimed to dilute the tax. It is also particularly relevant in the support that it will allow to the actions to be undertaken by the Service towards the taxpayer (legal notice, determination of tax due, etc.) making difficult the presentation of counter evidence. It could also help to prove concealment of relevant data by the heirs, which would be included in the offences criminalized in articles 61 and 62 of the Act N ° 16.271.

Finally, it is important to include some additional considerations referred to in the text of the Reviewed Explanatory Report of the Multilateral Convention on Mutual Administrative Assistance in Tax Matters:

a. **Residency**: "... would help the taxpayer to guarantee their right to tax credits (for example, making it easier to verify that he is not resident for tax purposes in a specific State, or that he paid foreign taxes to obtain the benefit of the Elimination of double taxation)" (OECD, 2011). In the case of inheritance, if the deceased taxpayer resided abroad, the heirs only should declare the assets that he had in Chile.

b. **Psychological effect of automatic exchange**: "If taxpayers are aware of the existence of an agreement of this type, and of the items exchanged... it is possible that they improve their compliance standards, reducing the number of cases... "However, there might be ways to maximize effectiveness and minimize costs, for example, limiting the automatic exchange to elements in which the compliance is lower, through rotation of the items..." (OECD, 2011).

c. **Ignorance of the heirs:** "...The heirs could ignore the fact that the deceased has left tax debts in another country... it is considered reasonable to not include their personal assets for covering the tax credit of that State... it could be very difficult for the successors of a deceased with connections in several countries, to estimate if the heritage will be solvent or insolvent." (OECD, 2011).

## 8. SOME SUGGESTIONS FOR ANALYSIS

In order to introduce improvements in the management of the Inheritance Tax, the following ideas are proposed and should be evaluated in terms of feasibility and resources:

**Internal area:**

1. To facilitate the compliance of this tax for those future heirs who wish to declare and properly obey their tax obligations, the creation of a periodic Provisional payment could be evaluated. It would be used as a saving account against that tax, and could be paid in life by the person who will die or by the heirs. This suggestion implies a legal change.

2. Generating mechanisms for further detection of typical structures and/or new hereditary planning, analyzing the risk. In this sense, an Exchange System could be established with the notaries or an affidavit to inform societies with minor children or grandchildren.

3. Encourage preventive actions that promote the compliance of obligations related to Inheritance Tax in concordance with the new powers delivered by Act N° 20.899[14] to the Director of the Internal Revenue Service. In this sense, conducting talks with business and labor associations to explain the main elements of the Inheritance Tax would allow the institution and the taxpayers to adopt a proactive stance, so they could correct some erroneous statement with anticipation. The above would also reduce the presentation of Inheritance Statements with their tax liability prescribed.

**Global scope:**

1. The creation of a single international portal (or online forum) that allows minimizing the response time to consultations, provide the automatic information from different countries at the same location, and build a "file" with the antecedents of each taxpayer around the world.

2. Include within the antecedents of reported automatic exchange the additional identification numbers of the subject, delivered in different countries to non-resident investors.

3. Create a mechanism to know, as soon as possible, the changes in tax legislation of each country, which can probably modify the information to be exchanged.

14. *Act N° 20899, February 2016, modifies article 7 letter q) of DFL N ° 7 (Organic Law of the Internal Revenue Service) and can carry out training and activities to encourage promotion of tax compliance agreements.*

## 9. CONCLUSIONS

Reflecting on the situation of the Inheritance Tax, it can be concluded that:

1. The Inheritance Tax presents several difficulties for its control, including opinions against its application, the administrative process prior to the statement, tax schemes for transfer of assets to the heirs and complexity to obtain data on the assets.

2. Currently it is difficult to obtain information and review those inherited assets that are abroad, since the sources of antecedents are rather limited.

3. The Tax Reform has certain elements that will have positive repercussions in the control of the Inheritance Tax. Among them, the consequences of the voluntary and extraordinary system of reporting assets and the general anti-avoidance rules.

4. The Chilean law has specific anti-avoidance rules to be applied in the control of the Inheritance Tax.

5. Financial and tax information are becoming transparent globally. Examples of this are the BEPS, which will support indirectly with obtaining of data to review the tax, and the Convention on Assistance of the OECD, which includes expressly the consultation of exchange of information for the purposes of the Inheritance Tax.

6. These latest trends mentioned above allow projecting an improvement in the control of the Inheritance Tax.

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# IMPROVING THE EFFICIENCY AND EFFECTIVENESS OF THE AUR PROGRAM

George Guttman and Phil Shropshire



## SYNOPSIS

Tax authorities need comprehensive and accurate financial information to ensure income is accurately reported. This paper discusses how the United States Internal Revenue Service (IRS) uses the over two billion third party information reports it receives each year in the automated underreporter program (AUR). The result is that IRS collects billions of dollars of additional revenue at low cost.

This paper can provide useful lessons for any tax authority receiving third party information reports. In addition, tax administrators may develop creative ways to utilize new sources of information to increase revenue in the short-term and voluntary compliance in the longer term.


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Contents



After the audit, the automated under reporter (AUR) program is the most productive IRS compliance program from a revenue standpoint. AUR is comprised of two separate modules, AUR and Information Returns Document Matching - Case Inventory Selection and Analytics (IRDMCISA). An initial data match between individual Form 1040 tax returns and Information Returns is performed in Information Return Processing (IRP). After this match, potential AUR cases are loaded onto the system and tax examiners then compare the Form 1040 (annual tax return filing by individuals) with the third party (i.e. payers, employers) data to determine if the income in question has been reported by the taxpayer (on another line/form of the return,) or if the absence is otherwise explained. For Fiscal Year (FY) 2015, the IRS received approximately 2.6 billion information documents reporting taxpayer income, deductions, and other information reported by third parties. Using about 1,740 staff years, the IRS closed about 3.7 million cases and assessed over $6.3 billion in additional taxes. Therefore, the program assessed over $3.6 million for each staff year.

While these results are impressive at first glance, to increase the revenue yield with the same staff resources, the IRS needs to consider modernizing the AUR process. This paper will discuss two approaches the IRS could use to increase the efficiency of AUR without additional resources. Specifically, in the short-term, rather than working just one year at a time, the IRS could combine multiple years identified mismatches with one contact letter. In addition, the IRS should consider annually sending out a limited number of warning or so-called soft notices for certain mismatches that IRS may not have the resources to work during one year but would work in the subsequent year. Put another way, these process changes would allow IRS to work more efficiently to increase the revenue yield with substantially the same amount of staff resources.

For the longer-term, the IRS needs a new AUR strategy because each year IRS receives more information returns and the number of identified mismatches continues to rise. This increase is due to additional information reporting requirements and the need to administer a tax system that continues to become more complex. Whether by omission or commission, the likelihood of identifying reporting errors will continue to rise. Therefore, the IRS needs to improve the matching algorithms to reduce the staff resources required to screen the AUR mismatches.

## 1. BACKGROUND

In the early 1960s, the IRS began matching information returns to self-reported items on a taxpayer's filed return. However, matching had limited utility in the early years because both the information and tax returns were submitted in a paper format. In the early years, IRS would pick one letter of the alphabet at random, and match those information documents with filed returns. However, for the most part, IRS did not perform extensive returns matching until an automated Information Returns Program (IRP) was implemented in 1974. As computer technology matured, more information returns were filed in computer readable formats and the IRS was better able to use the data in the AUR program.

For CY 2015, the IRS received over 2.2 billion information documents.[1] These documents record payments received by taxpayers, e.g., bank interest and dividends, and in some cases payments made by the taxpayer that can be deducted or can produce a credit that may reduce a filer's tax liability, e.g., mortgage interest paid. The two most common forms are the Form W-2 wage and tax statement and the Form 1099 interest income statement.

After receiving information returns, IRS perfects them and matches them against filed tax returns. Perfection is the process to assure that the taxpayer identification number, usually the social security number (SSN), and the payee's name match. For example, in some cases the information document was filed with an employer identification number, and an SSN must be substituted. Where there is no filed tax return, this provides potential leads for nonfiler investigations. This is known as the automated substitute for return program (ASFR). In 2015, for example, IRS worked over 600,000 individual nonfiler cases and assessed $2.7 billion using 93 staff years.[2]

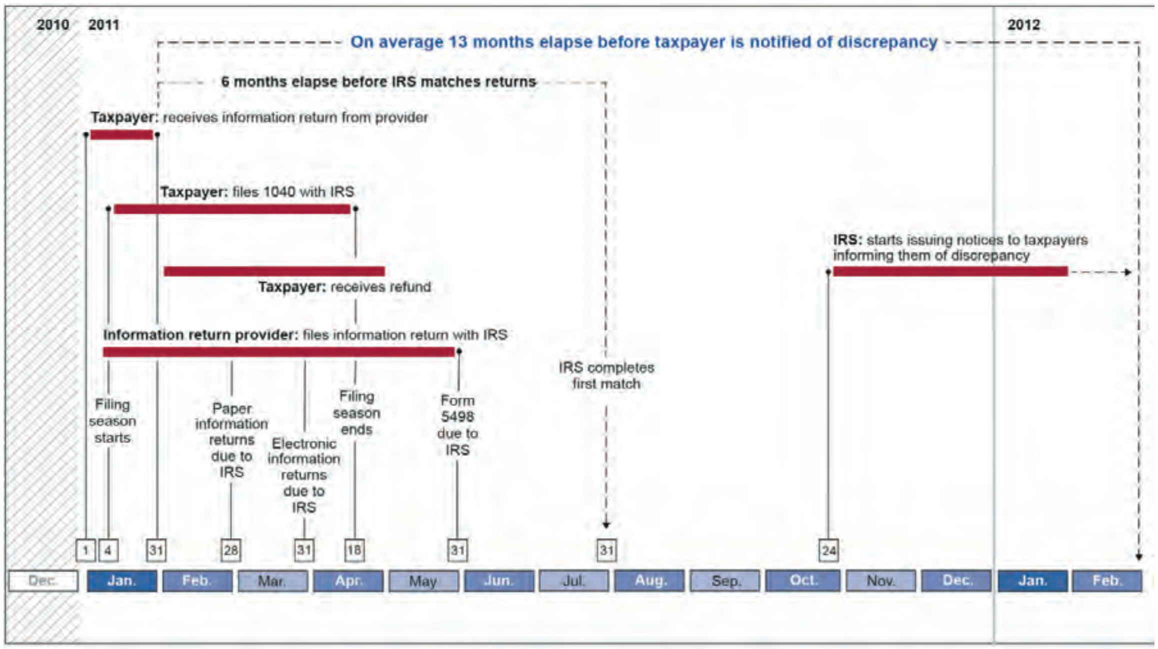
IRS makes three computer matches each year to identify discrepancies between entries on the filed tax return and the information documents. The first match is for returns filed by April 15, the second are for those with an extension, and the third for late filed returns. The IRS ignores a difference between the tax return and information document if it is below an undisclosed tax threshold. For example, if the taxpayer underreports the interest income earned by $100, it is likely below the tax threshold and will not be pursued. The reason is that it would not be cost beneficial to pursue the tax de minimus tax owed.

Graphic 1 provides an illustrative timeline for submitting information and tax returns for Tax Year (TY) 2010 to IRS and the subsequent matching process.

1. *See, Publication 6961 Calendar Year Projections of Information and Withholding Documents for the U.S. and IRS Campuses (2015) Table 2.*
2. *IRS 2015 Data Book, Table 14*

## Graphic 1

**Timelines for Submission, Matching and Taxpayer Notification of Discrepancies for Information Returns and Timely Filed Individual Income Tax Returns, 2011 Filing Season (Tax Year 2010)** [3]




Source: GAO analysis of IRS documents.

IRS works AUR mismatches one year at a time, and sends notices for one tax year. After taking the de minumus tax threshold into account, the IRS identified 23.8 million mismatches for 2010. The mismatches may be for more than one category. For example, IRS may find that the taxpayer may have underreported both wage and dividend income for that year. For AUR purposes, this amount is aggregated to determine if future action is warranted. Subsequently, if the cutoff for sending an AUR notice is $500 and the taxpayer underreported $400 each of wages and dividends, AUR may work the case because the total is $800.

We say “may” for two reasons. First, since IRS has limited resources, there may be too many cases at or above $500 to work all of them. Second, IRS works cases across all income types, even below threshold so taxpayers are not able to be noncompliant in any income reporting without the chance of detection.

3. See, GAO-13-515 *Tax Refunds: IRS is Exploring Verification Improvements, But Needs to Better Manage Risks June 4, 2013 P 13*

## 2. THE AUR CONTACT PROCESS

When the IRS identifies a mismatch, further manual analysis is generally required. An IRS tax examiner (TE) retrieves the tax return and analyzes it to determine whether the discrepancy was reported on another line or category on the return. If the TE is unable to resolve the discrepancy and it exceeds a certain dollar threshold, the taxpayer is contacted for an explanation.

The AUR contact is made with a computer generated notice, known as the Computer Paragraph 2000 (Notice of Proposed Adjustment for Underpayment or Overpayment)[4], or CP-2000 for short. Typically, the CP-2000 includes a transcript of everything the IRS has associated with a Social Security Number. The notice explains the apparent discrepancy and proposes an adjustment to the tax liability. The CP-2000 is not a demand for payment. However, if the taxpayer does not respond or the matter is not satisfactorily resolved, the IRS may issue a notice of deficiency, assess the tax, and attempt to collect tax on that basis.

On the other hand, if the taxpayer responds with an acceptable explanation, an AUR examiner will consider the reasonableness of the response and may close the case. Tax examiners generally do not assess the accuracy of the information in the response because they do not have examination authority. If there is a question regarding the response, the case may be referred for a correspondence examination.

Another possibility is an inquiry letter, such as a CP-2501 Notice—an initial contact letter: This typically does not have a proposed balance due, rather it requests clarification on differences between what is reported on the tax return and information from other sources. With the additional information, AUR can compute if there is any additional tax owed One such example is the sale of stock. Without knowing what the taxpayer paid for the shares (i.e., the basis), it is not possible to determine the taxable gain, if any.

The taxpayer can agree to the adjustment by signing the notice and sending a payment. If the taxpayer disagrees and decides to contest the CP-2000 notice, the taxpayer can submit an explanation and any supporting evidence. If the evidence is sufficient, the matter is resolved and the case is closed. If not, the taxpayer can contest the matter with the IRS Appeals Office. If still unresolved, the IRS will issue a formal deficiency notice. If the taxpayer ignores the AUR notice, the IRS computers will usually issue a notice of deficiency after a certain amount of time has elapsed, and has the option of beginning collection action.

### 2.1. How Productive is AUR?

Table one provides a breakdown of dollars assessed per AUR notice, and staff year. IRS has defined an AUR contact as a case closed. If the AUR notice claims that the recipient owes additional tax due to underreporting and taxpayer proves otherwise, this is a case closed without additional dollars assessed. IRS does not publish data on the number of AUR contacts that are closed without additional dollars assessed.[5] Although anecdotal, some tax practitioners claim that about one in five AUR notices are incorrect. This does not mean no additional tax is owed, just that the dollars claimed are incorrect. Also, for smaller amounts

4. *See, Appendix V of the TIGTA report 2008-40-180 for a copy of the CP-2000 notice that IRS used in FY 2007. http://www.treas.gov/tigta/auditreports/2008reports/200840180fr.pdf*
5. *According to IRS, for FY 2009 18.4 percent of the computer identified discrepancy cases were closed without contacting the taxpayer. TIGTA report*

practitioners advise clients to just pay because the cost of contesting an incorrect notice can exceed the tax claimed to be owed.[6]

Using IRS published data, IRS assessed over $3.6 million per staff year and $1,700 per AUR contact in 2015. The actual dollars owed are somewhat higher since a successful assessment also includes interest from the time the tax return was due, and often a small negligence penalty as a percentage of the tax owed.[7]

**Table 1**
**AUR Contacts and Dollars Assessed**[8]

| Year (FY) | AUR contacts (millions)[9] | Tax assessed (millions)[10] | Staff Years[11] | Dollars Assessed per notice | Dollars Assessed per staff year (thousands) |
|---|---|---|---|---|---|
| 2000 | 1.354 | $1,930 | | $1,425 | |
| 2001 | 1.162 | $1,937 | | $1,667 | |
| 2002 | 1.491 | $2,521 | | $1,691 | |
| 2003 | 1.561 | $2,863 | | $1,834 | |
| 2004 | 1.948 | $3,576 | | $1,836 | |
| 2005 | 2.837 | $3,994 | | $1,408 | |
| 2006 | 3.209 | $4,075 | 1,752 | $1,270 | $2,339 |
| 2007 | 3.403 | $5,079 | 1,742 | $1,493 | $2,915 |
| 2008 | 3.530 | $6,396 | 1,782 | $1,812 | $3,518 |
| 2009 | 3.621 | $6,280 | 1,900 | $1,734 | $3,305 |
| 2010 | 4.336 | $7,238 | 2,255 | $1,669 | $3,210 |
| 2011 | 4.703 | $6,437 | 2,343 | $1,369 | $2,747 |
| 2012 | 4.525 | $7,113 | 2,217 | $1,572 | $3,208 |
| 2013 | 4.116 | $7,732 | 2,035 | $1,879 | $3,800 |
| 2014 | 3.777 | $5,906 | 1,952 | $1,564 | $3,026 |
| 2015 | 3.720 | $6,341 | 1,739 | $1,705 | $3,646 |

**Source:** IRS Data Book 2000-2015

6. *Based on a statistically valid random sample, a 2008 TIGTA report indicates that approximately five percent of the AUR notices sent in FY 2007 by W & I were inaccurate. This could have resulted in an over or under assessment of tax. It should be noted that this report did not look at SB/SE notices, which currently comprise about half of the AUR notices sent. See, http://www.treas.gov/tigta/auditreports/ 2008reports/200840180fr.pdf*
7. *Although the table shows significant dollars assessed, one reason is that AUR picks the cases it believes have the highest dollar assessment potential. Should IRS put more resources into AUR? See, infra.*
8. *IRS Data Books for 2000-2015*
9. *IRS has defined contacts as cases closed. If AUR claims that the recipient owes additional tax due to underreporting and taxpayer proves otherwise, this is a case closed without additional dollars assessed. IRS does not publish data on the number of AUR contacts that are closed without additional dollars assessed.*
10. *Due to a change in how IRS reports data, amount assessed includes interest and penalties for 2000-04 but excludes them for subsequent years.*
11. *One staff year is the total staff hours expended, converted to the number of full-time equivalent (FTE) positions. In other words one staff year is equal to 2080 hours.*

While the AUR program generates millions of leads that could produce revenue for the Treasury, there are costs that make it uneconomical to work all the cases identified above the secret tolerance. While the cost of generating letters and postage may be small, there are other downstream costs to consider.

