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**TAX AVOIDANCE AND TAX EVASION : A COMPARATIVE STUDY OF THE
BRAZILIAN AND AMERICAN LEGAL SYSTEMS**

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Abstract

The present study is dedicated to the tax avoidance and tax evasion phenomena, and to the particular ways in which the Brazilian and the American legal systems face them.

These practices undermine fiscal equality, produce negative budgetary effects and distort competition, obstructing the development of modern economies.

Since these two countries adopt different legal systems, one being Civil Law, inspired by Roman Law and the other Common Law, originated in England in the Middle Ages, initially this study will explore the structural characteristics that set the systems apart, as a way to foresee the eventual effects that the legal system itself produces on the treatment of these phenomena, and to be able compare them, regardless of these differences. The study will then examine the definition of tax avoidance and tax evasion, through the statutes, scholar theories and judicial decisions of each country, analyzing its reach and effectiveness.

The conclusion focuses on the possibilities of improvement resulting from the comparison of the two realities, since the establishment of boundaries to tax evasion and tax avoidance is a need in every modern economy, so as to improve the system's predictability and ultimately unleash economic growth.

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1. Introduction

It is a fact that there is a permanent tension between the duty to pay taxes and the creativity of the taxpayer to reduce his or her burden. The act of paying taxes is not joyful to anyone, nor to the more conscious of their role as citizens of a democratic state.

However, to perform its activities, the government needs financial resources, and their main origin comes from taxes. In addition to this primary function, tax collection plays an important social role, whether by stimulating desirable activities or by restraining less desirable ones, acting many times as an instrument of social policy.

As the legislation evolved, taxpayers continuously tried to shape their businesses with the objective of paying fewer taxes, sometimes through abusive avoidance schemes, achieved through the manipulation of the legal form, but safeguarding the economic result sought. Having precise limits to what is considered to be the legitimate use of one's liberty, in the activity of reducing its tax burden, came to be a demanding question.

Unfortunately, the line that separates tax avoidance and tax evasion sometimes comes out much thinner than we would like, surrounded by shady, gray areas in which boundaries are difficult to distinguish.

These phenomena contribute significantly to the tax gap, that is, the amount of taxes due but not collected, which, for the year 2005, was estimated by the American Internal Revenue Service (hereafter IRS) to be \$345 billion⁽¹⁾ U.S. dollars. The Economy Institute of Brazilian Getúlio Vargas Foundation estimated that the amount of non-reported income by the nation's informal economy in 2009 reached \$340 billion⁽²⁾ U.S. dollars, or 18.4 % of Brazilian GDP.

A significant share of Brazilian tax law authors agree that there are two groups of tax evasion procedures. One group should be considered licit, and, for this reason, should better be called “tax avoidance” procedures, and the other should be considered illicit, thus properly called “tax evasion”. The first group would be composed of preventive taxpayer’s actions, that, through licit means, avoid, reduce or retard the effective occurrence of the legal hypothesis that obligates the payment of a tax. The other one would be illegitimate, consisting of a conscious, voluntary taxpayer action that, through illicit means, like fraud or simulation, eliminates or lessens the payment of a tax or duty.

Yet, it is possible to find respected authors who add to this division a third group. They point out that not all preventive actions are lawful, some would be apparently lawful, but, in the essence, would configure a misuse of the law, leading to an abusive situation. The theory of the abusive use of rights, commonly used in other juridical branches, was gradually being addressed in the tax law, under the vigorous criticism of traditional jurists who saw in this theory a violation of basic principles of Brazilian tax law, like the one which requires, for every tax, a formal law defining it’s characteristics. No matter how widespread the controversy, the Brazilian Congress approved in 2001 the Complementary Law no.104, that altered the text of the Brazilian National Tax Code ⁽³⁾ (hereafter CTN), to introduce a general anti-avoidance clause.

Many jurists found that the text signaled the legislator’s option for the economic interpretation, giving the tax law an understanding that prevents the taxpayer’s from manipulating the juridical appearance of transactions for the sole reason of paying less tax. These diverse views will fuel the critical analysis of the Brazilian anti-evasion clause,

which gave the administrative and judicial authorities the right to disregard taxpayer's dissimulated acts, if they were practiced as a way to conceal a triggering event.

In the United States one finds a different scenario. Since 1860 many court decisions shaped the understanding and terminology regarding avoidance and evasion, as well as abusive schemes. In 1934 the United States Supreme Court held in *Gregory v. Helvering*⁽⁴⁾ that "The legal right of an individual to decrease the amount of what would otherwise be his taxes or altogether avoid them, by means which the law permits, cannot be doubted". Statutes regulate the subject, being the main one the Internal Revenue Code of 1986, which adopted the purpose test to detect abusive conduct.

In the next section the origins of each legal system, that is, Civil Law and Common Law, will be examined, in order to identify their structural characteristics.

2. An Overview of Civil Law and Common Law Systems

History

The development of the science of Law is connected to living in society. Dating back to 3.000 B.C., the laws of ancient Egypt were divided in twelve books, and valued tradition, rhetoric, impartiality and social equality. Around 1.760 B.C. King Hamurabi decided that the Babylonian law should be written in stone, allowing people to easily access its sayings, and giving origin to the Hamurabi Code. These ancient codifications didn't survive long.