First, some recipients or their return preparer will telephone IRS asking for clarification or contest the amount claimed. It costs the IRS about $25 for each telephone call. IRS received over 100 million calls in 2010 on all matters. This is one reason that IRS tries to stagger when and how many AUR notices are sent at a given time. Including AUR, IRS sends over 200 million notices a year.[12]

Secondly, a recurrent problem with AUR (and other notices sent by the IRS) is complexity. Often times, a recipient either does not have the tax background or reading comprehension level to understand what exactly the IRS wants. This can lead to contacting the IRS—with mixed results, or just ignoring the letter that leads to subsequent compliance actions. (In turn, the IRS must train tax examiners and update procedure manuals.) Complexity increases the costs for both the taxpayer and the IRS.

Third, if the taxpayer responds, enforcement resources must be used to evaluate the documentation or explanation. For example, a parent may claim that the amount of unreported interest in a bank account with her social security number was actually that of a minor child or nephew. Should the IRS accept the explanation and close the case, or should it go further and check if the interest was actually reported?

Fourth, for the minority of taxpayers who do not respond to the notice or don't pay, how should IRS respond? Usually, a nonresponse leads to an assessment and is turned over to the collection function. If the dollars involved are small, it is unlikely that collection staff will spend much time on the case—increasing the inventory of accounts receivable and the dollars uncollected. In other words, dollars assessed do not necessarily mean dollars collected.

Just as cost drives how AUR selects and works cases, this can also affect taxpayer responses. For small dollar amounts, the IRS often wins by default. The majority of taxpayers use a paid preparer. Since the cost of sending the notice to the preparer to research or contest it may exceed the tax owed, the preparer's advice is often to just pay what IRS says is owed.

Although Table One shows impressive dollar assessments, one reason is that AUR picks the cases with the highest dollar potential. Should IRS put more resources into AUR? See, below for a discussion of this.

### 2.2. How can AUR do better?

#### 2.2.1. Multiyear contact notices

The AUR system handles cases on a one-year basis. This means that IRS has 36 months from the time a tax return is filed to contact the taxpayer and resolve the matter or issue a notice of assessment. On average, IRS begins to send out the first group of CP-2000 notices about thirteen months after the tax return is filed. Put another way AUR has almost two years to resolve the case. With this time frame, why not include any amounts owing from the prior year in the contact. Let us give an example.

For a TY 2010 tax return which was filed on April 15, 2011, IRS plans to send a CP-2000 notice to John Smith claiming that he may have underreported income that will produce an extra $1,000 in tax liability. It takes IRS 15 months after the return is filed to do the necessary prep work

12. *http://www.americanprogress.org/issues/open-government/news/2011/05/16/9588/irs-aims-for-letter-perfect-language/*

and send the notice—in other words IRS has 21 months left for this matter. For the prior year (here TY 2009), AUR files indicate that Smith also had unreported income that would result in an extra tax of $400. The case was not worked because it was either below the tolerance or there were insufficient resources. Before sending the 2010 notice, AUR could do a quick check to its TY 2009 discrepancy file to determine if there is an amount in question.

By combining the amounts in a CP-2000, few additional resources will be needed and the potential revenue yield will increase. In light of the 36 month assessment window, for this example, the IRS has 9 months left to resolve the 2009 matter and 21 to resolve the 2010 matter. While there are obvious complexities and procedural issues, that affect merging mismatches across multiple tax years, it seems worth doing a pilot of a sample of cases to see what the costs and benefits of this approach are. If the results are satisfactory, it can be expanded.

### 2.2.2. Using soft notices

IRS has periodically experimented with a concept commonly known as a soft notice. A soft notice informs the taxpayer that there may be an error on the return, and asks the filer to review the return and take appropriate action. The IRS uses soft notices for various purposes, including for earned income tax credit eligibility inquiries.

For its TY 2007 pilot, AUR sent out approximately 29,000 CP-2057 notices to taxpayers specifying that certain payments were not reported.[13] It asked the taxpayer to file an amended return if the amount was not properly reported, or contact the payer if there was an error, and have the payer file an amended information return. Although the notice requested that the taxpayer file an amended return, if appropriate, or contact the payer, there was no requirement that the recipient pay additional tax, provide documentation, or even respond to the IRS.

The primary goal of the TY 2007 soft notice initiative was to correct taxpayer behavior on future filed tax returns, with a secondary goal to collect any additional tax due. Approximately 30 percent of those receiving the notice filed amended returns. For a control group that received the standard CP-2000 notice, the response rate was more than double. The soft notice group generated over $1 million in additional revenue, substantially less revenue than the control group.[14]

### 2.2.3. Focus on AUR repeaters

With additional AUR staff, the IRS would presumably be able to follow up on more discrepancies. Is this a good idea? Answering this raises both practical and philosophical questions. For the mismatches, the AUR program creates inventory categories of potential tax changes. Category A is the highest potential tax change, presumably involving many thousands of dollars of tax and G is the lowest, presumably involving a few hundred dollars in tax. The further into the inventory of cases AUR is able to work, the less potential additional tax there is likely to be assessed, i.e., diminishing returns. For the smaller dollar amounts, the cost may exceed the revenue collected.

However, the primary goal of AUR is not revenue realization but to increase voluntary compliance. Therefore, working selective lower priority cases

13. *13,330 notices went to W & I taxpayers and 15,331 to SB/SE taxpayers.*
14. *See, TIGTA report 2011-30-091 (Sept. 9, 2011) Using Soft Notices to Address Reporting Discrepancies Has Merit, but Cost and Benefit Questions Remain.*

may help achieve this goal. The process would be as follows. When a taxpayer has amended the previous return based on the AUR notice, if there is a smaller, under tolerance mismatch in the current year, the taxpayer would also receive a notice. This process would inform whether the IRS can achieve taxpayer behavioral changes by tracking mismatches in future years.

By pursuing a small amount, the IRS sends the taxpayer a message that small amounts are also important. Hence, the taxpayer is more likely to be compliant in the future, and repeat this message to friends and family. To the extent that a taxpayer's friends and relatives are more compliant because of the AUR contact, the indirect effect is multiplied.

## 3. CONCLUSION

The audit is among the most expensive and time consuming compliance tools available to a tax administration. With its AUR program, the IRS has been able to establish a less costly and efficient way to increase compliance. Using third party information returns, the IRS provides tax filers with information to show where there has been an "inadvertent" failure to report or underreport certain income. In most cases, this is a graceful way for a taxpayer to pay the tax owed while allowing the more efficient use of limited compliance resources.

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# THE TAXATION OF DIVIDENDS IN ECUADOR

**Marlon Manya Orellana**


## SYNOPSIS

This article focuses on how the tax system deals with dividends in Ecuador. To this purpose, it begins with a brief definition of the term from several perspectives: Legal, economic, financial and fiscal. The source principle is analyzed for determining the tax to be applied thereon, the use of treaty shopping and the beneficial owner as avoidance mechanisms, and the normative analysis of the Ecuadorian legislation in their treatment, including a case study on the issue of withholding.


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**Content**



According to the dictionary of the Real Academia Española, the term dividend refers to the "quantity to be divided by another", which, if considered as active dividend, determines the " quota corresponding to each share of a mercantile company distributing its profits", while if considered as passive dividend refers to "each partial quantity that the subscriber of a share or bond promises to satisfy at the request of the issuer".

From a legal perspective, this term is used in commercial law, financial and stock market law, accounting law and tax law. From an economic and financial point of view, it is used to describe a flow of assets of an entity to its owners, established by the opportunity cost of capital, pursuant to the economic rights of their shares.

"Dividends" usually means profits distributions made to shareholders or business partners by limited companies or limited liability companies. In the first case through stocks, while in the second case through shares. Therefore, for the stockholders or shareholders, dividends constitute income from capital contributed to the society.

The Organization for Cooperation and Economic Development (OECD) in its Model Tax Convention on Income and Capital, article 10, expresses in the third paragraph: "The term "dividends", as used in this article, means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in the profits, as well as income from other corporate rights which is subjected to the same taxation as income from shares by the laws of the State of which the company making the distribution is resident."

Because of the diversity of laws among OECD member countries, it is not possible to offer a complete and exhaustive definition of the concept of dividend. Therefore, the definition in article is limited to examples contained in the majority of these laws and, in any case, are not treated differently. Another commonly used model is the one of the Andean Community (CAN), which in its Decision 578 deals with the regime to avoid double taxation and prevent tax evasion, where the taxation of the "dividends and shares" of companies is limited by regulation; where these will be only taxed in the country where the company that distributes them is domiciled, thus excluding the tax on the basis of the principle of residence, in order to avoid double taxation; However, there is no definition provided for these terms.

What we can see within the comparative tax law, is that the distributions of benefits from shares result from participating in a company whose responsibility is limited to its shares, and their taxation will depend on the tax authority of each State to tax or not certain revenues, in this case from the capital, such as the dividends.

In the tax regulations of Ecuador, after article 7 of the regulation for the implementation of the Internal Organic Tax Law, a non-numbered article defines the term dividend: "For tax purposes, all types of participation in profits, surplus, profits or similar that are obtained based on rights representing capital held by the beneficiary, directly or indirectly, shall be deemed dividends and will have the same tax treatment ".

It should be noted that, given the existing standard, capital rights or titles or ownership rights shall be understood as any type of entity, assets or any term appropriate according to the nature of the society, with determined monetary value, such as shares, participations, and land rights, among others. Therefore, the holders or beneficiaries of these rights will be the shareholders, partners, participants, beneficiaries or similar. The amplitude of this last definition show that incomes which in principle are not dividends for commercial purposes could be considered as "implied dividend" or failing this, "covert distributions of dividends" from a tax point of view.

International tax law provides three elements relating to the concept of dividend:

- The existence of an entity distributor of dividends, to which the profits are attributed.
- Participation in such an entity that gives right to distributed income.
- The relationship between the source and the return, which is what the doctrine has called "societatis causes", i.e., the link between what is paid by the company and the participation in the company.

## 1. THE SOURCE PRINCIPLE TO ESTABLISH THE TAXATION ON DIVIDENDS

The development of the income tax has been influenced by two economic theories of income: Firstly the theory of source whose origin lies in the Roman law (income resulting from fruits of capital goods), and second theory of the net accumulation which gives form to the traditional concept of the global income tax, based on the concept of income by Schanz-Haig-Simons. This concept of global income focuses on the "net accumulation of economic power of a subject between two temporary references". On the other hand, the theories of source include only the income from the source, or the source itself, and exclude capital gains and losses resulting from the sale of the source. In the current income tax of many countries, the tax base is a mixture of theories of accumulation and source, in the best of cases completed by a separate regime for capital gains and capital losses.

In that sense, the design of the income tax requires to define the source of the dividends for the purpose of determining the real obligation to contribute, which will be directly the property of the company's shares, but indirectly the activity that generates the benefits of society. Within the tax allocation criteria, this could be understood as the state of residence of the company that distributes, where the shares are registered, or where the payment obligation is fulfilled.

The tax residence is determined by factors such as the place of constitution of the company, its commercial address or the place of its effective management. However, if one takes into consideration that the source of income is the underlying economic activity, the objective criterion is what has been called "origin", that is, the place where the profit from which dividends are derived is obtained. In other words, the origin of the economic benefits of the company paying the dividends is not necessarily in the entity that distribute them, but where the capital is generated.

In relation to this idea, the Committee on Fiscal Affairs of the OECD has expressed its views in the comments of article 10, indicating that there is no exclusive right to tax dividends in the State of residence of the beneficiary or in the residence state of the society that pay the dividends. The exclusive taxation of dividends in the Source State is not acceptable as a general principle. There is also a certain number of States that do not tax the dividends at the source, while, as a general rule, all States tax residents for the dividends obtained from corporate non-residents. It is not possible, either, to establish as a general rule the exclusive taxation of dividends in the State of residence of the beneficiary. This taxation would correspond better to the dividends that are obtained income from movable capital. But it would not be realistic to expect that the taxation of dividends at the source would be abandoned. For this reason, the Committee only states that dividends may be taxed in the State of residence of the beneficiary.

Adopting the criterion of the Source State, we can observe an economic double taxation, since the entity (resident) that distributes the dividends paid the corporate income tax for the fiscal year; While at the same time, the individual or legal entity that shares the company's capital (shareholder) receives these benefits that have already been taxed, and the dividends are also included as part of their global income. This is a situation that good international tax practice recommend to correct through the exemption methods (total or escalated) , to consider these income from dividends as exempt from tax income, or through the method of allocation (full or regular), giving shareholders a tax credit corresponding in proportion to the tax paid by the institution that distributes the dividends. The exemption method solves many of the problems posed by the allocation method, which contrary to the principle of simplicity that a good tax system should adopt.

The two other methods increasingly used in order to minimize taxation and eliminate economic double taxation are: The underlying tax credit, and the deduction for unpaid taxes (tax sparing).

- The first option makes possible that in tax compensation, those who have paid from an economic point of view, and not only those who have contributed legally as taxpayers are taken into account. In the case of dividends, it can be admitted that a shareholder will benefit from a tax credit for the income tax paid by the institution distributing the dividends, in the part corresponding to the received dividend, and this in addition to the tax credit that corresponds for the double taxation resulting from taxation through the income tax dividends withheld at source. It should be noted that the problem of their double taxation is avoided, provided that the tax credit is not subject to limitations.

- The second is a tax benefit consisting in the recognition of existing tax incentives or specific exemptions typified in the law. It aims to attract investments, exclusively benefiting to the investor taxpayer. A variety of this tax benefit is the matching credit that supposes the concession of a tax credit for unpaid taxes, which can be more effective than the tax benefits recognized in the source income country.

As a good practice in international tax matters, the valuation of the described methods cannot stand against basic tax principles such as neutrality and equity. Tax neutrality refers to the relationship between taxes and the goal of economic efficiency. The purpose is that the tax should not affect, or do so at the lowest possible degree, the efficiency of economies, allowing resources to be allocated to their most productive uses, so that such assignment is the answer to real differences in costs and rates of return, and not a response to differences between taxes.

In the field of the taxation of capital revenue, such as dividends, and in a situation of international mobility of these revenues, the concept of tax neutrality requires that the tax burden on capital should not be altered by the location of investments that would take place in the absence of taxes. For this reason, it is said that the exemption methods aim at obtaining neutrality in the importation of capital: In the State hosting the foreign investment, all investments made in its territory keep the same degree of effective taxation, regardless their origin, which promotes foreign investment.

Conversely, the imputation system achieves the neutrality in the export of capital when all residents of a State support the same effective taxation on their obtained incomes, regardless of their origin (national or foreign), which overrides the interest of investing in countries other than the residence of the investor only for tax purposes. For Ecuador, being an importer of capital, from the perspective of the country host of the investment, the tax administration should ensure efficiency in the international localization of the capital, favoring fair competition and preventing discrimination.

Likewise, the criterion of taxation at source is the most often used to achieve international equity; This means, that the country at the origin of income has a legal priority to tax it, even when the income recipient factors are not residents of that source country, but the definition of the tax base as part of the global income and the tax rate can cause issues. Therefore, the economic double taxation of dividends can cause distortions in the efficiency of the allocation of resources, in the corporate composition, in the choice of its financial structure, investment decisions, policy dividends, at the level of private savings. The system based on the integration of the company's taxation and the shareholders' taxation allows reducing, but not eliminating, this problem.

## 2. TREATY SHOPPING AND THE BENEFICIAL OWNER

Treaty Shopping, also called treaty purchase, is a mechanism of tax avoidance, which usually is related to international agreements to avoid double taxation, and can be defined as incorrect or abusive use of conventions of double international taxation, which occurs when residents of a third State create a legal entity in one of the two contracting countries in order to benefit from the reduced rates of withholding or other tax benefits, to which they would have no right if acting directly.

Notwithstanding that, this can also take place by using loopholes in the internal law for the application of exemptions and tax incentives in force. For that operation to make sense, intermediary companies that are created or used to reduce the taxation in the source State, subject to no taxation or a minimum taxation amount, while the accumulated profits in the intermediary company, when they are distributed, regardless the method used, should not be subject to real taxation in the State of residence of that company. This type of economic-financial structures takes its name from conduit companies, or instrumental companies or also called intermediate corporate holdings, which form part of the equity capital of the dividend distribution entity, and once they have paid the corporate income tax, the dividends obtained will be exempt from income taxes for these intermediary companies. Usually, behind this operation, there is a shareholder resident who owns these resources, and has evaded the tax payment. Their use intend to optimize the taxation of dividends and capital gains as a result of the holding of shares in the capital of resident companies which can even be domiciled in different States.

Article 10 of the OECD Model Tax Convention on Income and Capital, in its sections 1 and 2, states the following:

"1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

   a. 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

   b. 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid".

In this way, we can indicate that in agreement with the OECD model, some taxation power is reserved to the source State of the dividends; that is, the state of residence of the company paying the dividends; However, this right to collect the tax is limited considerably. The tax rate cannot exceed 15%. A higher rate is not justified, given that the source state has already been able to tax the corporate benefits.

The section 4 states the following: " 4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, holds a business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment...

The beneficial owner condition was incorporated in paragraph 4 of article 10 of the OECD Model, to explain the meaning of the words "paid to a resident", the Committee on fiscal affairs of the OECD concluding that a conduit company cannot be considered in normal situations as the beneficial owner, what should conduct a thorough analysis of the powers of that conduit on the obtained incomes.

The Financial Action Task Force International FATF designates as beneficial owner "the individual(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is made." It also includes those persons who exercise ultimate effective control over a legal person or arrangement". The treatment of the concept goes far beyond a simple conclusion to find the actual individuals behind possible corporate and involves a widespread study of their transactions, their accounting, their tax contributions, etc. The important part of this approach lies in showing the true background of participants in companies.

The expanded FATF recommendations require to establish mechanisms for accessing a comprehensive information of companies, as well as their real beneficiary. To this effect, the different legal definitions of companies must be identified, the processes of creation of such legal entities must be verified, with the respective collection of information concerning the beneficial owner, information and previous data on public access database. We must include the necessary international cooperation so that the authorities of different countries can access the databases collecting the information on the beneficial owner of each national society, and the exchange of information on the tax, corporate, banking and commercial information of the taxpayer

From the entry into force of the law of incentives to production and prevention of tax fraud in Ecuador; that is, from January 1, 2015, to the regulations for the enforcement of the internal tax regime, a non-numbered article has been added after article 7, defining the beneficial owner:

> "Art. (…). "- **Beneficial owner**.- "for tax purposes, the beneficial owner is understood as the one who legally, economically or in fact has the power to control the allocation of the income, benefit or utility as well as to use, enjoy or dispose of it".

The essential elements of the beneficial owner are similar characteristics that a tax resident of a Contracting State in a Convention to avoid double international taxation must have, conditions to apply a reduced rate of withholding on dividends from income, in this case. This beneficial owner must be able to use, enjoy and dispose of the total use of resources, without limitation, also demonstrating the essence of his personality. I.e. that he is holder of the rights acquired by the registrant, as well as the intellectual property rights, and credit rights, among others. And is not legally obliged to transfer such income; that is, the exclusivity of ownership over them.

In an illustrative way, in order to identify the beneficial owner, we can mention that in first instance the stock percentage of a company must be verified, i.e. If they control more than 25% or 50% of the shares, we could observe a partial or absolute control respectively, and by contrast, after observing a transaction log, when a company sells or trades only with another company and not with any other, this will help to understand if we are facing the beneficial owner or a simple transfer agent. Specifically, both cases are described in our tax legislation on possible relations regarding control of companies or related parties.

## 3. ANALYSIS OF THE TAX TREATMENT OF DIVIDENDS IN ECUADOR

### 3.1. Internal Taxation Act

In Ecuador, article 8 of the Organic Law of Internal Revenue (Spanish: Ley Orgánica de Régimen Tributario Interno), considers earnings and dividends distributed by incorporated companies or companies established in the country as Ecuadorian source income.

Article 9 of the Organic Law of Internal Revenue, in its first paragraph, indicates that: "Dividends and profits, calculated after the payment of the income tax, distributed by national or foreign companies resident in Ecuador, in favor of other national or foreign, companies, not domiciled in tax havens or jurisdictions of lower taxation or individuals not resident in Ecuador.

This exemption does not apply if the beneficial owner, in the terms defined in the regulation, is an individual resident in Ecuador.

"Also will be exempt of the income tax, the dividends in shares that are distributed as a result of the application of the reinvestment of utilities in the terms defined in article 37 of this law, and in the same proportional relationship."

It is necessary to clarify that by definition, dividends are exempt from income tax revenue, a situation allowed by the domestic tax legislation. However, one of the amendments to this law, as of January 1, 2010, excludes from this exemption foreign corporations domiciled in tax havens and individuals resident in Ecuador. Among the justifications given to this reform, there is the change in the table of the income tax on individuals with the Tax Equity Act of Ecuador (Ley de Equidad Tributaria del Ecuador, effective from January 1, 2008), which maximum percentage on the surplus fraction reached 35%, while on the other hand, the maximum corporate income tax rate was kept at that time at 25%.

This surplus to the tax authorities is regarded as a revenue, since the shareholder did not include it in his global income, because according to the control agency, personal income was disguised in the form of corporate income.

Notwithstanding this, on this last aspect, dividends and profits of companies distributed in favor of individuals resident in the country will be part of their global income, situation that causes for them an economic double taxation, because the company which distributed dividends has already paid the tax corresponding to the income obtained by the companies obtained in the fiscal year; while at the same time, the resident individual in Ecuador (shareholder), who receives these benefits, will be subject to withholdings at source from the income tax in respect of dividends.

Product of various avoidance practices used by conduit companies, instrumental companies or also called intermediate holdings companies, which form part of the capital stock of the entity distributor of dividends: the resident shareholder who holds these resources as beneficial owner, and has evaded payment of the tax, is also excluded from this exemption since January 1, 2015, in accordance with the Law of Incentives to Production and Prevention of Tax Fraud.

A third important aspect that this law considers, refers to the types of dividends that can be paid in cash or in shares. A cash dividend is paid by a company in the form of cash payment to each shareholder of a fixed amount per share. Thus, each shareholder receives a payment based on his or her number of shares. However, there are also dividends paid in shares, which shareholders receive in the form of shares, newly issued or not. Distributing this dividend represents a decrease of reserves and an increase in capital accounts As a result, cash dividends are therefore different from dividends in shares, which are paid to the holders of ordinary shares through additional shares from the social capital of the company.

Analyzing the case from a tax point of view, with the current standards, there is a different tax treatment, the cash dividend constitutes an income taxed to the partners or resident shareholders in Ecuador, and is part of their global income; this dividend is subject to income tax withholding at the source by the distributing company, which must deliver proof of the corresponding withholding, within the five days following its date.

On the contrary, when new shares are received from the company, the partner or shareholder registers a capital increase, raising the percentage of participation in the company capital, and this would not be subject to withholding since the company is not making any payment or crediting an account in the name of the partner or shareholder at the time of distribution of the dividend; and therefore, taxation is postponed until the moment that the shares are sold, since it is at that time that the taxable fact takes place. We must remind that profits from direct or indirect sales of shares, participations, or other capital representation rights or other rights that allow the exploration, exploitation, concession or similar of companies domiciled or permanent establishments in Ecuador, constitute income of Ecuadorian source.

The payment of dividends in shares is part of the flexible remuneration forms, which include other in-kind payments such as the granting of subscription rights, compensation for passive dividends, among others. The granting of the right to choose the form of remunerating the shares to the partner, who can opt for a payment in shares or subscription rights or shares, is referred to as scrip dividend.

The partner or shareholder resident in Ecuador, however, must inform the tax administration regarding his statement of assets considering for the calculation, the percentage that corresponds to him or her in the marital or common-law union members, and of their non-emancipated children.

### 3.1.1. Loans to shareholders

Article 37 of the tax law excludes this practice: "When a company grants financial loans to its partners, shareholders, participants or beneficiaries, or any non-commercial loans to its related parties, this operation shall be considered as payment of advance dividends and, therefore, the company must perform the corresponding withholding on the transaction amount, at the corporate rate specified."

"Such withholding shall be declared and paid the month following the operation within the time limits provided for in the regulation and shall constitute a tax credit for the company on its income tax return"

## 3.2. Rules for the application of the Organic Law of Internal Revenue

Article 15 of the regulation for the implementation of the Organic Law of Internal Revenue, states: "In the case of dividends and profits calculated after the payment of the income tax, distributed by national or foreign companies or resident in Ecuador, in favor of other national or foreign companies, not domiciled in tax havens or jurisdictions of lower taxation, or of individuals not resident in Ecuador, there will be no withholding or additional income tax payment." This provision will not apply if the beneficial owner of the income is an individual resident of Ecuador.

Notwithstanding the foregoing, the tax administration may determine the obligations of the beneficial owner and of the withholding agent when, due to being related parties or any other circumstance, the withholding agent would know that the beneficial owner is an individual resident in Ecuador.

Dividends or profits distributed directly or through intermediaries in favor of individuals resident in Ecuador constitute taxed income for those who collect them, and therefore the corresponding withholding at source must be performed by those who distribute them. The withholding percentage shall be established by the internal revenue service through resolution within the legal limit.

Where dividends or profits are distributed, directly or through intermediaries, in favor of companies residing or established in tax havens or jurisdictions of lower taxation, the corresponding income tax withholding at source must be performed.

The value on which the withholding established by this article shall be calculated will be the one which should be considered as income taxed within the global income, i.e., the distributed value plus the tax paid by the company, corresponding to that distributed value.

Regarding the tax base for the income tax of the company, in the fiscal year corresponding to the dividends or profits distributed, a proportional rate will be applied if they had a corporate composition corresponding to tax havens or jurisdictions of lower taxation of less than 50%, the tax attributable to dividends that correspond to that composition will be 25%, while the tax attributable to the rest of dividends will be 22%."

According to the law on internal tax procedure in its article 9, first clause, the distribution of dividends or profits calculated after the payment of the income tax, in favor of individuals resident in Ecuador is taxed and subject to the payment of such a tax; i.e., paid by the partners or shareholders.

For the calculation of the overall income for dividends; the company's taxable base and the corresponding distributed value will be considered, plus the tax paid by the society corresponding to this distributed value.

Article 37 of the Organic Law of Internal Revenue considers the corporate income tax rate, indicating: "Companies incorporated in Ecuador, as well as branches of foreign companies domiciled in the country and permanent establishments of non-resident foreign companies will pay a 22% rate on their taxable income.” However, the tax rate will be 25% when the company has shareholders, partners, partners, constituents, beneficiaries or similar resident or established in tax havens or regimes of lower taxation with a participation, direct or indirect, individual or joint, equal to or greater than 50% of the capital stock, in agreement with the stipulations of the regulation...”

Article 137 of the regulation implementing the Organic Law of Internal Revenue gives the possibility to consider the tax credit for utilities, dividends or profits distributed to resident individuals. To consider as tax credit the income tax paid by the company, in the case of utilities, dividends or profits distributed to resident individuals in Ecuador, the following considerations will be taken into account:

a. Within the global income, the value distributed plus the tax paid by the society, corresponding to that value distributed, is considered as taxable income, regardless the bookkeeping obligation.

b. The tax credit cannot exceed any of the following values.

    i. The tax paid by the company corresponds to the dividend.

    ii. The value of the taxable income multiplied by the rate of 22% or 25%, as has been applied to profits from which dividends originated.

    iii. The income tax that an individual would pay for that income within his or her global income, i.e., the difference resulting from subtracting the tax caused on its global income including the value of the utility, profit or dividend, minus the tax caused on their global income if the revenue, profit or dividend had not been considered.

c. When a same dividend, profit or benefit is obtained through more than one company, the tax paid by the first company that distributed it shall be considered as a tax credit.

d. In case the company that distribute the profits, dividends or benefits, within its tax reconciliation had right to some incentive or tax benefit or include tax-exempt income, under provisions of the law on tax procedure, the beneficiary individual can use as tax credit the value of income tax that the distributing company would have had to pay, if it had not applied some of these exempted income, incentives or tax benefits, without prejudice to the limits established in clause b) of this article. This provision shall not apply to those cases in which the dividend, utility or benefit is paid or credited to shareholders domiciled in tax havens or preferential tax regimes.

e. in any case, when companies that distribute utilities, dividends or profits, are requested to inform the recipients of the income, in the terms defined by the Internal Revenue Service, about the value to be considered on their global income and the tax credit they are entitled to, inclusive for the case referred to in clause c) of this article.

### 3.2.1. Anticipated dividends.

Article 126 of the implementation rules of the Organic Internal Tax Law, refers as follows to the withholding for anticipated dividends or other benefits: “When a company distribute dividends or other benefits with charge to earnings in favor of their partners or shareholders, before the end of the financial year and, therefore, before that the results of the activity of the company are known, the company should perform the withholding at the general rate of the corporate income tax, except when the beneficiary is resident or established in a tax haven or lower taxation regime, in this case the 25% rate will apply on the total amount of such payments.

Such withholding shall be declared and paid the following month and within the time limits provided for in this regulation and shall constitute a tax credit on for the company on its income tax return.

This withholding will not proceed when the dividends ore anticipated dividends are distributed by a company who whose purpose is exclusively shareholding, in which case only the withholding established in article 15 applies".

## 4. SUBJECTS TO WITHHOLDING FOR THE INCOME TAX ON DIVIDENDS

Among the subjects of income tax withholding for dividends are:

1. If the distribution is in favor of a resident company or established abroad which is NOT located in a tax haven jurisdiction of lower taxation or preferential tax regime whose beneficial owner is a resident individual in Ecuador, the said income is taxed to whom it is distributed, therefore it is subject to a withholding proportional to the dividend. This will also apply in the case of non-compliance with reporting the composition of the company.

2. If the distribution is in favor of a company resident or established in Ecuador, the revenue will be exempted for the company, and therefore is not subject to the income tax withholding, even if the beneficial owner of the company is resident in Ecuador

3. If the distribution is in favor of a company resident or established abroad, unless in a tax haven, jurisdiction of lower taxation or preferential taxation, income are exempt and therefore will not be subject to income tax withholding provided that the beneficial owner is a non-resident in Ecuador.

4. If the distribution is in favor of a company resident or established in a tax haven or lower taxation or preferential taxation jurisdiction, the income is taxed, therefore, it is subject to income tax withholding.

5. If the distribution is in favor of a resident individual in Ecuador, the income will be taxed and subject to withholding. He must consolidate it in his global income, declare and pay the tax on all of his or her income.

6. If the distribution is in favor of a NON-resident individual in Ecuador, the income is exempt and is not subject to withholding.

**Table 1**

**Table 1. Tax Treatment of dividends in Ecuador**

| RECEIVER OF DIVIDEND | BENEFICIAL OWNER | DIVIDEND | % WITHHOLDING |
|---|---|---|---|
| EXT. COMPANY NO TAX HAVEN | ECUATORIAN | TAXED | |
| EXT. COMPANY. NO LOW TAXATION | ECUATORIAN | TAXED | |
| COMPANY ECUATORIANA | ECUATORIAN | EXEMPTED | 0% |
| EXT. COMPANY NO TAX HAVEN | FOREIGN | EXEMPTED | 0% |
| EXT. COMPANY. NO LOW TAXATION | FOREIGN | EXEMPTED | 0% |
| EXT. COMPANY NO TAX HAVEN | ECUATORIAN | TAXED | |
| EXT. COMPANY. NO LOW TAXATION | ECUATORIAN | TAXED | |
| EXT. COMPANY. PARAISO FISCAL | FOREIGN | TAXED | 10% |
| EXT. COMPANY. LOW TAXATION | FOREIGN | TAXED | 10% |
| INDIVIDUAL | ECUATORIAN | TAXED | |
| INDIVIDUAL | FOREIGN | EXEMPTED | 0% |

**Source:** Resolution NAC-DGERCGC15-00000509 SRO 545 of July 16, 2015
**Elaboration:** By author

In this regard, the resolution NAC-DGERCGC15-00000509 shows us how the withholding must be calculated by companies resident or established in Ecuador, if they distribute dividends to individuals resident in Ecuador or to companies residing abroad, not located in tax havens, lower taxation or preferential tax regimes jurisdictions, but having a beneficial owner resident in Ecuador.

For this calculation the dividend distributed to each shareholder or partner should be added to the tax paid by the company that distributes it, attributed to that dividend; on this item shall apply the income tax for individuals, according to the table of the Internal Tax Law, article 36, clause a).

Finally, based on this result, companies must subtract the tax credit to which the resident individual in Ecuador is entitled, in accordance with the provisions of article 137 of the regulations for the application of the Internal Tax Law. The value thus obtained will be withheld at source by the company that distributes the dividend and should be reported in the corresponding withholding statement.

**Graph 2**

**Calculation of dividend income tax withholding at source**

| | |
|---|---|
| TAX BASE (BI) | $ 500.000,00 |
| Income Tax (IR) | $ 110.000,00 |
| Profit after tax (UDI) | $ 390.000,00 |

| Shareholder | Nationality | % Share holding |
|---|---|---|
| Pepito Piguave (INDIVIDUAL) | Ecuatorian | 40% |

| | |
|---|---|
| Distributed value for dividends | $ 156.000,00 |
| ITax paid by the Company corresponding to those distributed values | $ 44.000,00 |
| Income tax (Global income) | $ 200.000,00 |

| | |
|---|---|
| Article 36 LORTI (Tax year2015) | $ 52.999,50 |

| | |
|---|---|
| Article 137 RALORTI.<br>(-) Tax credit for dividends | |
| 1) | $ 44.000,00 |
| 2) | $ 44.000,00 |
| 3) | $ 52.999,50 |

| | |
|---|---|
| Value to withhold for dividends | $ 8.999,50 |

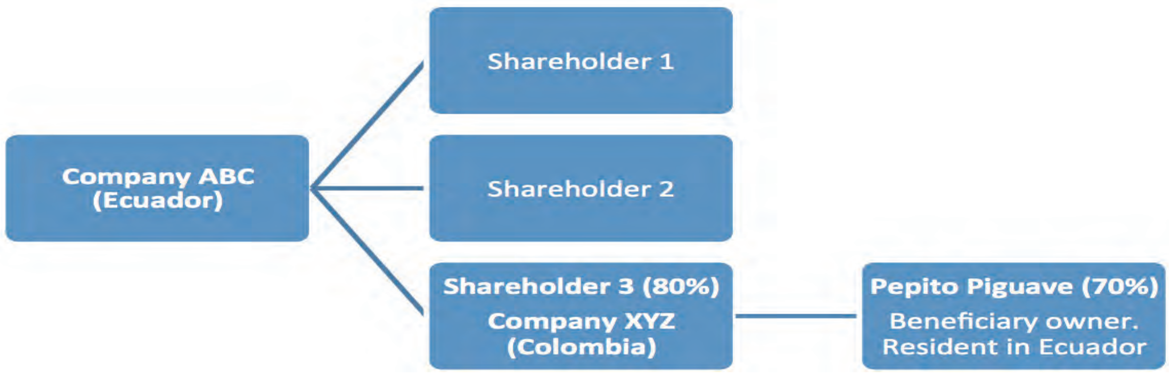
**Source and development:** By author

In the case of dividends distributed to residents companies, or established in tax havens, lower taxation or preferential tax regimes jurisdictions, on the part on which the company distributing dividends has been taxed with the 25% rate, the withholding will be 10%, applicable to the sum of the value of the dividend, plus the tax attributable to this dividend.

Let's take the example for ABC Company resident in Ecuador, which distributes dividends to its shareholder the company XYZ, domiciled in Colombia, which has a percentage of 80% of the shares, and with Pepito Piguabe, tax resident in Ecuador, as one of its shareholders, with a shareholding of 70%, making him beneficial owner, according to the normative of Ecuador.

**Graph 3**

**Calculation of the withholding at source for the income tax for dividends when the beneficiary owner is resident in Ecuador**




**THE WITHOLDING AT SOURCE WILL DEPEND ON THE PARTICIPATION OF THE BENEFICIARY**

**COMPANY ABC (ECUADOR))**

| | |
|---|---|
| TAX BASE (TB) | $ 1.000.000,00 |
| Income tax (IT) | $ 220.000,00 |
| Profit after taxes | $ 780.000,00 |

| Shareholder | Nationality | % Shareholding | Observations |
|---|---|---|---|
| Company XYZ | Colombian | 80% | The Company composition includes Pepito Piguave as beneficiary owner. Tax Resident in Ecuador with a shareholding of 70%. |

| | | |
|---|---|---|
| Dividend corresponding to the beneficiary owner | $ 436.800,00 | Corresponding to profit after tax: 780,000 multiplied by the shareholding of COMPANY XYZ (80%) and the shareholding of beneficiary owner Pepito Piguave (70%) |

| | | |
|---|---|---|
| Tax corresponding to the beneficiary owner | $ 123.200,00 | Corresponding to the income tax paid by the company that distributes the dividends 220,000 multiplied by the shareholding of COMPANY XYZ (80%) and the shareholding of the beneficiary owner Pepito Piguave (70%) |

| **TAX BASE (BENEFICIARY OWNER)** | **$ 560.000,00** |
|---|---|

| | |
|---|---|
| Article 36 LORTI (Fiscal period 2015) | $ 178.999,50 |
| (-) Tax credit for Dividends | $ 123.200,00 |
| Value to withhold for Dividends | $ 55.799,50 |

**Source and development:** By author

The ABC company, which distributes the dividends in Ecuador, will have to withhold on the taxable base value calculated for the beneficial owner, applying article 36 of the Organic Internal Tax Regime Law (Income tax table), and discounting the tax credit for dividends, in this case, the tax paid by the society that generated and distributed dividends in proportion to the taxed and declared dividend, the value of $55,799.50 being withheld for dividends, which results from the difference between $178,999.50 and the tax credit for dividends of $123,200, by application of the income tax table corresponding to the fiscal year 2015.