The oldest law system to influence our days probably is the Old Testament, or the Torah. Besides that, the Greek city-state of Athens, on the golden years of 500 to 300 B.C., developed significantly the concept of citizenship, and gathered great innovations regarding constitutional rights and democracy. Roman Law is considered to be a bridge between the old law experiences and the contemporary ones, and was heavily influenced by Greek concepts.

Through the centuries, as the Roman Empire achieved its peak of glory and fell, law was continuously adapted to evolving social needs, and by the demand of Emperor Justinian I, was extensively codified, resulting, in the year 534 A.D., in the "*Corpus Iuris Civilis*." Roman Law knowledge was lost in western Europe during the Middle Ages, up until the eleventh century, when medieval jurists called "glossarists" started studying and referring to its concepts. Roman Law influenced the development of law systems all over the world, and assumed an important role as a catalyst of a common European culture.

In medieval England royal judges started to develop a set of precedents which would, in time, be in the heart of the Common Law system. Meanwhile, on continental Europe the "Lex Mercatoria" helped businessmen carry out their duties, and was setting the foundation for what came to be modern commercial law. When nationalism intensified in the eighteenth and nineteenth centuries, "Lex Mercatoria" was incorporated to the countries civil codes, being the Napoleonic Code and the German Civil Code the most influential ones.

On the upper Middle Ages law was a phenomenon originated in the civil society, according to relevant juridical costumes, that revealed a certain consensus of social conduct or that were based on equality principles. At that time there was no politically organized body for civil rule and government, resembling what we would call a state, as we have today. With the development of the modern state, the possibility to create and enforce law was monopolized.

In modern times, the concepts of law and state overlap, since the latter is established and managed according to the ruling law, even though having simultaneously to create and enforce it. The consolidation of the modern states corresponds to the gradual empowerment of positive law, at the expense of natural law.

As for today, it is possible to identify many legal system families, such as Civil Law (Roman Law), Common Law, Communist, Islamic and others, all of them originated in the historic scenario described above. This way, to correctly identify the family of a legal system, one must gather its main characteristics and origins. The major legal systems in the world are Civil Law and Common Law.

Due to the lack of uniformity on continental European traditions, scholars of comparative law and jurists promoting the legal origins theory adopted a subdivision of Civil Law into four groups, Romanistic, Germanic, Scandinavian and Chinese. The Brazilian system evolved from French to German influence, as its Civil Code⁽⁵⁾ was initially inspired by the Napoleonic Code, migrating on the twentieth century to the German “Bürgerliches Gesetzbuch” influence. The recent 2002 Civil Code⁽⁶⁾ shows strains of Italian influence.

To examine the development of Common Law in England one must return to the eleventh century, when the Norman Conquest took place. Before that, justice was administered by county courts, in which civil and ecclesiastical jurisdiction were exercised. By the year 1154 A.D., King Henry II institutionalized Common Law, elevating local custom to a national reach, thus unifying the system, which should be applied to the whole country, so to speak, the common law of the country. The judges from the central courts travelled along the country to solve the various disputes, and, upon returning to London, handed in their reports. The courts filed these reports, creating the framework that would allow the development of a system based on binding precedents.

When a judge had to solve a dispute similar to one already addressed, and recorded in a file, he was bound to follow the previous reasoning. The system gave distinguished value to precedent, favoring the consolidation of decisions over time, and established a common set of rules to be observed all over England. This way, Common Law, also called case-law, emerged from the judges decisions, and for many centuries was the primary source of law, until the Parliament acquired legislative powers to create statutory law.

Following the American Revolution in 1776, the United States adopted reception statutes in which it opted to remain under the rule of the originally British Common Law, in all the aspects that were not incompatible with its new political condition. British traditions like the monarchy were rejected, but many others were welcomed, like the “habeas corpus”, jury trials and certain civil liberties.

Main Characteristics

Authors agree that the main characteristic of Civil Law systems is that the source of its laws are statutes. But that is not enough, since the written statutes must be regarded as the primary source of law. Statutes may originate from national, state or municipal legislatures, and, in Brazil, its genesis and hierarchy are set on the Constitution, which defines a legislative process that regulates the inception of all statutes.

Materially, Civil Law systems proceeds from abstractions, establishing rules of conduct closely connected to an ideal of justice and to special moral values, formulating general principles that influence the law's text. This way, there is greater interest in the law's design than in its applicability. The primary objective is to provide citizens with an accessible and written collection of laws that judges must follow. This way, the jurists responsibility would essentially be to research the legislation, and, through the most adequate interpretation methods, try to find which is the applicable law to a certain case.

Reneé David, in "Les Grands Systèmes du Droit Contemporains,"⁽⁷⁾ argues that by conceiving laws with generic commands, requiring interpretation every time a case is under analysis, Civil Law systems stimulate a less predictable environment. In addition, the system is unbound by precedent, and past decisions do not necessarily influence future ones, although higher Courts can extend its decisions, in repetitive matters, to all hierarchically inferior Courts.

The opposite is true for Common Law systems, which do benefit from the binding effect of precedents, resulting, as some authors argue, in a better commercial environment. This is so because of the predictability that emerges from the various previous decisions about every other relevant subject. The boundaries of the law become more clear when the successive decisions tackle the same subject in an orderly way, nearly exhausting its possibilities of interpretation. Once again, in Civil Law systems, where precedent most times do play a limited role, the final interpretation will only be known when a case is taken to court, which forces the parties to operate with bigger safety margins, in a less efficient manner.