## 4. CONCLUSIONS

- In view of the diversity of laws of OECD member countries, it is not possible to offer a complete and exhaustive definition of the concept of dividend. Therefore, the definition is limited to the examples contained in the majority of these laws and, in any case, are not treated in them in a different way.

- The exclusive taxation of dividends in the State of source is not acceptable as a general principle. In addition, there are also a number of States that are not taxing dividends at the source, while, as a general rule, all States tax residents for the dividends obtained from non-resident companies.

- It not possible, either, to establish as a general rule the exclusive taxation of dividends in the State of residence of the beneficiary. This taxation would correspond better to the dividends of income from movable capital. But it would not be realistic to expect that the taxation of dividends at the source would be completely abandoned.

- Adopting the criterion of the Source State, we can observe an economic double taxation, since the entity (resident) that distributes the dividends, has paid the corporate income tax in the fiscal year; While at the same time, the individual or legal entity, shareholder of the company capital, who receives these benefits that have already been taxed, includes dividends as part of its global income

- The best international tax practice recommends to correct this via exemption methods, considering these incomes from dividends as income tax exempt, or through the allocation method, giving shareholders a tax credit for the proportion corresponding to the tax paid by the entity distributing the dividends.

- In Ecuador, the ordinary imputation method is used, as a mechanism to counteract the economic double taxation which arises when distributing the dividend to the shareholder, individual resident, which attenuate the issue but does not eliminate it.

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# CONSIDERATIONS ON ANTI-AVOIDANCE STANDARDS IN THE BRAZILIAN LEGAL SYSTEM

**Eliseu Sampaio Nogueira**


## SYNOPSIS

The categories the doctrine lists to obtain less tax burden, types of tax planning, are called fiscal evasion and avoidance. The general anti-avoidance standard came about as an attempt by the Tax Authorities of legalizing behaviors against the attack of the taxpayers of doing fiscal planning. Specific anti-avoidance standards which arise even before the general anti-avoidance standard are aimed at discouraging behaviors which lead to escape from paying taxes, whether by considering some practices as an express prohibition or by extending the field of taxation or even using the legal presumption technique.


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**Content**



Among the most recently discussed issues in Brazil, in the field of Economy, the Total Tax Burden - TTB (the same, in one of its aspects, calculated on the basis of the GDP – Gross Domestic Product) is what has had greater relevance due to increasing importance of taxes in the accounting of individuals and bodies corporate.

The TTB ends up affecting the economy as a whole since it has the power to stop companies' from investing, inhibit family consumption and, often, favor the contribution of capital in places where taxation is more favorable.

Due to this, the tax liability of taxpayers, whether directly or indirectly, seeks and study alternatives to reduce any type of tax burden, by using legal o illegal means.

On the other hand, fiscal authorities try to fight illegal tax planning by using, i.e., anti-avoidance standards.

The discussion about anti-avoidance standards gained the notoriety of a great doctrine controversy by outlining the appearance of the General Anti-Avoidance Standards, (Article 116, single paragraph), incorporated into the National Tax Code - NTC (Law N° 5.172/1966) through Complementary Law N° 104/2001.

The purpose of this paper is to present considerations on the General Anti-Avoidance Standards as well as on the Specific Anti-Avoidance Standards, which are already in force in the Brazilian legal system (including prior to the General Standard), to be in line on the concepts of Avoidance, Evasion, and Fraud and analyze the efficacy and applicability of said standards.

This study was fundamentally guided by bibliographical and document research, by revising and critiquing the literature on the subject, as well as an analysis of the relevant legislation, by also placing attention on the decisions on the subject in discussion. From this point, considerations will be made with the purpose of reaching conclusions on the need/ importance of a general standard of the anti-avoidance type in our country, the applicability of the general standard and the validity of disregard proceedings.

## 1. CONCEPT, ORIGINS AND PURPOSE OF ANTI-AVOIDANCE STANDARDS

In order to conceptualize anti-avoidance standards, the importance of the concepts in the law must be clarified, because said anti-avoidance standards are legal rules and as such, included in the legal system of a country.

Concepts are representations of an object of thought which general characteristics or ideas for the formulation of actions through words, definitions and characterizations[1].

To know how to conceptualize a determinate concept, the scope of the tax standards must be understood, i.e., in this manner mistakes arising from a poor interpretation of the object under study concerning conflicts coming from certain terms is avoided.

Therefore, to illustrate, the example of the nature of the non-accumulative mechanism of certain taxes is presented. This mechanism allows the taxpayer to credit the value of a tax incurred during a previous phase of the tax chain, i.e., what was debited from the taxpayer's account as tax owed will correspond to a later credit of the same value during the next stage[2]. This allows the taxpayer of this obligation to only be a debtor, in tax terms, of what influenced the value added. Why use the term *influence* instead of paid?

The answer is in the fact that in order for a taxpayer to obtain the right to tax credit it does not matter is the tax was paid or collected, save for what was truly due. The mere occurrence of the tax is enough and this already makes the taxpayer a debtor of the tax and establishes the difference between balances, debtor and credit. Many incur in a mistake when, by defining what is a non-accruable, use the word paid instead of incurring or due, without taking into consideration the meaning of such words.

Having made these considerations, the characteristics of the legal standards is examined herein.

Anti-avoidance standards are said to be legal standards. Nevertheless, what are legal standards? The teachings of Jurist Hugo B. Machado are quoted herein:

> Standards are, therefore, regulations that are hypothetical in nature and have repetitive effectiveness. They predict the behaviors to situations described on a hypothetical basis. In other words, they forecast the behaviors to be adopted in the situations described hypothetically. Some argue that standards are not only behavior predictions, because they also established the structure of certain organs, confer competence, define certain concepts, among other things, and are not limited to the prediction of behavior. This is true, however, such standards can be considered non-autonomous in the sense that they only are useful when connected with other legislation, complementing them in the regulation of behaviors[3].

The expression legal standard, therefore, defines a genre of requirements. This genre is divided into two types: rules and principles.

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1. *FERREIRA, Aurélio Buarque de Holanda. Novo Aurélio Século XXI. 3ªed. Rio de Janeiro: Nova Fronteira, 1999,p. 518.*
2. *As stipulated in the following article of the Constitution of the Republic:*
   *Art. 153, CF/88: It is the competence of the Union to establish taxes on:*
   *IV – Industrialized Products.*
   *§ 3º The tax stipulated in Roman letter paragraph IV:*
   *II – The same shall not be accumulative, compensating what is owed in each operation with an amount collected during previous terms.*
3. *MACHADO, Hugo de Brito. Introduction to the Study of Law. 3rd ed. Sao Paulo: Atlas, 2012,p.9*

On the distinction between one and the others, the definition of Humberto Ávila is used for comparison purposes:

> The definition of the principle ("Grundsatz") was developed by ESSER in 1956. For ESSER the principles, contrary to the standards (rules), do not contain direct orders, but only legal grounds, a criterion for the justification of an order. The distinction between principles and rules would not be, therefore, only based on the degree of abstraction and generality of the legal provision regarding the cases to which the same must be applied: "Qualität" is the distinction. Principles do not have directly an established linked order, but only legal grounds for the same to be determined. [...] The definitions quoted are similar inasmuch that they seek to distinguish the principles from the rules based on two criteria: degree of abstraction and generality of the legal provision, whereas the principles will be distinguished from the rules for being addressed to an indeterminate number of people and an undetermined number of circumstances, whilst the rules would be less general and will contain more specificity elements regarding behavior; and the legal grounds of validity, as from which the principles are distinguished from the rules for being deductible from the Rule of the Law, at the same time that the rules are deductible from regulatory texts. [...] It was under Anglo-Saxon tradition that the definition of principles received a decisive contribution. The purpose of DWORKIN's study was to make a general attack on positivism, especially concerning the open manner of argumentation allowed by the application of what would be defined as principles. For DWORKIN, rules are applied "all-or-nothing," in the sense that if the hypothesis of influence of a rule is complied with, or is the valid legal framework and the consequences of the legal framework must be accepted or the same is not considered valid. In the event of clashes between the rules, one of them must be considered invalid. The principles, on the other hand, do not determine a binding decision, but only contain legal grounds, which must be conjugated with other legal grounds coming from other principles. Therefore, the affirmation that the principles, contrary to the rules, have a dimension of weight, probable in the hypothesis of the clash of principles, in the event that the principle with a relatively greater weight is superimposed over the other, and, the former does not lose its validity. In this sense, the distinction developed by DWORKIN does not consist of a distinction of degree, but in a differentiation of the logic structure, based on classification criteria, instead of comparisons, as affirmed by ALEXY. ALEXY, starting from DWORKIN's considerations, further clarified the concept of principles. For ALEXY, juridical principles only consist of a type of legal standards through which optimization duties are established and are applicable in various degrees, according to regulatory and factual possibilities. Based on the jurisprudence of the German Constitutional Court, ALEXY shows the relation of tension which happens in the event of clash between principles: in this event, the solution is not solved with the immediate determination of the prevalence of one principle over another, nevertheless, it is established in function of the weight among the principles in conflict, in function of which, one of them, in determinate specific circumstances, receives the preference. Therefore, the principles, have a dimension of weight, and, do not determine the regulatory consequences directly, unlike the rules. It is only the application of the principles vis-à-vis concrete cases which are put into practice through the clash of rules. [...] Hence the definition of principles as "optimization duties" applicable in various degrees according to the regulatory and factual possibilities, because the application of the principles depends on the principles and rules that are in contradiction with the same; factual, because the content of the

principles as behavior standards can only be determined when the facts are considered. Something different happens with the rules. "On the other hand rules are standards, which may or may not be executed. When a rule is valid, then it is determined exactly what the same demands, nothing else and nothing less." Legal rules as affirmed, are standards which premises are or are not, directly complied with, and, in the event of a conflict, the contradiction will be solved, by the introduction of an exception to the rule, in order to exclude the conflict, by decreeing the invalidity of one of the rules involved. The distinction between principles and rules, according to ALEXY, cannot be based on the "all-or-nothing" means of application proposed by DWORKIN, but must be summarized, mainly in two factors: difference regarding the collision, inasmuch the principles in conflict only have their regulatory realization reciprocally limited, unlike the rules, which clash is solved with the declaration of invalidity of one of them or with the opening of an exception which excludes incompatibility; difference regarding the obligation they establish, since rules establish absolute obligations, not superseded by standards in contradiction, while principles establish prima facie obligations, as they can be overtaken or annulled in function of other principles in conflict.[4]

The presentation of the above distinction was necessary since hereinafter the principle of Tax Legality is discussed as well as its implication in the context of the integration of anti-avoidance standards in the Brazilian legal framework. The point of view of other authors can also be discussed here; however, right now the conceptualization of anti-avoidance standards is more important.

## 1.1. Anti-avoidance standards. Concept and Origins

The concept of anti-avoidance standards is inextricably related to the concepts of Fiscal Avoidance and Evasion, this is because there are authors who recognize the standards mentioned as anti-evasion standards, i.e., André Gustavo B. Leite (Atypical General Anti-Evasion Clause)[4] or even including a general anti-avoidance standard, according to Marciano S. de Godoi[6]. There is not uniform terminology, in spite of the fact of being guided by dominant doctrine on this issue[7].

Anti-avoidance Standards are authorizing commands addressed to the Tax Administration to reconstitute the elements of a tax liability as from the practical confirmation of the actions which characterize the concealment of the taxable event or the nature of the elements which constitute the tax liability.

Anti-avoidance standards are the genre formed by the Specific Anti-Avoidance Standards and the general anti-avoidance standard. The latter appeared in the Brazilian legal framework through Complementary Law 104/2001, which introduced single paragraph of Article 116 of the National Tax Code - NTC.

Specific Anti-Avoidance Standards came about even before the enactment of the general standard and, depending on the circumstances; others will continue to arise, in the NTC itself or in dispersed legislation[8].

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7. *The concepts of Fiscal Fraud, Evasion and Avoidance is discussed in detail further herein when covering the specific topic.*
8. *This is covered in Chapter 5 of this article ...*

### 1.2. Purpose

The question of where the language of the term comes from has also caused many controversies, as an example of its constitutionality and applicability. The term anti-avoidance presupposes something that fights avoidance, i.e., it should not be considered according to the single paragraph of Article 116 of the NTC by the Tax Authorities as a practice constructed as avoidance. The majority of the doctrine, however, classifies Avoidance as a legal procedure, while evasion is the practice of illegal behavior. Based only on this concept, it would be more convenient to call anti-avoidance standards anti-evasion standards, since the Tax Authorities would only have to ignore something that happened illegally – evasion – and not vice-versa, as it can be seen by reading the aforementioned article of the NTC[9]. In the same sense, Cristiano Carvalho affirms that the purpose of the single paragraph of Article 116 of the NTC was to prevent tax avoidance, and it is not difficult to verify that the legislation failed in this item, by mentioning concealment, since fiscal evasion is being discussed and not fiscal avoidance[10].

In this outpouring of ideas on the concepts of avoidance and evasion, there a very logic comprehension, which according to the author is adjusted to the terminology of the anti-avoidance standard, which comprehension was expressed by jurist Hugo B. Machado. Herein:

> However, if a difference in the meaning between these two terms is to be established, maybe it is preferable, contrary to preference of many, to use evasion to name a legal behavior and avoidance to name an illegal behavior. In fact to avoid is to eliminate or suppress and, only what exists can be eliminated or suppressed. Hence, who eliminates or suppresses a tax is acting illegally since the established tax relation is being avoided or suppressed. On the other hand, to avoid is to flee and who flees is avoiding, when the avoidance action can be preventive. Therefore, who avoids can be acting legally.[11]

The problem of the lack of standard terminology in regards to the concepts of avoidance and evasion disappear when the election of one or another concept, clarifying the sense in the sense that one or the other word is used. This paper uses the word “avoidance” to describe legal behavior and evasion for illegal procedures, as understood by the majority of the doctrine. Similarly, the term “anti-avoidance standard” is preserved because this is manner in which most authors recognize the same.

The purpose of specific Anti-Avoidance Standards is to hinder avoidance through the description of the forms of trade which practice is forbidden or which adoption includes the imposition of a tax treatment different from the one the business usually has. They are used in regards to taxes or specific situation, as shown in the following topic.

General Anti-Avoidance Standards act more broadly, stipulating for taxes in general the necessary conditions and parameters to define the main tax liability.

General Anti-Avoidance Standards are covered in depth in a specific chapter herein, where their regulation, terminology problem and the theory on which they are based is discussed.

9. *Art. 116. (...)*
   *Single Paragraph. The administrative authority may ignore legal acts or business practiced with the purpose of concealing the occurrence of the taxable event or the nature of the elements constituting the tax obligation, without detriment of the procedures established in the ordinary law. (Author’s emphasis).*
10. *CARVALHO, Cristiano. Brief Considerations on Fiscal Avoidance and Evation. In: PEIXOT, Marcelo Magalhães. Sao Paulo: Quartier Latin, 2005, pg. 65.*
11. *MACHADO, Hugo de Brito. Introduction to Tax Planning. Sao Paulo: Malheiros, 2014, p.68*

## 2. AVOIDANCE, EVASION AND FRAUD

In an increasingly globalized world, the growing competition among economic agents is already a reality and cost reduction becomes an imperative for companies to remain in the market. People feel the entire weight of the tax burden where it is hard to pass the tax burden on to third parties, because often they are the sole intended recipients or are at the end of the tax burden.

Facing this scenario, the weight of the taxes becomes the target for cost reduction, which makes taxpayers to look for alternatives that are not always legal to not pay, reduce or delay the payment of fiscal levies.

The study of alternatives seeking to achieve a tax economy is called tax or fiscal planning. This planning, as discussed, may be legal or illegal.

The concepts presented hereinafter are the minimum expression of tax planning, whether the same is conceived or implemented legally or illegally. These concepts, Avoidance, Evasion, and Fraud, the expressions in mention, may, according to each author or judgment used, may shape one or another behavior.

Not only the use and meaning of the foregoing terminologies is the object of controversies but also the same right to tax planning is so. This is because pursuant to the Constitution of the Republic[12] the free practice of any economic activity is assured as well as the company freedom is guaranteed.

On the other hand, it must be taken into consideration that Brazil is a Democratic State of the Law, and, as such, it may be understood as the States that postulates collective values and specially a one that defends social interest. The principle of Social Solidary arises here, which leads everybody to comply with the tax liabilities in the measure of their profits or possessions in order to guarantee collective wellbeing.

And, how are antagonist a priori principles conciliated? How to conciliate the principle of economic freedom where each person is entitled to in order to organize their businesses in the manner they deem convenient or under its corollary, the principle of fiscal freedom (private autonomy), with the principles of solidarity and taxpaying capacity? Better said: Where should individual freedom go without denying the participation in public positions?

On the principle of the taxpaying capacity, Robert W. Lima states that this principle prevents the tax duty applied from being greater than taxable event. Mr. Lima affirms that the parameter to allow the evaluation of the reasonable connection between the taxable event and the corresponding amount of the tax duty, shall be determined if the amount paid by the taxpayer is in the correct measure (cannot be greater or lesser) of their possibilities, taking into consideration that it is the duty of everyone to contribute towards the financing of public expenditure in the measure of their economic capacities. For the author this means that who can pay more, because it is possible for them to pay more, must always pay more (prohibiting any excuse using fiscal options [without negotiation] to pay less than what can

12. *CF/88 , Art. 170 The economic order, funded on the valuation of the work and free initiative, has as a purpose to assure all a dignified existence, according to the judgements of social justice, observed in the following principles:*
   ............
   *Single paragraph. The free practice of any economic activity is guaranteed, regardless of the authorization of the public organs, except in the cases stipulated in the law.*

be cost-effectively paid) and those who cannot pay, because it is not possible for them to pay, they must pay what they can[13].

There is principle that has a harmonization role of the constitutional objectives foreseen the principles of fiscal freedom and taxpaying capacity. The principle of proportionality, principle of law as well as the principle of the interpretation of the law regulate and harmonize conflicts in the application and protection of rights and guarantees.

In a clear and asserted version on the issue, Roberto Wagner L. Moreira states that in a society of risks, such as ours, where the State is responsible of complying with the various obligations which arise from a vast catalogue of fundamental principles (Article 5 of the CF/88) and limited public resources, the principle of proportionality arises as a regulating and harmonizing principle of conflicts[14].

## 2.1. Avoidance and evasion

Many renowned authors confuse the meaning of avoidance with the concept of tax planning. The fact is that this concept covers avoidance, taking into consideration that this is a species of the genre of the former. Not only the activity for which the planning is formed, but the result of the activity may be legal or illegal as well.

Here is where the great difference between the concepts of tax avoidance and evasion rest. As mentioned, there is no uniform terminology, although many consider avoidance as a legal procedure and evasion as illegal. The discussion on if it is legal or not accentuates even more the discussion since there is a thin line between both since what can be considered legitimate for not being stipulated in the law as such, may be considered legal for having, according to the understanding of some, an abuse to the right of practicing an economic activity related to tax saving.

This a dry subject and challenging at the same time, the forms in which tax planning can be practiced awaken the most diverse opinions and doctrines, leading the expert reader of the subject to the conclusion that only in this specific case, the situation is more clear and that this is an indication of more authorized opinions.

In this paper the concept of avoidance, according to the preference of many, means the legal procedure which purpose is to save taxes and evasion as it antonym. Various studies adopt the concepts of avoidance and evasion that are associated with the temporary taxable event of the tax liability, and these concepts are presented herein to finally analyze the same at the end.

André Luiz C. Estrella proposes in regards to the moment of the occurrence of avoidance, if the action practiced by the taxpayer to avoid, delay or reduce the payment of a tax is practiced prior to the occurrence of the taxable event, there would be fiscal evasion and avoidance. On the other hand, if it is practiced after the occurrence of the taxable event, the phenomenon is fiscal fraud. The author also quotes Ricardo Lobo Torres[15] as also associated to this idea.

Similarly, Celio Armando Janczeski states that the distinction between avoidance and evasion cannot only be based on the voluntary elements mentioned herein since in both concepts the intentions and the purposes are identical. He also highlights the fact that if the subjective nature is excluded, the objective criteria affirms the distinction when using the means to avoid, reduce or delay the payment of the tax, i.e., if the

13. *NOGUEIRA, Roberto Wagner Lima. Ethical and Juridical Limits for Tax Planning. In: PEIXOTO, Marcelo Magalhães. Tax Planning. Sao Paulo: Quartier Latin, 2004, pp.43-44.*
14. *Ibid., p.47*
15. *ESTRELLA, André Luiz Carvalho, op. cit., p. 106.*

actions practiced by taxpayers prior to or after the occurrence of the taxable event, it would still be considered avoidance or evasion, respectively. In this comment, the author quotes the position with the doctrine of Rubens Gomes de Souza, the great academic of the NTC.[16]

Another author who made a contribution to the definition of concepts related to avoidance and evasion was Pedro Anan Jr., for who the difference between avoidance and evasion is in the fact that avoidance looks for a legal way, the reduction of the tax burden through operations allowed or not prohibited by law, having as a main characteristic, as he indicates, the occurrence of the behavior prior to the taxable event. The author in reference defines evasion as an illegal or fraudulent behavior where the taxpayer carries out operations contrary to the law, which take place after the taxable event, trying to conceal the true intention of the contracting parties[17].

Therefore, as seen, the foregoing concepts distinguish between one and another concept due to the temporary aspect of the tax liability.

The great temporary framework, the occurrence of the taxable event, the first primitive division of the realm of legality is an outdated. There are various legal possibilities to reduce the tax burden (in an ample sense) after the occurrence of the taxable event, as the so called judicial tax planning through a fiscal litigation, the use of fiscal benefits, the use of the voluntary complaint institution and many other examples. Being important to affirm that there are certain behaviors, prior to the taxable event of the tax liability, which show illegal behaviors, i.e., the issue of a fraudulent invoice, prior to the departure of the goods from the commercial establishment.

The truth is that the avoidance mechanism operates in the following manner: the taxpayer looks for another form to disclose the desired economic result, taking advantage of the legal possibility of using valid alternatives. The means are legal and adequate to the acts carried out, that is, there is a correlation between the firm of the act and its contents, where there is no serious or hidden distortion of the legal reality.

This means, that since there are various possibilities to formalize a specific business, the taxpayer, attentive to tax standards, chooses the one that is most convenient to it within the existing legal alternatives. The taxpayer is free to analyze the tax legislation and search for gaps and failures, to take advantage of the same and reduce its tax burden.

Evasion, from the juridical standpoint is an expression of frequent use with the same meaning of fiscal fraud, since in both cases the final objective is to pay less taxes than those corresponding thereto, because where there is deliberate bad faith and there are actions or a series of acts marked by simulation, concealment and dishonesty.

There are two types of fiscal evasion: simple and qualified. Simple is when the lack of payment of the tax owed, declared by the taxpayer. There is no resulting fraud or malice from this type. Fiscal documents, for example, are issued regularly and are duly recorded, where the tax calculated and owed by taxpayer, informed to the Tax Authorities, but not collected, while qualified evasion states the total or partial lack of payment of the tax, which value is not duly declared by the taxpayer, having to then be calculated ex officio by the Tax Authorities. This behavior is deliberate and fraudulent

16. *JANCZESKI, Celio Armando. Anti-Avoidance Clause in light of the Interpretation of the Tax Law. Sao Paulo: Quartier Latin, 2004, p.183.*
17. *ANAN JR, Pedro. Remuneration of Partners and Shareholders and Fiscal Planning. In: ANAN JR, Pedro (Coord.). Fiscal Planning. Sao Paulo: Quartier Latin, 2005, p.304.*

and involves the use of legal means to avoid, eliminate or delay the payment or collection of the tax owed.

In general, qualified evasion involves committing penal crimes such as the tweaking of books and documents (public and private), preparing and filing false returns, document falsification, ideological falsification, misappropriation of funds, etc. This evasion modality comes from the informal, illegal or concealed economy.

### 2.2. Avoidance

What is Avoidance? Some renowned scholars do not even approach the subject, taking into consideration that it is a poorly widespread phenomenon, and, where the terminology used does not find uniformity on what this novel phenomenon should include.

Avoidance, as a phenomenon ascribed to the economy of taxes, would be between what is legal and illegal. It would be in the middle of the road between the legitimate tax economy and concealment. Actions practices are not covered, however, the applicable legislation would have a "scheme," with less common, atypical uses, which objective is to pay less, not pay or delay the payment of the tax. Habría, por así decirlo, una violación indirecta de la norma tributaria.

It is also called contrived avoidance, avoidance, as the set of behaviors whereby the taxpayer seeks to avoid the cause of the tax standard through contrived and distorted juridical forms, appear as a third field of action, in addition to fiscal avoidance and evasion. In effect, to avoid is defined as avoiding or eluding with skill; refuse with skill and guile.[18]

On the subject, Marciano Seabra de Godoi, affirms:

> In Brazil, most of the current tax experts still deny to admit the existence of a third field distinctive from tax avoidance and evasion. Hence, unlike other countries there is not term or expression in Brazilian doctrine to describe the phenomenon which is defined in tax evasion study. In a study published in 2001, declared that "maybe it is time to differentiate tax avoidance from tax evasion (...) a type of planning that is not adequately simulated or duly avoided." Heleno Torres recently published a paper which uses exactly the expression of tax avoidance to name the set of action which differentiate avoidance from evasion.[19]

The abuse of the forms, the lack of commercial purpose and the indirect legal business may be framed as avoidance phenomena.

As an example, it must be simply clarified, without the intention of further analysis, the form in which these avoidance figures.

### 2.3. Concepts Involving Fiscal Crime

On the subject of the institutions which gravitate around fiscal crime, the concepts of simulation, concealment, abuse of the law and the forms, indirect business and tax or fiscal fraud. First of all, however, it is necessary to clarify what is fiscal crime.

In terms of fiscal crime, jurist Hugo de Brito Machado already clarified well its meaning by affirming is broad concept, which includes fraud, that is, the concealment or alteration of the facts (falsehood o modification of the fact as an element of the phenomenal world with the purpose of eliminating or reducing taxes), and, the error of the law, understood as the situation where the law was not abided by the taxpayer, because the taxpayer construed it erroneously.

18. *FERREIRA, Aurélio Buarque de Holanda, op.cit., p.730.*
19. *GODOI, Marciano Seabra. A proposal for the understanding and control of the limits of fiscal avoidance in Brazilian Law. Case Studies. In.: YAMASHITA, Douglas (Coord.) Tax Planning in light of Jurisprudence. Sao Paulo: Lex Editor, 2007, p. 241-242.*

The noble jurist complements that the error of the law, although it is an illegal behavior in the ample sense, does not constitute fraud, because the error of the law does not constitute a crime against the tax order precisely because it is not due to willful misconduct – this is an essential element for the constitution of fraud and abuse of rights. [20]

The legal concept of simulation is stipulated in the Civil Code in Article 167 [21]. Therefore, according to the foregoing article, simulation occurs when you want to believe in something that does not exist o did not exist. It is to pretend what is not. Concealment or relative simulation is the contrary. This seeks to hide, conceal something. According to Andrea N. Neves y Priscilla F. Rocha Leite, simulation and concealment are interconnected concepts, related and co-existing. While simulation is the act, concealment is the effect hidden by simulation, a consequence of the same. That is, whoever simulates conceals up to the real will, by hiding the same. [22]

Fiscal fraud has a positive meaning stipulated in Law Nº 4.502/64, art. 72. Transcribed as follows:

Art. 72 Fraud is any intentional act or omission directed towards hindering or delaying, totally or partially, the occurrence of the taxable event of the main tax liability, or to exclude or modify its essential characteristics, in order to reduce the amount of tax owed, or to avoid or delay payment.

The foregoing concept is criticized by great prestigious scholars due to the inadequate use of the terminology[23] or because its application supposes an ample subjective nature[24]. The author of this paper agrees the foregoing authors regarding the critiques to the concept of fiscal fraud stipulated by the mentioned law, because, if there is an action, carried out by the taxpayer, even deliberate, directed towards avoiding the occurrence of the taxable event, and if this action is illegal, what can be qualified as fraud? This concept, given by law, still it must be fully discussed due to its controversial nature.

Ricardo Lobo Torres explains the difference between defrauding the law and fraud against the law: “criminal fraud cannot be confused with fraud contra legem, which is a form of evasion and fraus legis, which is the abusive form of avoidance (Article 116, single paragraph of the NTC, and article 166, VI, of the CC).” [25]

The theory of the abuse of the law is based on the poor use of the law, which is explained as follows. The abuse of the law does not mean an illegal behavior properly stated, but legally formal. These are behaviors that are not adjusted to the law due to reasons of justice or equality. The abuse of the law is based on Article 187 of the Civil Code [26]. Due to this theory, due to the manner in which the right was exercised, what was legal became illegal. The legality took place when the right was exercised (legally).

*20. MACHADO, Hugo de Brito, 2014, op. cit., p. 119..*

*21. Art. 167. The legal business simulated is null, however, what was simulated subsists, if valid in form and substance.*
*§ 1o There is simulation in legal business when:*
*I – when apparently rights are conferred or transferred to persons other than those to which are truly conferred or transferred;*
*II – include an untruthful declaration, confession, condition or clause;*
*III – Predated or postdated individual instruments.*
*§ 2o Goodwill third parties rights are excluded regarding the parties of the simulated legal business..*

*22. NEVES, Andrea Nogueira, LEITE, Priscila Farisco Rocha. The Validity of Complementary Law n° 104/01 in the Brazilian Tax Legal Framework - Correlative effect in the scope of Fiscal Planning. In: ANAN JUNIOR, Pedro. Fiscal Planning. Sao Paulo: Quartier Latin, 2004, p. 38-39.*

*23. MACHADO, Hugo de Brito, 2014, op. cit., p. 77.*

*24. TORRES, Heleno Taveira. Sanctioning Tax Law and the Constitutional Guarantee. In: ROCHA, Valdir de Oliveira. Great Current Issues of Tax Law. 19ºvol. Sao Paulo: Dialética, 2015, p. 12325.*

*25. TORRES, Ricardo Lobo. Tax Planning. Abusive fiscal avoidance and evasion. Rio de Janeiro: Elsevier, 2013, p. 128.*

*26. Art. 187 The holder of a right also commits an illegal act, which when practiced, noticeably exceeds the limits imposed by its economic or social purpose, due to goodwill or decency.*

Professor Klaus Tipke, quoted by André L. Carvalho Estrella, was one of the great proponents of this theory and defended citizens by stating that citizens can in effect organize their lives as they deem convenient, however, if there is an abuse of this right, stipulated in the practice of irregular business, for this State the right to not take into consideration abusive practices and reclassify the same would be born, all this based in the principles of tax equality, payment capacity and solidarity[27]. The school of thought of this doctrine opposes the other, a more traditional one, headed by Alberto Xavier, for who the duty of paying taxes exists, but the duty of paying more taxes among several legal alternatives offered by the legal framework does not exist.

The theory of the abuse of the form is a result of the development of the theory of the economic interpretation of the taxable event. A brief comment on the theory of the economic interpretation[28], the same suggests that the businesses practiced by the taxpayer of the tax liability be construed and levied according to the economic purpose and not by the legal form they are invested with. Brazil has one of the main defenders of this theory, Amílcar de Araújo Falcão as well as its most stern critic, Gaucho (from Southern Brazil) Alfredo Augusto Becker. The theory of abuse of the form states that the forms whereby the legal business must be practiced are the common one, and, the person applying the standard must evaluate these forms as to their normality. Nevertheless, who is going to decide which?

The theories of the abuse of the forms and economic interpretation of the taxable event face the requalification of the actions carried out by the taxpayer. Curiously, the abuse of the forms, as an element for the lack of knowledge of the juridical act or business was stipulated in Article 14, § 1 of the Temporary Measure 66/2002. It was precisely this article, along with articles 13 to 19 of the mentioned law, were not validated, therefore, were not included in the conversion of the provisional measure into Law N° 10.637/2002.

André Luiz C. Estrella critiques this theory:

> Traditional authors ask: Up to what point can the Tax Administration consider abusive the legal form adopted in an operation, if the means used is perfectly allowed by law? Which is the logic criteria and purpose of not taking into consideration the “atypical” or “more common” form for the business? This theory places the right in a straightjacket. The business world, and this also includes Public Administration, have dynamics as their main characteristic. To say that it is abusive or not, compromises the interpreter to subjectivism without measures. The form of purchase and sale to transfer a property to a corporation cannot be imposed on a businessperson, affecting the transfer tax, instead of using the incorporation of the assets to equity of the body corporate in the realization of capital, not affecting the tax (Article 156 , § 2, letter paragraph I, of the CF/88). Attitudes of this type lead to authoritarianism of the forms, since it restricts free initiative, establishing a stalled and uniform regulation. The Democratic State of the Law does not include theories of this magnitude, although it questions everything in classic doctrine[29].

In this manner the author refers to those who criticized the use of this theory as the lack of grounds of the juridical acts or businesses by the administrative authority, which caused, as stated, in the non-approval of the devices stipulated to insert the abuse of forms in the juridical framework.

27. *ESTRELLA, André Luiz Carvalho, op.cit., p.124.*
28. *Further in detail comments in the following chapter.*
29. *ESTRELLLA, André Luís Carvalho, op. cit., p. 123.*

Indirect juridical business or indirect tax planning means to file a juridical relation between the objective, that is, the taxpayer wishes to obtain an economic result without incurring in field of influence of a more onerous fiscal standard, although this foresees a simpler means of achieving the same purpose.

The taxpayer's behavior does not go against the tax standard because there is an election of another form, another way, perhaps more tortuous and complex. This election is done by taking advantage of an accessory tax liability.

It is important to highlight that the indirect juridical business is not similar to simulation, because there is no disagreement between the real and declared will. According to Julio M. de Oliveira y Renata C. Antonio, quoting the position of Federal Judge Diva Malerbi, in the indirect juridical business there is only a misalignment among the means which serve the parties to achieve certain economic results and the scopes sought with such business. The Judge highlights that the means and the scopes seem always to be compatible amongst themselves[30].

The lack of purpose of the business is a theory that originates in Anglo-Saxon countries and directly corresponds to the economic interpretation of the taxable event. According to the theory of lack of purpose of the business, juridical business which sole purpose is tax savings, that is, they lack a different basis, i.e., corporate reorganization or any other commercial purpose may not be taken into consideration by the fiscal authorities, since the substance of the facts should be overlaid on the adopted juridical form.

## 3. GENERAL ANTI-AVOIDANCE STANDARDS

The introduction of a General Anti-Avoidance Standards in the Brazilian legal framework took place, as seen, with Complementary Law Nº 104/2001, which modified the National Tax Code by means of the single paragraph of Article 116.

The objective of said standard was to reclassify the act intended to conceal the taxable event of the tax or the nature of the elements which form part of the tax liability.

If the single paragraph of Article 116 of the NTC is compared to Articles 113 to 115 of the NTC, it is easy to see that the standard can only be in force if the taxable event has taken place and if the concealment of this fact took place or the nature of the elements which are part of the obligation, an obligation which has at its core the taxable event. Up to there the contents of the single paragraph of Article 116 of the NTC does not seem plagued by any vices concerning the unconstitutionality since, with the exception of the cases stipulated by the law (the establishment of fiscal benefits, voluntary complaint, etc.) if the taxable event takes place, evasion occurs.

The device of the standard foresees its regulation by means of ordinary law; the federal government issued a temporary measure 66/2002 which in its articles 13-19, broadened the possibilities of exclusion by including in its text the mechanisms of lack of commercial purpose and the abuse of the forms.

These mechanisms, in the opinion of many fiscal experts, do not exist in our legal framework. It was precisely, these devices that broadened the possibility of exclusion were not turned into law.

30. *OLIVEIRA, Julio, ANTONIO, Renata. Tax planning in respect of the anti-avoidance standard. In: PEIXOTO, Marcelo Magalhães. Tax Planning. Sao Paulo: Quartier Latin, 2004, pg. 350.*

Lately in the context of not only accounting, but mainly in tax law, the appearance of debates on the supremacy of the substance of the facts over the form is seen. The General Anti-Avoidance Standards would be the instrument; therefore, it would reclassify the act, with the purpose of connecting their contents with the design of their taxable event.

However, the form in which this reclassification would take place is not what has generated controversy, inasmuch that it would relegate certain principles stipulated in the Federal Constitution:

> It is affirmed that depending on the interpretation given to the general anti-avoidance standard, included in single paragraph of Art. 116 of the NTC, said standard must be considered unconstitutional or useless. The unconstitutionality if it is construed to underestimate the principle of tax legality. Useless if it is construed within the limits of this principle, because even without the same the Tax Administration has already disregarded a series of acts or legal businesses because it understands that they were practiced by abusing the law, and the courts have supported this point of view in all cases in which it considers that an abuse to the law has taken place[31].

One of the cannons of the Constitution of the Republic is the principle that nobody can be forced to do or refrain from doing something. But by virtue of the law (Article 5º, I CF/88). This command has its corresponding vector in the National Tax System in Article 150, I, which stipulated that without detriment to other guarantees assured by the taxpayer; the Union, the States and the Federal Districts and municipalities are forbidden from levying or increasing the tax for anyone without a law stipulating the same.

The foregoing principle, known as Tax Legality, is addressed to who applied the standard and constitutes one of the best guarantees used by taxpayers against the State tax. The defendants of the theory of the economic interpretation of the taxable event, however, relativize this principle by making a counterpoint with the principles of payment capacity and equality in tax issues.