3. Tax Avoidance and Tax Evasion, the Brazilian Experience

Introduction

In Brazil the issue of tax avoidance has aroused much discussion. Not only from a theoretical point of view, but also due to the inception of Complementary Law no.104, dating of 10.1.2001, whose first article gave new wording to art.116 of the CTN,⁽³⁾ in order to function as a standard anti-avoidance clause.

To clearly see how this clause modified the system, one must start by identifying the distinction between evasion and avoidance. Their ultimate objective do bring them together, as both are used as a means to reduce the tax burden, but, other than that, the differences between them are substantial.

Tax laws, as any other branch of law, require interpretation to be applied. The search for the adequate meaning of a legal text may influence the reach of its inherent concepts,

and, since that is true for avoidance and evasion, the interpretation of tax law will be presented in a separate sub-section.

Interpretation of Tax Law

The definition of avoidance is linked to the interpretation of tax law, and, to a further extent, to the answer that the interpreter gives to a central question: how far does the liberty of the taxpayer go, in the pursuit of a lesser tax burden?

As observed by Ruy Barbosa Nogueira,⁽⁸⁾ the interpretation methods applicable to tax law do not differ from the ones applicable to constitutional, criminal, or other branches of law, meaning that tax law interpretation should be done in light of the same ideas and principles that govern the interpretation of laws in general. According to Ricardo Lobo Torres,⁽⁹⁾ the interpretation of tax law historically followed a pendulum movement between a favorable attitude towards the Government interests or towards the taxpayer protection. In a few moments the principle embraced was “in dubio pro tax,” but, in all others, the diametrically opposite position prevailed.

This historical development of the methods of interpretation, specifically in the last two centuries, can be divided into three distinct phases: the jurisprudence of concepts, which enshrines the systematic interpretation, the jurisprudence of interests, which excels the teleological method of interpretation, and the jurisprudence of values, underpinning the methodological pluralism.

The Jurisprudence of Concepts and Systematic Interpretation

During the nineteenth century the jurisprudence of concepts flourished, elevating the systematic method of interpretation to a higher position. Formed in a liberal and individualistic world, where the law was intended to preserve legal relations, the jurisprudence of concepts launched foundation to the resumption of legal formalism, laying its roots in German law. In this historical context, the principle of legality became a major pillar of the legal system, resulting in the subordination of tax concepts to the concepts of private commercial law, rather than to the economic reality.

According to the systematic interpretation, the law's texts, along with its concepts, should be interpreted accordingly to their place in the legal system as a whole, in order to maintain the cohesion and unity of the system.

This way, the private law concepts used by tax law would retain their original meanings, and the taxpayer would be entitled to exercise the reduction of its tax burden by all means not prohibited in the law's text, regardless of the economic underlying aspects. Brazilian authors Gilberto de Ulhoa Canto⁽¹⁰⁾ and Sampaio Doria,⁽¹¹⁾ along with Argentinian Gian Antonio Micheli and French Georges Morange adopt this views.

The Jurisprudence of Interests and Teleological Interpretation

In the late nineteenth century, as a reaction to excessive formalism, the jurisprudence of interests arises, setting the bases to the tax law's economic interpretation. Ricardo Lobo Torres⁽⁹⁾ named Philipp Heck as the main advocate of this theory, being its fundamental principle the notion that laws are designed to protect interests, requiring a methodological

approach in order to identify, with historical accuracy, the real interests involved with the law's inception, so as to correctly apply, in each case, those interests.

Using the teleological method, the interpretation focus shifted to the underlying facts, be it historical, social or economic. This method was extensively criticized for being uncertain, arbitrary, homeward-looking, and for being a disguised search for equality, rather than a principled application of law. According to this interpretation, the tax law, while an autonomous branch in relation to private law, would eliminate the possibilities of tax avoidance, being the duty of the enforcer to put aside the law's text when in collision with the economic reality. Their representatives are German Karl Larenz, Italian Benvenuto Griziotti, and Argentinian Dino Jarach. In Brazil, there is Amílcar Falcão de Araujo⁽¹²⁾. Even its proponents recognize that the use of this interpretation method does not exclude the use of other interpretative methods.

The Jurisprudence of Values and Methodological Pluralism

The jurisprudence of values, which appeared in the early twentieth century, puts positivism aside, whether it's trend related to the jurisprudence of concepts, or the one related to the sociological Jurisprudence of Interests, resurfacing with ethical and moral standards, and promoting the redemption of an idealized justice. Adopting the methodological pluralism, it assumed that between methods of interpretation there is no hierarchy, the importance of each method varying according to the specific case, with valuations to be developed when needed. Ricardo Lobo Torres⁽⁹⁾ cited Klaus Tipke and Klaus Vogel as advocates of this view, as well as Brazilians Marco Aurelio Greco⁽¹³⁾ and Hermes Marcelo Huck⁽¹⁴⁾.

Thus, methodological pluralism, based on the jurisprudence of values, gives a different approach to the problem of avoidance. It departs from the assumption that the taxpayer has complete freedom to plan their businesses in search of lower taxes, provided they keep within the limits of the expressive possibilities of the letter of the law. Taxpayers may not exceed such limits, taking advantage of vague concepts, to end up offending basic values and principles related to the unity of the legal system, once considered the unavoidable interaction between tax law and economics.