In the vision of scholar Hugo de Brito Machado, the principle of legality cannot be relativized because it is also a rule. A rule which already has a close structure, not admitting relativity and principle due to its fundamental nature, given its enormous importance in the entire juridical system[32].

As presented in this paper, as presented in this manner, without regulation, the Complementary Law - LC 104/2001 brought a fiscal evasion control mechanism. However, if the anti-avoidance standard is applied to LC 104/2001, it allows the modification of the regulation in these terms, it would be implementing the economic interpretation of the taxable event with the purpose of characterizing the taxable event taxes in tax law, this theory has not been accepted in our legal framework.

The economic interpretation of the taxable event is a theory originated in Germany; one year after the First World War, after being disseminated by Enno Becker, and its objective was to pursue the economic importance of tax laws, based on the principles of equality and paying capacity. It is also known as the theory of the predominance of the economic content (substance) of the facts.

Ricardo Lobo Torres, on his part, defends a position that is contrary to the previously indicated understanding. The author uses the terms legal and abusive avoidance, separates the term pure evasion in tax savings and illegal evasion and advocates for the use of the

31. *MACHADO, Hugo de Brito, 2014, op. cit., pg. 130.*
32. *Id. General Theory on Tax Law. Sao Paulo: Malheiros, 2015, p.75.*

General Anti-Avoidance Standards by the Tax Administration when an abuse occurs when reclassifying the fact in the tax standard, where the administration has to correct this by means of reclassification; the reclassification of the act according to the correct interpretation of the rule of influence[33]. The author, however, did not indicate that this would be the correct interpretation.

In the opinion of the author of this paper, the Tax Authority allows legal tax planning in evasion cases, as already defined here. The economic interpretation, by reclassifying the act or juridical business, stumbles upon the principles of legality (Article 150, I, CF/88), freedom of choice and freedom of contracting (Article 170, CF/88) as well as the rule which prohibits taxation by analogy (Article 108, NTC).

## 4. ON THE ENFORCEMENT, EFFICACY AND APPLICABILITY

### 4.1. About the Concepts

The existence of a law refers to its inclusion in the legal framework by the competent authority. In the Brazilian case, the law exists when it is published. Then the analysis of its validity follows, which may be considered from formal and material standpoint. When a law is drafted by the competent authority, it is said that is formally valid. If its contents are in agreement with the higher hierarchic rule, it is said to be materially valid.

Enforcement is another conceptual aspect. It is about the capacity to influence or provide juridical importance to the facts contained in the same. On the other hand, effectiveness is the capacity of producing effects in the world of facts, while the fact of being applicable or not refers to the imposition of one person over another to comply with the standard.

### 4.2 Situation of the text included by Complementary Law 104/2001

The General Anti-Avoidance Standards depends on the ordinary to produce effects. While said law is not amended, the standard in mention lacks efficacy and applicability. As a parameter, herein is the classification of José A. da Silva, quoted by Alexandre de Moraes, on the applicability of the constitutional standard son full, limited and controlled efficacy:

> Constitutional standards of full efficacy are those which, from the enforcement of the Constitution, produce or have the possibility of producing, all essential effects. Regarding the interests, behaviors and situation, which the constitution legislator, directly or standard-wise wishes to rule. Constitutional standards of contained efficacy are those which the legislator sufficiently ruled the interests with regards to a determinate matter, however, left a margin for a restrictive action by the discretion of public power, in the terms stipulated by law or in the terms of the general concepts enunciated in the same. (...) Finally, constitutional standards of limited efficacy are those which present an indirect, mediate and reduced applicability, because they only have total influence on these interests, after a further legal framework is developed for their applicability[34].

Taking as a parameter the foregoing classification, the anti-avoidance standard is a standard with limited efficacy, this standards opens the way for the interpreter, which must give more importance to the substance than to the form.

33. *TORRES, Ricardo Lobo, op.cit., p.25.*
34. *MORAES, Alexandre. Constitutional Law. Sao Paulo: Atlas, 2008, p. 12.*

## 5. ABOUT THE OTHER ANTI-AVOIDANCE STANDARDS

On the basis of what has already been stated in this paper, anti-avoidance standards of a specific nature already existed in our legal framework, even before the issuing of a General Anti-Avoidance Standard.

Corroborating the understanding already presented here by scholar Hugo de B. Machado, even without the referred general standard, the Tax Authorities already are paying no heed to allegedly elusive practices, even with the approval of the Judicial Branch (see Note No.33).

Complementary Law No. 104/2001, same that included the single paragraph in article116 of the NTC, also added to article 43 of the same code, the first paragraph, known as the income tax anti-avoidance standard. Namely:

> Article 43 The income tax and the capital gains tax of any nature are the competence of the Union, having as taxable event the economic or juridical acquisition of availability:
> I – Income tax, understood as the product of capital, work or a combination of both;
> II – Capital gains tax of any nature, understood as equity increases not contained in the foregoing letter paragraph.
> § 1º The influence of the tax depends on the designation of revenue or performance, of the location, juridical situation or nationality of the source, the origin and the form of collection.

As may be deduced by reading said device, the old understanding of territoriality of taxation was abandoned, and “closing the circle” was sought by imposing taxes on all income or revenues, independently of where the same had been earned.

This standard was the result of a consolidation of other devices transmitted in the disperse legislation, for example, Law No. 7.450/85, article 51 and Law No. 7.713/88, article 3º, § 4º.

Another device of the law that may be counted as a specific anti-avoidance standard is Decree-Law No. 1.598/77, which regulated the concealed profit distribution.

In Article 60 of this standard, the Tax Authorities use a technique called legal presumption. In the opinion of Paulo Cesar R. Vaz., the use of this remedy is used to define situations whose tax treatment is attempted to be defined in a clear and objective manner, that is to say, the goal would be to avoid a privileged tax treatment granted to a specific legal situation, so that the same is detoured through the tax planning practice. [35]

> Article 60 Concealed profit distribution in the business is presumed when the body corporate:
> I – sells for a noticeable lesser market value a good of its property to a related person;
> II – purchases at a noticeably higher market value a good of a related person;
> III – losses as a result of the non-exercise of the right to purchase, a good and profit of a related person, a sample, escrow or amount paid for the purchase option;
> IV – the part of active monetary variations (Article 18) which exceeds passive monetary variations (Article 18, single paragraph). (Wording of Decree Law Nº 2.064, of 1983);
> V – lends money to a related person, if on the date of the loan it has accumulated profits or profit reserves;

35. *VAZ, Paulo Cesar Rubisca, op.cit., p.285*

VI – pays to a related person rents, royalties or technical assistance for an amount which notoriously exceeds the market value;
VII – carries out with a related person any other business under favorable conditions, understood as more advantageous for the related person than those prevalent in the market o where the body corporate would contract with third parties; (Included by Decree Law N° 2065, 1983);
§ 1º The provisions of item V are not applied to the operation of financial institutions, insurance and capitalization companies and other bodies corporate, which purpose are activities which contain mutually beneficial operation or the extension of credit, if carried out under the conditions prevailing in the market or, when the body corporate contracts third parties. (Wording of Decree Law Nº 2065, 1983);
§ 2º - The test that the business was carried put in the interest of the body corporation and under strictly accumulative conditions of where the body corporate contracts with third parties, excluding the presumption of the concealment of profit distribution.

In the author's opinion, this remedy shall be valid as long as the presumption is not absolute (jure et de jure). In fact, the legal presumption shall have to admit evidence to the contrary, as there must be the option of rebuttal by the taxpayer who sees an act that is practiced and subsumed, in the opinion of the Tax Authorities, to a standard that rates a behavior. As an example, mention can be made of the legal presumption of a credit balance in the Cash account (article 281, I of the RIR – Tax regulations), signifying, according to legal provisions, omission of income. The taxpayer must be assured of the contrary, being up to the taxpayer to rebut or not the statement that there has been undeclared income (the legal presumption inverts the burden of proof).

### 5.1. Jurisprudence related to the topic

In this point, there are some administrative decisions that establish jurisprudence, both from CARF – Tax Remedies Administrative Council, which can be mentioned, with a merely illustrative purpose, which show the evolution, apologizing for the expression, in the understanding of the application of the anti-avoidance standards and figures related to tax planning.

In first place, it is the case of a corporate reorganization, by succession, where an unprofitable company incorporates another one with a surplus.

**Summary(ies)**
ATYPICAL INCORPORATION – INDIRECT LEGAL BUSINESS – RELATIVE SIMULATION – The incorporation of the Company with a surplus for another unprofitable, although not unusual, it is not prohibited by law, representing an indirect legal business, inasmuch that, underlying the juridical reality, there is an unrevealed economic reality. In order for juridical acts to produce avoidance effects, in addition to having a nature prior to the occurrence of the taxable event, it is necessary to legally have a form, not including in the same the relative simulation hypothesis, configured regarding the data and the facts in the process of rendering accounts.
EVIDENT INTENT TO COMMIT FRAUD – The evidence of willful intent, required by the law to increase a fine imposed, must necessarily come from procedural accounts, having to be unquestionable and fully proven. Compliance of all the requests of the Fiscal Authorities and compliance with corporate legislation, with the dissemination and registry of the competent public entities, including compliance with due formalities before the Federal Revenue Secretariat, denote the

intent of obtaining tax savings, through allegedly avoidance means, however, do not denote bad faith inherent to the practice of fraudulent acts.
FINE - SUCCESSION – The purchasing corporation, as successor, is responsible for the tax owed by the incorporated corporation, not being responsible for fines applied after this date and the resulting sanctions previously carried out by the successor (NTC, article 132).

(Published in D.O.U. of 28/11/02). Sentence 103-21.047 (Issued on 16/10/2002)

In this last case, there was a partial division of the company, with responsibility for the businesses, in the succeeded company, taken over by the former partner.

**Summary(ies)**
NULLITY – NON-EXISTENCE – FISCAL PROCEDURE MANDATE – EXTENSION – ELECTRONIC REGISTRY IN INTERNET – The extension of the MPF in light of the provisions of Article 13 of Decree 3007/2001, takes place through electronic registry, available in the Internet.
IRPJ – CSL – INCORPORATION OF A COMPANY UNDER FALSE PRETENSES – LACK OF KNOWLEDGE OF THE SERVICES ALLEGEDLY RENDERED – QUALIFIED FINE – NEED OF RECONSTITUTION OF TRUE EFFECTS – Having proven the factual impossibility of the rendering of services by a Company owned by the same partners, given the non-existence of the operational structure, being characterized the falsehood of the operations, which purpose was to reduce the tax burden of the applicant through the taxation of the relevant portion of their results for the foreseen profits, in the alleged service provider. Hence, the corresponding expenses should not be taken into consideration. However, if false operations take place, the Company which allegedly rendered the services in effect paid the taxes, although various taxes, the true material must be restored, compensating all taxes already collected.
IRPJ – CSL – PIS – COFINS – CASH CREDIT BALANCE – This is not the case of loans coming from partners or managers, but the existence of the same without adequate evidence, the dismissal of the charges deducted would be the correct procedure. The option of the fiscal authorities is to correct such amounts in the cash account, with the purpose of determining the credit balance, having to do so for income as well as for loan payments.
Voluntary remedy partially contributed.
Nº Sentence: 101-95208 Tax / Materia: IRPJ - AF- omission of revenue – other legal presumptions. Publication Date: 19/10/2005

## 6. CONCLUSIONS

Taking into account what has been explained throughout this text, it may be concluded, in sum, that:

a. the concepts have their importance acknowledged in the measure that, when dealing with legal language, utmost care must be applied with the words, give the theory, while the systemized set of concepts assumes a very significant degree under the Law;

b. there is no uniformity in the terms when dealing with the concepts of avoidance, evasion and fiscal fraud. Likewise, there is a lack of a uniform understanding when dealing with the concepts of avoidance, evasion and fiscal fraud. There is also no uniform understanding when dealing with the very concept of tax planning. However, this difficulty disappears when a conceptual position is assumed from the beginning, when the discussion involves tax planning, which may designate the planning activity and the very results of the same;

c. the proportionality principle arises as a harmonizing principle for the free economic initiative and legal certainty principles, on the one hand, and the principles of tax equality and tax-paying capacity, on the other. The must be, in each case, weighting between the conflicting principles;

d. tax planning, understood as a prior study of alternatives, legal or illegal, aimed at achieving savings from the tax point of view, includes the concepts of avoidance, evasion and fiscal fraud;

e. the difference between the avoidance and fiscal evasion concepts must no longer be sought by means of the moment of the occurrence of the taxable event, but rather through the use of legal or illegal procedures in the search for a lesser tax burden;

f. presented as it is, the anti-avoidance standard of the sole paragraph of article 116 of the NTC, includes, as an essential element for the practice of exclusion of the acts, the presence of concealment, principle that characterizes tax evasion, and not avoidance. What the failed regulation attempt achieved was the insertion of new figures that bear no relation to the elusive practices and are not accepted by the Brazilian legal framework as an abuse of forms and the reason for commercial purpose;

g. the so-called General Anti-Avoidance Standards is a standard in force, but with limited efficacy since it depends on the enactment of the ordinary law so that it may sufficiently regulate the interests contained therein. However, even without regulation, the administrative courts have been used with elusive concepts with the purpose of not taking into account the acts or businesses of the taxpayer;

h. the Specific Anti-Avoidance Standards are characterized by setting its sights on taxes and specific situations, and use, quite often, legal presumptions, mechanisms whose purposes are to characterize or carry out positive acts, facts or situations that fit into the legal frameworks.

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# SPANISH TAX FRAMEWORK AND INTERNATIONAL TAX PLANNING FOR RESEARCH, DEVELOPMENT AND TECHNOLOGICAL INNOVATION ACTIVITIES

**Laura Pastor Arranz**


## SYNOPSIS

The promotion of corporate innovation is essential to economic growth, increased competitiveness, and the development and well-being of Nations. Aware of this reality, Governments have established policies to support Research, Development and Technological Innovation (RDI) activities through direct assistance, bonuses and tax incentives.

This paper analyzes the way in which the Spanish tax regulations support these activities. Likewise, from the standpoint of comparative law, the measures adopted by other jurisdictions to support RDI will be analyzed, without disregarding the effects on international taxation.


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In a context of economic globalization, companies consider as fundamental to invest and spend in Research, Development and Technology Innovation activities, (RDI), to modernize the productive sector and improve its competitiveness. Obviously, to carry out successfully this project, companies must not only rely on the availability of skilled workers, infrastructure, legal protection and legal certainty but also, similarly, will consider how to maximize their profits. A way of achieving these benefits is to reduce costs, via subsidies or tax incentives.

At the same time, States, knowing that the referred activities play an essential role in social welfare, increasing the productivity and economic growth of the country, have developed policies for attracting and promoting these activities, emphasizing the tax policies. Recent studies conclude that the developed countries most resilient to economic crises often coincide with those having the most intensive RDI activities.

It is important to underscore the efforts made at supranational level, to unify the terms of RDI in order to converge in a general framework that enables measurements and comparisons, which will eliminate the legal uncertainty at the time of welcoming the measures adopted by the authorities to promote these activities. To do this, although an absolute consensus could not be reached, most countries uses methodological manuals prepared by the OECD. Among them, the Frascati Manual[1], sustains that the concept of R&D encompasses basic research, applied research and experimental development. Through negative delimitation, it establishes which related activities do not belong to R&D. In addition, the Oslo Manual[2] defines the technological innovation and distinguishes between four types of innovations that include a wide range of changes in the activities of companies: product innovations (changes of characteristics of the goods or services); process innovations (significant changes in methods of production and distribution), organizational innovations (new methods of organization) and marketing innovations (implementation of new methods of marketing). They all involve a degree of novelty in the company as a minimum requirement for innovation.

Precisely, defining the concepts of RDI let us determine what instruments provided by the different Governments are instituted as more beneficial for promoting the entrepreneurial innovation. In this sense, tax incentives in the form of exemptions, reductions in the taxable or payable base, reduced tax rates, bonifications and tax deductions are highlighted.

As a result, once materialized this general scenario about the significance of RDI activities and the importance to promote them, in this work, I will try to provide reflections on the matter and refer to initiatives from different countries, from the OECD and the European Union.

1. *OECD (2015). Frascati Manual - 2015 Edition. Guidelines for Collecting and Reporting Data on Research and Experimental Development. OECD Publishing. Paris.*
2. *OECD and Eurostat (2005). Oslo Manual: Guidelines for Collecting and Interpreting Innovation Data, 3rd Edition, The Measurement of Scientific and Technological Activities. OECD Publishing. Paris. pp.23-24.*

To introduce the topic, I will analyze the Spanish tax framework that favors carrying out activities of RDI, and next compare them with measures approved by others countries. Also, in the third section, we will study the idiosyncrasies of international taxation in this matter and the instruments to articulate an optimal tax planning from the Spanish perspective.

## 1. SPANISH TAX FRAMEWORK

Prior to the analysis of the tax normative regulating the topic, it must be noted that, as indicated by the Central Economic Administrative Court and the National Audience, given the difficulty for the conceptualization of research, development and technological innovation activities, we should use the criteria established by the OECD (Frascati Manual, Oslo Manual...), the related reports from competent government agencies (CIEMAT, CEDETI...) or take into account the possibility that the results may be object of patent.[3]

Act 27/2014, of November 27, of the Corporate Tax Law (LIS) and its corresponding normative development, regulate the tax advantages to promote carrying out these activities. In particular, **three tax incentives are established:**

I. **Freedom of amortization:**[4] of which underlies that certain assets benefit from an amortization not subject to any limit for tax purposes, i.e., that the taxable person may freely distribute the cost of the assets. We find here a tax benefit resulting in a deferral of assessment established by the tax legislation.[5] It must be made clear that freedom of amortization may not apply to the activities of technological innovation.[6]

Paragraph 3 (letters b and c) of article 12 of the LIS Act (Corporate tax Act) provides freedom of amortization for:

- Tangible or intangible inmovable assets affected to research and development activities. The buildings, that can depreciate linearly over a period of 10 years, in the part related to the research and development activities, are excluded.