Either method of interpretation can be used in any order, since they are not contradictory, but complementary, and intercommunicate in-between. For the proponents of this method, property taxes postulate the systematic interpretation, as supported by concepts of private law. On the other hand, taxes on income and consumption would be open to economic interpretation, as based on concepts developed by tax law. Visualizing an equilibrium between private law and tax law concepts, and safeguarding legality and the respect for individual tax ability, the idea of tax justice encompasses the rejection of abusive schemes, through the anti-avoidance clauses.

The Methods of Interpretation in Brazilian Tax Law

The normative positivism is still the predominant trend in Brazil, embodied in the systematic method of interpretation, for the sake of an alleged legal certainty, irrespectively of the principles of equality and apportionment according to wealth. Effectively, though, the interpretation of tax law can be done by any of the existing methods, once it does not differ from other types of legislation in this respect. The articles

of the CTN (Brazilian National Tax Code) regarding interpretation are contradictory, not adding too much to the matter.

For Ricardo Lobo Torres⁽⁹⁾, the systematic interpretation is declining among the jurists because it excludes teleological assessment. The same is good for its corollaries, the primacy of private law, the separation between law and economics, the lawfulness of avoidance and the view of legislation as the single source of tax law. He goes further, saying that what is observed is the plurality and equivalence, the methods being applied according to the case and the laws text inherent values, which sometimes will lead to the systematic method, or the historic method, or even to the teleological, because they are not contradictory, but complementary.

Definition of Tax Avoidance and its Distinction with Respect to Tax Evasion

The analysis of tax evasion and tax avoidance should be done in a concerted way, because of their degree of similarity, their complementary characteristics, and especially because of their impact on today's modern tax systems.

Tax avoidance aspires to a condition of legality that distinguishes it from evasion. Marcelo Huck⁽¹⁴⁾ starts by establishing two key characteristics that sets the concepts of evasion and avoidance apart. The first lies in the means used in each activity. Avoidance, on one hand, focuses on the use of legal means, at least formally lawful, while evasion schemes involve the use of illegal means. The second characteristic, though not absolute, is the chronology of the act. In evasion, the distortion occurs at the time or after tax incidence, whereas in avoidance the individual somehow prevents the triggering event to take place,

altering the path that would otherwise be used. Despite its usefulness, the time criterion shows itself not to be enough, especially if we imagine that an illegal act may be practiced before the triggering event, and still constitute an evasive procedure.

Marco Aurélio Greco⁽¹³⁾ proposes a different distinction. Agreeing with the criteria based on the legality of means, he mentions that simulation, fraud and the abusive use of a right, as pathologies of a juridical act, lead to evasion. Avoidance requires legal means, but not only that, as for not being considered abusive, avoidance practices must not violate the ability to pay principle, enshrined on art. 145 of the Constitution of the Brazilian Federative Republic⁽¹⁵⁾ (hereafter CBFR). This third branch, encompassing abusive avoidance practices, would constitute taxable operations.

The author goes further, signaling that the abusive use of a right may take place through the use of a right with a different objective than the one envisioned by the legislator or through a functional distortion, that is, by inhibiting the efficacy of an incident statute without no justifiable reason. This abusive behavior, depending on the situation, could be accomplished through the adoption of particular legal forms.

Traditional doctrine, sheltered on the principle of legality⁽¹⁶⁾, does not accept this argument, believing that the taxpayer should not be compelled to pay more, on the basis of subjective analysis, if there are lawful alternatives authorizing him to pay less taxes.

Marco Aurélio Greco⁽¹³⁾ concedes that the taxpayer's do have the right to freely organize their economic life, but he also adds that when a transaction is made with the sole purpose

of paying fewer taxes the principle of the ability to pay is being violated, and an abusive use of a right may occur.

In view of these considerations comes the central point of discussion, namely, on one hand the government intervention in free enterprise may offend the principle of legality⁽¹⁶⁾ and other private liberties, but, on the other hand, the use of law's concepts contrarily to its inherent social purpose may violate the constitutional principles of the ability to pay⁽¹⁷⁾ and equality⁽¹⁸⁾.

The General Anti-avoidance Clause

The Complementary Law no.104/2001 changed the CTN by adding a paragraph to its article 116, which defines a general taxable triggering event. The paragraph is freely translated below.

“The administrative authority may disregard juridical acts or contracts practiced with the purpose of dissimulating the occurrence of the triggering event or the nature of some of its constituting elements, once observed the procedures which will be established in statutory law.”

This clause authorizes the interpreter to disregard the juridical act practiced by the taxpayer, if it dissimulates the occurrence of a triggering event, even if it appears, for all effects, to be legal. The act will be disregarded only for tax purposes. According to Marco Aurélio Greco⁽¹³⁾, the clause does not affect simulated, fraudulent or abusive acts. It addresses acts that do not suffer from these pathologies, but that put at risk the desirable equality and the principle of the ability to pay.

Brazilian law already contained specific rules to control tax avoidance, especially on income tax. Article 51 of Ordinary Law no. 7.450/1985 states that "all income (...) are included in the incidence of income and capital gains taxes, whichever the name given to it ..." and article no. 3 of Ordinary Law no. 7.713/1988 established that "the taxation of income is independent of the name, title or rights, location, legal status or nationality of the source, the effective source of goods, rents or profits, once they benefit the taxpayer in any form and under any title.", but, according to Ricardo Lobo Torres⁽⁹⁾, only with the inception of the general anti-avoidance clause, it makes a model choice.

In France, the "Code General des Impôts"⁽¹⁹⁾ establishes in its article no. 1.741 penalties for anyone who has concealed acts subject to taxes. In addition, article no. 64 of the "Livre des Procedures Fiscales"⁽²⁰⁾ regulates the abuse of law, by providing that acts that conceal the true understanding of a contract can not be opposed to the tax administration, leaving the administration authorized to reclassify them.

Is the Anti-avoidance Clause Unconstitutional?

In order to examine the clause's constitutionality, one must identify its formal and material aspects. According to article 146, item III, of the Brazilian Constitution⁽¹⁵⁾, general regulation on tax law is a subject that requires a complementary law to be approved. This way, if the legal requirements for the approval of Complementary Law no.104/2001 were met, and they effectively were, resulting finally in its approval and publication by Congress, one can say that formally the general anti-avoidance clause is constitutional.

Materially, the clause authorizes the state and federal tax administrations to disregard certain juridical acts, for tax purposes, operating within the typical limits of a general tax rule. The acts to be disregarded were used to dissimulate. The meaning of the word “dissimulate” in this context raises much debate. According to Ricardo Lodi Ribeiro⁽²¹⁾, the word “dissimulate” encompasses all the ways in which the abusive use of a right takes place, being it fraud, lack of business purpose, concealment, simulation or any other, constituting the exact verbal expression associated to the abuse of rights. Some of this means are regarded to be illegal, leading to evasive procedures, not exactly abusive avoidance. To dissimulate is to conceal the essential quality of a juridical act, by substituting it by another act. Washington Barros Monteiro⁽²²⁾ cites the following example:

“A wishes to buy a house (this is the real deal) from B, paying minimal taxes. They decide to constitute a legal entity, where A will pay for its shares with the house and B will pay in cash. The two values are equal. After awhile, they decide to end the legal entity, in a way that B will receive the house and A the money. The purchase and sale of the property is the real deal, while the constitution of the corporation is the simulated business. The real economic effect intended by the parties differ from the typical effects (apparent) of the transaction executed. The real effect desired is the purchase and sale of property, whereas the apparent effect is the constitution of a society.”

Moreover, the triggering event that was dissimulated must be itself legal, referring to a tax regularly created according to the constitutional requirements in effect. Some jurists, like Ives Gandra da Silva Martins, understands that the general anti-avoidance clause gives the tax administrations power to tax an operation done in its least expensive way, even when done according to the private legislation applicable. Writes this author:

“The general anti-avoidance clause allows the tax authorities to impose taxes and penalties in excess of the law’s text, disregarding the applicable law, choosing the interpretation that results in higher taxes, and assuming a more expensive operation happened, even when the least expensive was used, within the law, by the taxpayer.”

The position advocated by the author demonstrates a trend rooted in the normative positivism, tolerating a system based on abusive tax avoidance. The clause’s text does not authorize the tax administration to impose a tax without an underlying law, nor allows the interpreter to suppose that a triggering event occurred, its only goal is to allow the administration to remove the mask that was used to dissimulate a triggering event that effectively occurred. Following this reasoning, if the triggering event does not occur, as legally prescribed and factually verified, the hypothesis of the anti-avoidance clause would not materialize. This way, the legality remains intact, and formally and materially the anti-avoidance clause does not collide with the Brazilian Constitution.

Attempts to Regulate the Anti-avoidance Clause

At the end of the anti-avoidance clause’s text the legislator requires further regulation to the subject, as he says "..., observed the procedures to be established in ordinary law." This way, the clause would not be self executing, complete and ready to be implemented, requiring an ordinary law to establish detailed procedures on how to make effective the disregard of the acts targeted.

In a first reading, it could be claimed that the legislator aimed to establish, through statutory law, further regulation so as to guarantee the due process of law, and other

constitutional principles, when applying the clause to real cases. According to Ricardo Lobo Torres⁽⁹⁾, the Brazilian Federal Government was already operating with the existing tools, whereas the states and municipalities were not. Along with Ricardo Lodi Ribeiro⁽²¹⁾, Ricardo Lobo Torres⁽²²⁾ believes that in the federal level it would not require further regulation. The latter author considers that the attempt to regulate the clause, in the federal level, made by articles no. 13 to 19 of the Provisory Measure no. 66/2002 was essentially a mistake, since it narrowed the reach of the original text, mentioning only the business purpose test and the abuse of form, leaving other hypothesis out.

Regarding the business purpose test, the text suggested as indicative of a lack of business purpose the option for a more complex or more costly way to do it, between options that would produce the same economic result. The hypothesis in the text works as an example, not limiting other possible interpretations, thus not adding much precision to the understanding of the phenomenon.

On the other hand, a definition to the abuse of form was adopted, "...it is considered abuse of the legal form the practice of an indirect act which produces the same economic result of the legal act concealed." This time the text took a step further, defining that the economic result must be the same, but falling short when limiting its scope.

Bringing to the definition every other act that produces the same economic results enlarges the possibilities to an alarming extent. The abuse happens when the act, besides resulting in the same economic effects, was practiced with the main or sole purpose of avoiding or diminishing a tax.