- Research and development expenses activated as intangible assets, excluding amortization of the items that benefit from freedom of amortization.[7]; [8]; [9]

3. *Resolutions of the Central Economic Administrative Court of dates on December 21, 2006, March 15, 2007, and on May 29, 2008 and Decree of the National Audience of October 26, 2009 (rec. NO 714/2007).*
4. *Accelerates the tax depreciation with respect to the accounting, making negative adjustments to the accounting result until the element is fiscally completely amortized. From then, positive adjustments are made.*
5. *Lopez Espadafor, C.M. and camera Barroso, M.C. (2014). Estudio sobre la articulación del régimen fiscal de las spin-off. Documentos del Instituto de Estudios Fiscales. nº 2/2014. Madrid. p.8*
6. *The General Tax Directorate (DGT), the query no. V778/2014, determines that freedom of depreciation does not apply when the activity is technological innovation. (.....) In terms of the depreciation expense for the asset items directly related to the innovation activity, this may, where appropriate, form part of the basis of deduction for this concept.*
7. *The contributions paid to a related entity to finance R & D activities, are deductible whenever they are enforceable under a written contract in which what the previously signed agreement of rational distribution of the expenses of the project is described (that, in its case, contemplate the variation of circumstances or people participating), in which the project or projects to implement are idendified and the rights to use the results are granted. When there is no link, the costs of contracts are not conditioned to compliance with any requirement.*
   *In the event that contributions that have been recognised as expense in the period are deductible, they can benefit from freedom of amortization if they had been activated as intangible fixed assets.*
8. *There is no singularity to deduct the R&D costs charged to results of the tax exercise. Therefore, if they have been accounted as expenditure for the financial year respecting the accounting criteria, they also are computed as such to determine the taxable base.*
9. *The amortization costs of R& D expenditures object of activation, will be deductible since they are able to produce income, which will coincide with the time in which such expenses are charged to the profit and loss account, pursuant to provisions of the accounting regulations standards (DGT No. V772/2014).*

Lopez Espadafor and Camara (2014) agree that, despite the undoubted advantages that may result from the application of this mechanism, in practice, freedom of amortization is not a real exonerating benefit, but a simple deferral of tax on corporate income. With this, they do not mean to say that this deferral in payment is not useful because, obviously, it can become a major source of financing that help the economic recovery.[10]

## II. Reduction of the income resulting from certain intangible assets (internationally known as patent box)

This reduction in the tax base- included in article 23 of the LIS Act - is instituted as a direct tax incentive to the result (it applies at the time of commercializing the results created successfully during the RDI process) and operates with the purpose of stimulating the creation of technical knowledge with industrial application within the framework of an innovative activity, so that the exploitation of such knowledge through the cession of its use to third parties, benefits from a special treatment.

With effect from July 1, 2016,[11] income from the transfer of the right of use or exploitation of patents, drawings or models, plans, formulas or secret procedures, rights over information concerning industrial, commercial or scientific experience, as well as the transmission of these intangible assets between non-related entities, will be entitled to a reduction in the taxable base resulting from multiplying by 60% the result of the following coefficient :

a. in the numerator, the expenses incurred by the transferor entity directly associated with the creation of the asset, including those resulting from subcontracting unrelated third parties. These expenses will increase by 30%, without that, in any case, the numerator can exceed the amount of the denominator.

b. in the denominator, the expenses incurred by the transferor entity directly associated with the creation of the asset, including those resulting from subcontracting unrelated third parties and, where appropriate, from the acquisition of the asset.

The above coefficient can never include financial expenses, amortization of buildings or other costs not directly related to the creation of the asset.

To apply this reduction the following requirements have to be observed:

a. that the transferee use the rights of use or of exploitation in the development of an economic activity and that the results of that use do not materialize in the delivery of goods or provision of services by the transferee that generate fiscally deductible expenses in the assigning entity, whenever, in this last case, such entity is linked with the transferee.

b. that the transferee does not reside in a country or territory of null taxation or qualified as tax haven, unless being located in a Member state of the European Union and the taxpayer accredits that the operatiing entity responds to valid economic reasons and performs economic activities.

c. When the same contract of transfer include additional services benefits, the corresponding compensation must be differentiated in this contract.

d. that the entity holds the accounting records necessary for determining the direct income and costs corresponding to the assets object of the transfer.

10. *Lopez Espadafor, C.M. and Barroso, M.C. (2014). Actividades de I+D+i, spin off e Impuesto sobre Sociedades. Crónica Tributaria. No. 152. Madrid. p. 123.*
11. *Modification of article 23 of the LIS Act to adapt it to the agreements reached within the European Union and the OECD (BEPS) contained in article 62 of the law 48/2015, October 29, from the General State budget for the year 2016.*

However, revenues are excluded when proceeding from the transfer of the right of use or operation, or transmission, of brands;[12] names; literary works, artistic or scientific, including cinematographic films; rights personal susceptible of cession, such as the rights of image; computer programs; industrial, commercial or scientific equipment (since these last not are really intangible assets) and any another intangible different from patents, drawings or models, plans, formulas or procedures secret, and rights on information relating to industrial, commercial or scientific experience. Income proceeding from the technical support are also excluded, because they constitute services of technological component but their benefit is exhausted with their prestation.

It should be noted at this point that, on an international stage, if income arising from the transfer of the right of use of intangible assets have been taxed abroad, by an identical or analogous tax, in order to determine the deduction for double international taxation for the calculation of the total tax that would be paid for the income that should be paid in Spain for the income obtained abroad, a reduction practiced on the revenue obtained must be taken into account.

In addition, in the same case, to determine the total tax that would have been calculated in Spain, first the income actually generated in the transfer must be calculated, for which the costs, both direct and indirect, must be calculated so the amount of that income should be lower in the amount of the reduction by application of this tax incentive and to the amount resulting from this difference would apply the tax rate determined by the tax that would have resulted in accordance with the corporate income tax normative.

On the other hand, from the above, it may occur that the taxpayer could have doubts as to apply this reduction. Therefore, prior to the completion of the operations, he may submit to the tax administration a request accompanied by a proposal for a valuation based on the market value for:

- the adoption of a prior agreement of appraisal in relation to revenue arising from the transfer of assets and associated costs, as well as income generated in the transmission.

- a prior agreement of assets assessment and valuation referring to revenues proceeding from the cession and the related expenses, as well as the revenues generated in the transmission.

### III. Full Deduction (cuota integra) for activities of R&D (article 35 of the LIS Act)

In contrast to the mere financial effect resulting from freedom of amortization, this provision can result in significant tax savings of permanent nature. Finally , this is currently the most relevant tax incentive to promote the research activity by companies.

What the law include in RDI activities, how is set the basis of the deduction and what rates apply is discussed hereafter.

#### i. Deduction for research and development activities

In accordance with article 35 of the LIS Act, will be considered:

- Research: the original planned inquiry which pursues to discover new knowledge[13] and a greater understanding in the scientific and technological field.

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12. *Any sign capable of graphic representation that helps to distinguish in the market the goods or services of one company from those of another.*
13. *The definition requires originality regarding the scientific research method developed. The DGT position seems to be closer to the absolute innovation requirement.*

- Development: the application of the results of the research or any other type of scientific knowledge, for the manufacture of new materials or products or for the design of new processes or production systems, as well as for substantial technological improvement of materials, products, processes or pre-existing systems.[14]

Are also considered as research and development activities:

- the materialization of new products or processes in a plan, scheme or design.
- the creation of a first, unmarketable, prototype.[15]
- the projects' initial demonstration or pilot projects, provided that they cannot be converted or used for industrial applications or commercial exploitation.
- The design and preparation of samples for launching (introduction on the market) new products (essential innovation, not merely formal or accidental).[16] The activity of design and development of samples is considered R&D when it aims at launching products.
- the creation, combination and configuration of advanced software, using new theorems and algorithms or operating systems, languages, interfaces and applications intended for manufacturing new or substantially improved products, processes or services. Software intended to facilitate access to the information society services to persons with disabilities is assimilated to this concept, when this is done in a non-profit perspective. Normal or routine activities related to the maintenance of the software or minor updates are not included.

From the foregoing, it follows, therefore, that R&D activities require elements of novelty. As Vines (2015) points out, it seems logical to think that an objective innovation needed so that a project may qualify as original R&D and, consequently, benefit from lower tax rates , should be inserted in the specific context of the company. I.e., and according to the spirit of the tax normative, it would be sufficient that a company seeks to differentiate from its competitors within its strategy of development of R&D activities. If we apply a more stringent concept of objective innovation, i.e. beyond the competitive environment of the company, it would not be consistent with the spirit of the rule.[17]

The deduction base will be constituted by:

- the amount of expenses for research and development[18] [19] that correspond to activities carried out as well as the amounts paid by order of the taxpayer, individually or in collaboration with other entities, for carrying out such activities in Spain or in any Member state of the European Union or of the European Economic Space.

14. *The innovation that is required with regard to materials, products or processes must be essential, radical, i.e. the result must meet technological characteristics or non-existent properties to date, from a universal point of view.*
15. *Prototype: first model of the new product that has completed the R & D process, generally destined to the physical verification of the material and technical qualities which are presupposed it in their theoretical conception.*
16. *The novelty of the product should not arise, necessarily, of a prior process or activity of R & D, but has incorporate intrinsically new materials or resulting from combinations of existing materials in order to create a new product. The concept of sampling elaboration does not include costs incurred to obtain the successive samples from the prototype (DGT No. 2670 / 1997).*
17. *Vines Bargada, O. (2015). El concepto "novedad objetiva" en el contexto de las deducciones fiscales por I+D: Deducciones fiscales a proyectos de I+D. Finalidad de las deducciones fiscales: fomentar este tipo de actividades en las empresas. Revista Quincena Fiscal 5. Aranzadi.*
18. *Expenses carried out by the taxpayer expenses, including depreciation of the assets pertaining to the above-mentioned activities are part of R&D expenses, insofar as they are directly related to such activities and are applied effectively to the realization of these, specifically tailored by projects.*
19. *Expenses of patenting the result of the activity do not form part of the base of the R & D deduction; they are a complement and are posterior.*

- investments in properties, plant, equipment and intangible excluding the buildings and grounds. Investments shall be deemed completed when the assets become operational.

The basis of the deduction will be reduced in the amount of subsidies received for the promotion of such activities and imputable as income in the tax period.

The following deduction percentage apply to the resulting base:

- 25% of the costs incurred in the tax period for this concept and 42% on the excess with regard to the average of those completed in the two previous years.

- 17% of the amount of personnel expenses[20] of the entity, corresponding to qualified researchers[21] ascribed exclusively to research and development activities.

- 8% of investments in elements of material and intangible fixed assets, excluding buildings and grounds, provided that they are exclusively related to the activities of research and development.

**ii. Deduction for activities of technological innovation**

Are considered as innovation the activity which result is a technological breakthrough on obtaining new products or production processes or subtancial improvements of existing processes. The products or processes are considered as new if their characteristics or applications, from a technological point of view, differ subtantially from those previously existing.

This activity will include:

- the design of the new products or processes in a plan, scheme or design.

- the creation of a first, unmarketable prototype.

- the initial project's demonstration or pilot projects, including those related to animation and video games.

- Textile industry samples or footwear, tanning, leather goods, toys, furniture and wood industry samples, as long as they cannot be converted or used for industrial applications or commercial exploitation.

In practice, the key difference with R&D activity is that, in technological innovation, the technological subtantial improvement in the product or process is achieved based on already existing other processes or other products.

The main feature of the novelty that can be attributed to technological innovation is subjective, i.e., from the unique perspective of the own taxpayer, regardless that the same products or processes already exist in the market.[22]

The deduction base is formed by the amount of the period expenses in activities of technological innovation, which correspond to activities carried out as well as amounts paid on behalf of the taxpayer, individually or in collaboration

20. *Salaries and wages, Social Security and other payments (contributions to pension plans and other benefits in kind) are computed. On the other hand, there is full compatibility of the bonus in the contribution to Social Security of the research staff with the application of the RDI deduction for SMEs intensive in RDI, recognized as such by the seal of innovative SMEs.*
21. *The activity developed by the research personal must be exclusive to run the R & D project during all its development period, within the tax period, so this deduction additional for the expenditure of personal research can apply only if they perform exclusively tasks of R & D.*
22. *In accordance with the DGT (No. V1521/2006, no. V2079/2007 and no. V76/2008) and the TEAR of Catalonia (December 1, 2011 resolution), in technological innovation, novelty has to be subjective, i.e., relating to new products or processes or new applications and improvements of products or processes that are unprecedented for the company, although in the economic reality they already may exist. Innovation in this case refers to the scope of the company itself.*

with other entities, to carry out such activities in Spain or any Member state of the European Union or the European economic area that they refer to: [23]

- Technological diagnosis aimed at the identification, definition and orientation of advanced technological solutions, regardless of the results that will be achieved.
- Industrial design and engineering production process, which will include the design and the preparation of plans, drawings and supports destined to define the descriptive elements, technical specifications and performance characteristics required for the manufacture, testing, installation and use of a product, as well as the development of sample for the textile, footwear and tanning, leather goods, toy, furniture and wood industries.
- acquisition of advanced technology in the form of patents, licenses, know how and designs, to individuals or entities not related to the taxpayer, without exceeding the base amount of EUR 1 million.
- obtaining the certificate of compliance with the ISO 9000 quality standards serie, GMP quality assurance or similar, excluding expenses relating to the implementation of those standards.

The basis of the deduction will be reduced in the amount of subsidies received for the promotion of such activities and imputable as income during the tax period.

The percentage of deduction is 12% of the costs incurred in the tax period for this concept.

**iii. Exclusions. Research activities and development and technological innovation will not be considered when consisting of:**

- Activities that do not involve a significant scientific or technological innovation.[24]
- Activities of industrial production and provision of services or distribution of goods and services.[25]
- Exploration, scanning or prospecting for minerals and hydrocarbons.

**iv. Application and interpretation of the deduction**

In reference to the application of this deduction, taxpayers will be able to:

- provide a motivated report issued by the General Sub-Directorate for the promotion of competitiveness, relative to compliance with the scientific and technological requirements. This report will be binding for the tax administration for the purposes of the qualification of the activity[26] but not for the basis of deduction.[27]

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23. *It is necessary that the entity that is in charge of the task acquires ownership or rights to the results of RDI activities. Accordingly, the deduction will be practiced by the entity who physically performs the RDI activity, to the extent in which the entity that carry out the RDI activities and acquires ownership of the results of such activities, should they succeed, means that that entity is the one that generates the right to practise the deduction (DGT No. V2979/2015).*
24. *Among them, the routine efforts to improve the quality of products or processes, the adaptation of a product or already existing production process as well as aesthetic or lesser modifications to existing products to differentiate them from other similar.*
25. *Specifically, the planning of the productive activity; the addition or modification of facilities, machinery, equipment and systems for the production that are not affected by activities of RDI; technical troubleshooting; quality control and standardization of products and processes; market studies; the establishment of networks or marketing facilities; the staff training related to such activities.*
26 *DGT nº V3203/2015.*
27. *DGT No. V2033/2013: motivated reports emitted by bodies and approved bodies are intended to certify that the activities carried out by the taxable person deserve the rating of R & D activities, pursuant to article 35. In any case, such binding reports are intended to the quantification of the respective bases of deduction. On the other hand, the reasoned report cannot be considered as a condition for obtaining the deduction, but as a means of proof of the qualification of the activity developed as R & D activity.*

- present assessments on the interpretation and application of this deduction, whose answer will be binding for the tax administration, in the terms laid down in articles 88 and 89 of the General Tax Act 58 of December 17, 2003.

- Request the tax administration to adopt the previous agreements for the evaluation of costs and investments for RDI projects, as provided in section 91 of the General tax law.

**v. Limits on deductions**

The 25% coefficient limitation applies for all the modalities of deduction for investment.[28] However, it rises to 50% when the following conditions are simultaneously fulfilled:

- if the taxpayer has incurred in activities of RDI and TIC during the same tax period;

- if the amount of the deduction corresponding to the expenses of such activities exceeds 10% of the positive or minored total adjusted tax.

The part of deduction that exceed the indicated limits can be applied in the payments of the the tax periods that will conclude in the 18[29] immediate and consecutive years, with the particularity that the deduction limit is the general limit, except if the aforementioned conditions are present.

## 2. COMPARISON WITH OTHER COUNTRIES

The companies conduct RDI activities based on the expectation that such investment will bring future benefits, either in the form of lower costs of production or in the form of higher incomes. Unfortunately, due to the incertitude about the return on the investment, the private RDI activity can be below the optimal threshold and, for this reason, the intervention of the State is justified.

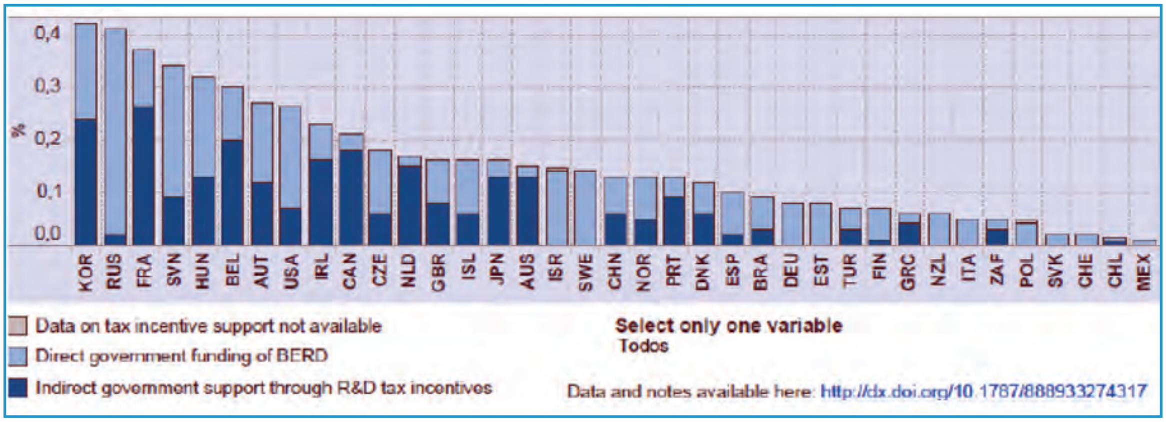
While the promotion of RDI has become a national objective, the governments agree that grantingassistancefor developing these activities was established as an instrument to improve the attractiveness of their country and, consequently, that foreign companies are located in their territory. For this purpose, they use grants, contracts, loans and tax incentives.

In 2013, 27 OECD countries granted a preferential tax treatment to R&D expenses from companies. Korea, Russia and France presented the greatest global support in terms of GDP. In relative terms, Netherlands, Australia and Canada were the countries that established the most important tax benefits, while jurisdictions like Sweden, Germany, Estonia, New Zealand and Mexico, among others, lack this type of indirect aid.