Provisory Measure no. 66/2002 was converted into Ordinary Law no. 10.637/2002, but the articles regulating the anti-avoidance clause were excluded from the final text, not existing other attempts, in the federal level, to regulate the clause since then.

4. Tax Avoidance and Tax Evasion, the American Experience

Introduction

The American legal system started to deal with avoidance and evasion at the end of the nineteenth century. *U.S. v. Isham*⁽²³⁾, in 1864, was one of the first decisions. In 1922 John H. Sears published "Minimizing Taxes,"⁽²⁴⁾ in which he refers to U.S. Supreme Court's decisions that shaped the understanding of the phenomena, such as *Bullen v. State of Wisconsin*,⁽²⁵⁾ in 1916. The latter decision refers to a dispute over state inheritance tax, but, other than that, the federal personal income tax was the origin of many disputes regarding avoidance.

The Constitution of the United States provisions are the starting point to a tax analysis, followed by the statutes, once taxation is not a Common Law subject. The letter of the statutes, the underlying reasons why they were adopted and even the recorded legislative debates, if existent, are all of interest. The actual main tax statute is the Internal Revenue Code of 1986. But statutes sometimes do not address all the important issues, as an example, the actual tax code does not contain a definition of fraud (section 6663).

This way, since the subject of this paper is closely related to the interpretation of tax law, the higher court's decisions on the phenomena are of exceptional interest. Federal tax

decisions come from the United States Supreme Court, the U.S. Courts of Appeals, District Courts, Court of Claims and the Tax Court. The Internal Revenue Service (hereafter IRS) has always taken the position that it is only bound by Supreme Court decisions.

The analysis to be done in the next paragraphs will differ substantially from the previous one, as the characteristics of a Common Law system leads us to examine each case brought to the Courts in its own specific terms. The Courts decisions are designed to solve a specific case, but the overall goal of the research is to identify patterns, that is, the existence of coincident essentials on the adopted decisions. This way, the evolution of the concepts will be presented as they appeared along time.

Case Law, doctrine, legislation and perspectives

In the nineteenth century the U.S. Supreme Court decided the first relevant case regarding avoidance, *US v. Isham*⁽²³⁾, a dispute over a stamp tax established in 1864. Isham, the superintendent of a mine, gave memorandum checks to pay the mine's expenses, instead of promissory notes. The two had the same economic effect, but promissory notes were subject to the stamp tax. The U.S. Supreme Court, pointing out that memorandum checks were well known in commercial law, reasoned that "...if a device to avoid taxation is carried out by means of legal forms, it is subject to no legal censure."

The decision clearly opted to safeguard the cohesion of the legal system as a whole, subordinating the tax concepts to the concepts of commercial law, rather than to the

economic reality. At this moment in time the jurisprudence of concepts was the main interpretation trend.

In 1916 the U.S. Supreme Court decided a case argued by George Bullen⁽²⁵⁾, deceased, and others against the State of Wisconsin. The fixture of the inheritance tax upon the estate of George Bullen was the central question, and, in its reasoning, the Court addressed the tax evasion phenomenon the way shown below.

“The deeds of trust was not a merely simulated transaction. (...) We do not speak of evasion, because, when the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits. When an act is condemned as an evasion, what is meant is that it is on the wrong side of the line indicated by the policy if not by the mere letter of the law.”

Setting simulation and evasion aside, the decision makes clear that the act did not involve unlawful procedures. What effectively happened was the disregard, for tax purposes, of an apparently lawful act, that is, the disposition of the estate through a trust, since it was considered to be equivalent to a taxing statute fee. The authorities verified that the principle which allowed the tax effectively took place, and, through economic interpretation, concluded the tax was due. Mr. Justice Holmes used the term evasion to denote an unsuccessful attempt to avoid taxation, rather than a synonym to fraud.

“The principle that allows the tax is to be applied, if ever, to a disposition that operates upon the great mass of the donor’s estate, and that takes effect only upon his death; at least, so far as concerns the persons before this court, the donor’s widow and sons.”

Bullen's main objective was not to avoid taxes. As a matter of fact, according to the Tax Court, fraud is the intent "(...)to evade taxes known to be due and owing by conduct intended to conceal, mislead, or otherwise prevent the collection of taxes, (where) there is an underpayment of tax(...)." ⁽²⁶⁾

Bullen v. State of Wisconsin reveals an important evolution as the jurisprudence of concepts was giving way to a new understanding of the phenomenon. In *Ransom v. City of Burlington*⁽²⁷⁾, Supreme Court of Iowa, 1900, the sole objective of a property transfer was to avoid a paving assessment, and it was repealed in the terms below.

"While one may lawfully dispose of his property to escape taxation, even taxation of a general character, the law will not uphold any mere manipulation under the guise of disposition, the only effect of which is to defeat a tax."

The parties involved did not want essentially to sell property, that is, to transfer all the rights associated with ownership, what they really wanted was to avoid taxation, and decided to achieve such objective through the abusive use of the juridical concept of sale. At this point an important distinction must be clear. If tax avoidance comes alongside, the act can not be disregarded, as in *Weeks v. Sibley*⁽²⁸⁾. The changing of status of an organization was in dispute, and the court held that since the original shareholders did not maintain their positions in the company, therefore not benefiting from the future tax effects, there was no tax due.

Another relevant limit comes from *United States v. Wigglesworth*⁽²⁹⁾, U.S. Supreme Court, 1842, regarding the interpretation of tax laws.

“(….)In the first place, it is, as I conceive, a general rule in the interpretation of all Statutes, levying taxes or duties upon subjects or citizens, not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out, although standing upon a close analogy. In every case, therefore, of doubt, such Statutes are construed most strongly against the Government, and in favor of the subjects or citizens, because burthens are not to be imposed, nor presumed to be imposed, beyond what the Statutes expressly and clearly import.(…)”

In 1921, in *United States v. Phellis*⁽³⁰⁾, the U.S. Supreme Court treated substance over form as appears below.

“(…)We recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases...we have under varying conditions followed the rule.(…)”

Despite occasional pre-eminence of form, in deciding federal tax cases the courts seem to be willing to focus on substance behind the veil of form, especially when facing self-dealing transactions.

From another point of view, the judicial disregard for the taxpayer’s motive to avoid taxes comes from three U.S. Supreme Court decisions, namely, *Bullen v. Wisconsin*⁽²⁵⁾, *Gregory v. Helvering*⁽³¹⁾ and *Commissioner v. Newman*⁽³²⁾, being it’s central message, “ the

doctrine that a man's motive to avoid taxation will not establish his liability if the transaction does not do so without it", widely accepted. But there are circumstances in which the motive can not be disregarded. For example, when the statutes explicitly mention tax avoidance as an operative factor in establishing tax liability. Secondly, when comparing the form with the essence of a transaction, since "motive is a persuasive interpreter of equivocal conduct" (*Morsmann v. Commissioner*⁽³³⁾, 1937).

John H. Sears proposed at the beginning of "Minimizing Taxes"⁽²⁴⁾ a definition for tax avoidance and tax evasion that combined legal and chronological criteria.

"(...)The term "avoidance" of taxes is used to describe some lawful action aimed to affect taxability in the future, as distinguished from "evasion", which refers to some fraud upon the revenue, past, present or future.(...)"

The distinction envisioned by the author fails to address the hypothesis of abusive schemes, resulting impossible to locate perfectly such procedures under any of the two possibilities shown, since it does not fits either description. It can be argued that abusive schemes may occur while lawful action takes place, even though, for tax purposes, these actions will possibly be disregarded, this way, abusive schemes would be grouped within the avoidance definition. In 1937 John B. Lowe⁽³⁴⁾ proposed a different distinction.

"(...)Avoidance is the use of specific exemptions, exclusions and deductions allowed by law. Evasion, on the other hand, is an attempt to clothe illegal deductions with a semblance of legality."

The text is less specific, but it's broad terms seem to fit better the facts. Returning to the U.S. Supreme Court decisions, in 1934 the reasoning developed in *Gregory v. Helvering*⁽³¹⁾ introduced the business purpose doctrine, which, years later, was summarized by Judge Learned Hand in the terms below.

"(...)The doctrine of Gregory v. Helvering...means that in construing words of a tax statute which describes commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation.(...)"

The tax statutes text inherently refers to transactions with commercial or industrial purposes. As a result, the economic interpretation would be the most adequate. But other doctrines emerged from judicial decisions. The doctrine of the step transaction, which proposes us to see the interrelated steps of a transaction as a whole, once eliminated the transitory steps, coincides with the business purpose or the form over substance doctrines. Regarding the latter doctrine, and referring to *Burnet v. Commonwealth Improvement Co.*⁽³⁵⁾, 1932, the court said as below.

"(...)On the other hand, the Government may not be required to acquiesce in the taxpayer's election of that form for doing business which is the most advantageous to him. The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute. To hold otherwise would permit the schemes of taxpayer's to supersede legislation in the determination of the time and manner of taxation.(...)"

Authors Harrop A. Freeman and Norman D. Freeman, in “The Tax Practice Deskbook,”⁽³⁶⁾ 1960, summarized the differences as follows.

“(…)(2) Evasion is not necessarily fraudulent but tends in that direction. (…) (5) Avoidance has a connotation of acting before tax liability attaches; evasion, of manipulation to escape a tax liability already attached or imminent.(…)”

Once again the proposed definition comes with broad words and meanings. Abusive schemes are now positioned within the evasion concept, since evasion does not require fraudulent behavior. But the authors went further, listing the Supreme Court’s rules regarding legitimate avoidance.

“(…)(6) Avoidance requires absence of subterfuge, deceit, misrepresentation or fraudulent intent and strict compliance with law. (…)

(7) Substance rather than form controls.(…)

(8) There must be a legitimate business purpose other tax avoidance for a transaction to be held proper.

(9) All the steps in a transaction must be viewed together and must be appropriate; it is not enough that each move complies with the statute.

(10) The situation after the transaction will be compared to that before (e.g. “continuity of interest” rule.(…)”

The list encompasses the three mentioned doctrines, business purpose, substance over form and step transaction, and adds other criteria, spanning a wide range of possibilities.

Author Camilla E. Watson, in “Tax Procedure and Tax Fraud in a Nutshell,”⁽³⁷⁾ 2006, argues that under section 6663(b) of the IRS Code fraud is synonymous with tax evasion,

the “willful attempt in any manner to evade or defeat any tax,” under the criminal fraud provision, section 7201.

Nowadays, when disregarding the effects of a transaction, Courts use to refer to *Knetsch v. United States*⁽³⁸⁾, a leading case decided in 1962, where Mr. Justice Brennan delivered the opinion of the Court as follows.