28. *Once the deductions under section 39.1 of the LIS is applied, apply, first deductions for R & D with a discount of 20% unless obtained by application of the limit laid down in paragraph 1 of this rule, and in the event that share the period IS to be less than 80% of the above deductions , you may request a refund of the excess.*
29. *The deduction applies in the tax period in which expenses are carried out and where the object of investment are in operating condition and affects the activities of R & D. However, not practiced by inadequacy of quota deduction may apply within 18 years, counted from the conclusion of the tax periods that were expenditures, although one of these periods was prescribed (DGT No. V2400/2014).*

**Graphic 1**

**(Funds and tax incentives)**
**State Assistance to R&D in terms of GDP**
**(2013)**

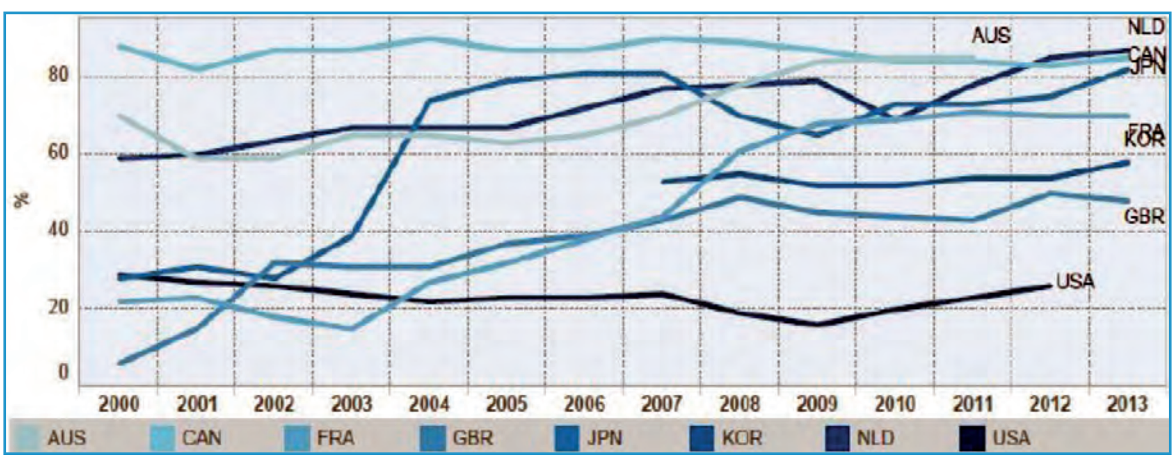



**Fuente:** OECD. Retrieved from: http://dx.doi.org/10.1787/888933274317

From the study of the trend in governmental support to RDI, it is to notice that several OECD countries, as France, Japan, the Netherlands and the United Kingdom have increased their tax incentives to their RDI since the year 2000. However, this tendency has not been uniform: during the economic crisis, some jurisdictions chose direct financing. However, it is unanimously agreed that most of the countries significantly emphasize the tax support.

**Graphic 2**

**Governments trends in direct**
**assistance and tax incentives for RDI activities**
**(2000-2013)**




**Source:** OECD. Retrieved from: http://dx.doi.org/10.1787/888933273262

As it can be verified, the formulas of most relevant tax incentives are tax credits, deductions of RDI expenses and the application of a reduced rate to certain revenues from RDI activities. Equally, these incentives can be directed to reducing the tax burden according to the typology of the company: For SME (France, Portugal and Spain) or for large enterprises (Spain, Portugal and Ireland). In addition, other countries have introduced reductions in costs and salaries of the RDI personnel in the interests of promoting such activities (the Netherlands).

Tax credits, as a traditional tool, include the possibility of deducing a sum from the whole of the tax debt. The choice will depend on the effective marginal tax rate of the entity. If we compare them with tax deductions, according to the OECD, the latter are more suitable for small and medium-sized enterprises because they reduce the taxable income, while the tax credits work only if there is a relevant tax responsibility, which is assumed to be lower for small businesses (Pérez Bernabeu, 2015).[30]

Tax credits, in turn, can be incremental (France, Ireland and Norway), based on the volume of expenses incurred by the company during the fiscal year (Austria, Belgium, Italy, Netherlands and Malta) or mixed (Portugal and Spain). In parallel, the deductions may be based on the volume of expenditure (Belgium, Czech Republic, Lithuania, Luxembourg, Malta, Netherlands, Romania and Slovenia) or be mixed (Hungary and United Kingdom) (Bal and Offermanns, 2012).[31]

To summarize, the following table presents the preferential tax incentives for RDI - for the Corporate Income Tax s well as for Social Security and withholding on wages and salaries, approved by the jurisdictions under review by the OECD in 2015.

30. *Pérez Bernabeu, B. (2014). R&D&I Tax Incentives in the European Union and State Aid Rules. Bulletin for International Taxation. may 2014. IBFD. Ámsterdam. p.180.*
31. *Bal. A. y Offermanns, R. (2012). R&D Tax Incentives in Europe. Bulletin for International Taxation. april 2012. IBFD. Ámsterdam. p.168.*

**Table 1**

**Main features of provisions on tax incentives for RDI in 2015**

| **Tax incentives for RDI** | | | |
|---|---|---|---|
| **Corporate Income Tax** | | | **Social security/ payroll withholding tax** |
| **Tax credit** | | **Tax allowance** | |
| **Volume** | **Incremental/hybrid** | | |
| • Taxable: Australia, Canada, Chile, United Kingdom (large enterprises)<br>• Non-taxable: Austria, Belgium (incompatible with subsidies), Denmark (only deficit), France, Iceland, Ireland, New Zealand (only deficit), Norway, Hungary | • Taxable: United States (fixed credit, the indexed fixed and incremental basis for simplified credit)<br>• Non-taxable: Italy (Legge di Stabilita 2015), Japan, Korea, Portugal, Spain | • Non-taxable: Belgium, Brazil, China, Czech Republic (mixed), Greece, Hungary, Netherlands, Poland (I + D centers), Russia, Slovenia, Slovakia (mixed and volume-based), South Africa, Turkey (mixed), United Kingdom | • Taxabl: Belgium, Franc, Netherland, Hungary, Russia, Spain, Sweden, Turkey |
| **Treatment of excess claims** | | | |
| **Refunds** | | | |
| Australia (PYMEs), Austria, Belgium (after five years), Canada (SMEs), Denmark, France (SMEs), Iceland, Ireland, New Zealand, Norway, United Kingdom (large enterprises) | Spain (reduced, payable credit optional) | United Kingdom (SMEs) | Automatic refund through wage system |
| **Carry-forward** | | | |
| Australia, Belgium, Canada, Chile, France, Ireland | Korea, Portugal, Spain, United States | Belgium, China, Czech Republic, Greece, Poland, Netherlands, Russia, Slovenia, Slovakia, South Africa, Turkey, United Kingdom | Not applicable |
| **Enhanced tax credit/allowance rates or more favourable terms** | | | |
| **SMEs** | | | |
| Australia, Canada, France, Norway | Italy (Innovative of new creation), Japan, Korea, Portugal (Start-ups) | United Kingdom | Belgium (New, innovative companies), France (JEI /Jue), Netherlands (start-ups), Spain (innovative SMEs) |
| **Collaboration** | | | |
| France | Italy, Iceland, Japan | Hungary | Belgium |

| Limitation of benefits | | | |
|---|---|---|---|
| **Threshold-dependent credit rates** | | | |
| Canada (SMEs), France | | | Netherlands, Russia |
| **Ceilings on amount of eligible R&D expediture or value of R&D tax relief** | | | |
| • R&D expenditure: Australia (floor and cap), Canada (SMEs), Chile, Denmark, Iceland, Norway<br>• R&D Tax relief: Hungary, New Zealand (deficit only) | • R&D expenditure: Italy (floor), Portugal (incremental)<br>• R&D tax relief : Italy, Japan, Korea (large firms) Spain, United States | • R&D tax relief: Hungary (R&D collaboration), United Kingdom<br>• R&D expenditure and R&D tax relief: Slovak Republic (volumen based tax allowance) | • R&D expenditure: Hungary<br>• R&D tax relief : France, Sweden, Turkey (five year limit) |
| **Accelerated depreciation provisions for R&D capital** | | | |
| Belgium, Brazil, Chile, China, Denmark, France, Israel (Non R&D specific), Poland, Russia, Spain, United Kingdom | | | |
| **No expenditure-based R&D tax incentives** | | | |
| Estonia, Finland, Germany, Luxembourg, Mexico, Switzerland | | | |
| **Preferential tax treatment of income derived from R&D or other innovation activities** | | | |
| Belgium, China, France, Greece, Hungary, Ireland, Israel, Italy, Korea, Luxembourg, Netherlands, Portugal, Russia (Special economic areas of innovation and technology), Spain, Switzerland (Canton of Nidwalden), (Technological development zones), Turkey, United Kingdom | | | |

**Source:** The R&D tax incentives. Retrieved from: www.oecd.org/sti/rd-tax-stats.htm, December 2015. (20 / 05 / 2016)

Apart from the precisions that we have mentioned, by being a Member State, Spain is relevant to underline the guidelines at Community level in this area. It is intended to make the European Union more competitive and dynamic, under the hypothesis that more money invested in RDI will produce higher productivity. [32]

As expected, those member countries have increased the establishment of tax incentives to attract investment. In this scenario and based on the primacy of Community law, all RDI tax incentives approved by the Member States must conform to the fundamental freedoms of the Treaty[33] and the principle of non-discrimination.

It is clear that direct taxation, even though still a competency from the Member States, must respect the law of the European Union and, in particular, these benefits must not incur the prohibition on State assistance referred to in article 107 TFEU. In this regard, article 107.3 of TFEU establishes in its section c) that assistance to facilitate the development of certain activities or of certain economic areas may be considered compatible with the common market, provided that they do not alter the conditions of trade against the common interest. Ultimately, state aids for RDI will be compatible when it is expected that they will contribute more RDI and that the distortion of competition is not considered contrary to the common interest.

32. *Article 173.1 from the Treaty on the functioning of European Union (TFEU) States that its action will be aimed at fostering a better exploitation of the industrial potential of policies of innovation, research and technological development.*
33. *The Court of Justice of the European Union (CJEU) argues that these fundamental freedoms are being violated when the tax incentive is only granted for expenses incurred in a Member State in particular. Affairs C 257/97 Société Baxter and others v Premier Ministre, C 39/04 laboratories Fournier, S.A. and C-248/06 Commission against Spain. In the latter case, in the deduction, abolished the limitation of 25% of costs for R & D carried out in the countries of the European Union.*

In the specific case of the patent box regime, as far as Spain is concerned, on February 13, 2008, the European Commission ruled that the tax benefit provided for by the Spanish tax regulations did not constitute State aid, as it is a measure of a general nature which is not addressed to a specific category of business or region.[34] This measure benefits all taxpayers in Spain regardless of the specific activity carried out in the activity sector and the geographic area in which they are established, their purpose being to contribute to increase companies' investment in RDI to boost the scientific and technological development of the business sector as a whole.

Other European countries that have adopted a patent box[35] regime are:

- Belgium: New patents and patent certificates are taxed at 6.8% as a result of the deduction of 80% of the revenue arising from them, provided that the payments are consistent with the Arm's Length principle.
- United Kingdom: taxation is reduced to 10% on patents, complementary certificates of protection, data protection and PVP (Plant Variety Protection).
- France: Patents, patent certificates, patentable inventions and industrial manufacturing processes are taxed at 15%.
- Netherlands: taxation is reduced to 5% on patent and intellectual property derived from RDI, provided that the new technological component contributes at least to 30% of the benefit derived from the use of this intangible asset (innovation box).
- Hungary: Patents, know-how, commercial brands, business names, business secrets and copyrights are taxed at 9.5%.
- Luxembourg: taxation is reduced to 5.84% on patents, commercial brands, designs, domain names, models and copyright of software. Exemption of 80% of income and capital gains of the intellectual property, generated by Luxembourg companies or by permanent establishments of non-resident entities. In the same way, the regime stipulates that a deduction of 80% for those taxpayers who develop patents for their own use.
- Ireland: the taxation is at 6.25% under the new knowledge development box.
- Portugal: an exemption of 50% is applied on the gross income derived from the transfer or the temporary use of patents and designs registered from January 2014.

In additon, in relation to RDI activities, Austria has approved a 10% premium for R&D regardless of whether a profit or loss is registered. This tax credit is unlimited for internal expenditures on R&D while the external costs are limited to 100,000 euros.

For its part, Switzerland - without prejudice to the regulations of the cantons - has approved a federal provision that fosters RDI activity: any business can make a deductible provision of tax for expenses incurred on RDI or fees paid to third parties, up to 10% of the taxable business income. However, the total balance of the provision is limited to 1 million crowns. On the other hand, Switzerland offers the so-called status of the joint venture, which allows companies with income predominantly non-Swiss to lower the effective income tax rate around 10% - 12%. This advantage has turned Switzerland into an attractive destination for international companies of intellectual property (Weber and Eichenberger, 2015).[36]

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34. *C (2008) 467 final. State Assistance no. 480/2007 - Spain. Reduction of the tax on intangible assets.*
35. *The proliferation of regimes of patent box in the tax systems of the European countries can also come justified by the Directive 2003/49 of interest and royalties, which reduces or eliminates the retention of certain canons.*
36. *Weber, D. and Eichenberger, S. (2015). Tax Incentives for Research and Development. Bulletin for International Taxation. april/may 2015. IBFD. Amsterdam. pp.259-260.*

## 3. ISSUES OF INTERNATIONAL TAXATION TO CONSIDER IN RELATION TO RDI ACTIVITIES

As he raised in the previous section, in a scenario of globalization result ig from economic interdependence, different jurisdictions have designed very competitive tax systems that promote the internationalization of enterprises and encourage RDI investment in their respective constituencies.

As expected, with the spread of preferential tax regimes for RDI, both in international organizations (see OECD) as in the European Union, a concern surges about the risk that they could be used to transfer profits artificially. Accordingly, within the actions of the BEPS Plan, the countries have reached an agreement that places the improvement of the transparency as a priority-including the spontaneous exchange of information mandatory in the individual resolutions relating to preferential regimes- and the existence of a substantial economic activity as basic requirement to apply for any preferential regime.

The approach that reinforces the criterion of substantial activity has been developed in the context of intellectual property regimes allowing the taxpayer to benefit from such regimes only when they incurred certain expenses associated with research and development activities that generate income from the exploitation of intellectual property. The approach, based on the existence of nexus, uses the expenditure as an indicator of the activity developed and is based on a principle according to which, regimes of intellectual property are designed as a tool for the development of RDI activities and boost growth and employment, the criterion of substantial activity must ensure that taxpayers that use them have developed effectively such activities and have incurred actual costs on RDI. (action 5 of the BEPS Plan).[37] [38]

On the other hand, a system which favours transnational operations and the promotion of RDI is the signature of agreements to avoid double international taxation between countries. The OECD Model Convention (hereinafter OECDMC)[39] is of almost unanimous application. Article 12 of the OECDMC defines the royalties as the amounts of any kind paid by the use, or the grant of use, copyright of literary, artistic or scientific works including films, movies, patents, trademarks, drawings or models, plans, formulas or secret procedures, or for information concerning industrial, commercial or scientific experiments. The provisions of this article with regard to the beneficial owner are always shared and observed by the tax authorities.

Moreover, article 12 of the UN Convention Model reproduces the provisions of article 12 of the OECDMC, with certain exceptions.

In the community scope, the policy of interest and royalties between associated companies from different Member States has to be

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37. *OECD (2015).OECD/G20 project about the Erosion of the tax Base and the transfer of benefits summaries reports late 2015. OECD publications. Paris. pp.21-22.*
38. *OECD (2015). Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5-2015 Final Report. OECD/G20 Base Erosion and Profit Shifting Project. OECD Publishing. Paris. pp. 24-25.*
39. *OECD (2014)." Article 12. Royalty", in OECD, Model Tax Convention on Income and on Capital: Condensed Version 2014. OECD Publishing Paris.*

considered,[40] under which the payments of interest and royalties[41] from a Member State are exempt from any tax on such payments (whether collected through withholding or by estimation of the tax base) in the State of origin, provided that the effective beneficiary of the interests or royalties is a society of another Member state or an permanent establishment located in another Member state. It is required that both companies adopt one of the legal forms provided for in the directive and that they are subject to income tax. In addition, a direct relationship of capital must exist between and be greater than or equal to 25%, or be directly maintained in a percentage greater than or equal to 25% by a third company which meets the above mentioned requirements. Another aspect to have in mind in supranational relations are the transfer prices, since the transfer or transmission of any intangible to a related party implies to assess the market prices and to document the operation.

### 3.1. Spanish tax instruments favouring the international tax planning of RDI activities

Particularising in Spain and in relation to the idiosyncrasy of supra-national taxation, I want to bring up at this point, fiscal instruments favouring the international tax planning of R&D activities.

Among them, apart from the signature of a wide network of conventions to avoid double taxation, we may highlight the following: the special regime of foreign values holding, the exemption to avoid double taxation on dividends and incomes derived of the transmission of assets representative of equity from entities resident and not resident in Spanish territory, and the exemption of incomes obtained abroad through a permanent establishment (articles 21 and 22 of LIS), deductions of articles 31 and 32 of LIS to avoid a legal double taxation (tax supported by the taxpayer) and an economic double taxation (dividends on participations in benefits), the special regime for the work actually carried out abroad or the tax regime of the Canary Islands which is attractive for the Reserve for investments and the Special Canary Islands zone (ZEC).

Therefore, taking into account the mentioned advantages, we can say that Spain is a good jurisdiction that must be taken into account when considering the tax planning of RDI activities within a global scope.

40. *Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to payments of interest and royalties between associated companies of different Member States.*
41. *Cannons: remuneration of any kind for the use or transfer of the right of use of any copyright of literary, artistic or scientific works including films and programs and computer systems, any patent, trademark, design or model, plan, formula or procedure secrets, or for information concerning industrial, commercial or scientific experience and industrial equipment commercial or scientific.*

## 4. CONCLUSIONS

As a synthesis of the ideas that we have developed, is the following conclusions can be drafted.

Companies carry out RDI activities in order to improve their competitive position and to obtain higher profits. However, as a result of the risk associated with this activity, it can be argueed that the level of provision is less than the desired and therefore the intervention of the States through public policies, especially tax policies, is defendable.

In this sense, the administrations make use the regulatory or extrafiscal function of the tax system to encourage enterprises to carry out research, development and technological innovation activities contributing in an added manner to economic growth, job creation, improving competitiveness and the attraction of foreign direct investment.

Taking into account the previous remark, investments and RDI expenditures have experienced a boom on a global scale due to their advantageous implications both for companies and for the community. It is important to note, in this regard, that the RDI worthy of public financing is only the one which becomes innovative and that brings an improvement or scientific-technical progress.

In Spain, the tax incentives are aimed at boosting the initiative of the private sector without conditioning the innovative scope decided by the company. The Spanish Government opts to give you advantages that are implemented in the deferral of fees levied on corporate income, the reduction of the taxable bases arising from the transfer of the use or exploitation of intangible assets, the tax savings with permanent character through the deduction of expenses and investments made for R&D activities, and bonuses in the company's contribution to Social Security of the research staff. These aids combined with other instruments describe in the tax legislation, turn Spain, in my opinion, into a very attractive jurisdiction, when it comes to structuring an international tax planning for RDI activities.

As it has been exposed in this work, other countries also use deductions, tax credits, assistance to Social Security, reduced rates to implement preferential regimes. A reflection that will be not missing at the time of establishing these preferential regimes derives from the consideration that they must be consistent and respect the normative of the European Union (fundamental freedoms, principle of non discrimination, state aids) as well as observe the standards identified internationally by the OECD for curtailing the artificial transfer of profits.

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