“(….)As was said in Gregory v. Helvering, [293 U. S. 465](#), [293 U. S. 469](#):

"The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted. . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended." (...) For it is patent that there was nothing of substance to be realized by *Knetsch* from this transaction beyond a tax deduction. (...)"

The Court interpreted the statutes in a way that envisioned substance, whether economical or other, as essential when interpreting the tax law applicable.

“(….)There may well be single premium annuity arrangements with nontax substance which create an "indebtedness" for the purposes of § 23(b) of the 1939 Code and § 163(a) of the 1954 Code. But this one is a sham. (...) "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Gregory v. Helvering*,(...)"

The transaction that created the indebtedness was considered to be false, not true, that is, a sham. The whole transaction was a mere artifice that should not prevent the tax incidence. The business purpose test as in *Gregory v. Helvering*⁽³¹⁾, was repeatedly

mentioned. *Goldstein v. Commissioner*⁽³⁹⁾, in 1966, developed even further the business purpose doctrine.

“(….)For all of the above reasons the Tax Court was justified in concluding that petitioner entered into the Jersey City Bank and Royal State Bank transactions without any realistic expectation of economic profit and 'solely' in order to secure a large interest deduction in 1958 which could be deducted from her sweepstakes winnings in that year. This conclusion points the way to affirmance in the present case.

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We hold, for reasons set forth hereafter, that Section 163(a) of the 1954 Internal Revenue Code does not permit a deduction for interest paid or accrued in loan arrangements, like those now before us, that can not with reason be said to have purpose, substance, or utility apart from their anticipated tax consequences.”

The concept of substance over form can be adopted by the courts as a principle of interpretation or explicitly set out in a statute. In countries with Civil Law systems it is embodied in the judicial concept of “abuse of law”, and in countries with Common Law systems it appears as a well recognized principle of interpretation that can be applied in certain circumstances to tax law.

Conclusion

The inventiveness of the taxpayer is an untamed source of imbalance to every tax system. If the system does not control, or loosely controls such initiatives, extensive harm can ensue. For this reason, tax avoidance and evasion need to be managed in a coherent and extensive manner, to discourage such practices and to restore equality when needed.

Preventive measures are welcome, such as the IRS publication of lists, with the description of abusive schemes, the administrative procedures associated and the related case law.

A good starting point would be to have statutory texts with as clear as possible procedural regulations. The U.S. legal system seems to be mature in this regard, whereas the Brazilian anti-avoidance clause text requires a specific law regulating its procedures. The Brazilian tax administration would be better off without this requirement, since it would work with general concepts already available. When the moment comes to set the text of the necessary law, legislators must fulfill every relevant aspect, in order to diminish or eliminate doubts over such instrumental matter.

The next step would be to envision an effective way to deal with the definition of the phenomena. When trying to identify avoidance, or evasion, it is inevitable to find that certain broad juridical concepts appear as key elements. “Dissimulation”, “fraudulent intent”, “legitimate business purpose” and “abusive use of a right” are just some of them. Avoidance and evasion are all about dodging legal obstacles, in the less risky way. If an obstacle is clearly identified, with precise juridical concepts, the less risky it becomes to avoid. This way, anti-avoidance measures will be more effective if they assume that broad concepts are not undesirable, they are, in effect, inherent to these phenomena. These broad concepts are subject to interpretation, as every other juridical concept, but, given the specific case, it’s boundaries are always identifiable.

In this sense, if we assume that the Brazilian anti-avoidance clause needs further regulation, its text should not try to over specify the practices that are to be considered abusive avoidance, on the premises of safeguarding juridical certainty. In the USA, from the Supreme Court rulings over legitimate avoidance comes five different criteria, all of them containing broad juridical concepts.

Assuming that Civil Law systems inherently leads to riskier legal environments, since previous decisions are not binding, being their authority limited to the specific case, and the statutes can not fulfill every other situation found in society, it would be possible to conclude that this risk would naturally curb evasion and avoidance. But that is not the Brazilian case. Even though that effect would eventually take place, we must not forget that every tax system needs a degree of predictability. The search for guidelines, even broad ones, would prevent potential uncertainty.

In this sense, the American legal system, based on Common Law, reaches a better equilibrium, once it exemplifies through its binding precedents unacceptable conduct, being at the same time open to curb new abusive conduct.

This way, the American legal framework seems to have a degree of maturity yet to be reached by the Brazilian system, which, regarding abusive avoidance, still depends on uncertain administrative initiatives that deal with juridical concepts located on the fringe of the legal system.

Notes

- (1) The Internal Revenue Service, an agency of the Department of Treasury created by The Revenue Act of 1862, published in 2009 the “Update on Reducing the Federal Tax Gap and Improving Voluntary Compliance”, see www.irs.gov
- (2) Joint survey conducted by the Economy Institute of Getulio Vargas Foundation and The Brazilian Institute of Business Ethics in 2009, see www.fgv.br
- (3) The Brazilian National Tax Code, originally Ordinary Law no.. 5.172/1966, which has a “status” of Complementary Law
- (4) Gregory v. Helvering, 293 U.S. 465 (1935)
- (5) The Brazilian Civil Code of 1916, Ordinary Law no.. 3.071/1916
- (6) The Brazilian Civil Code of 2002, Ordinary Law no.. 10.406/2002
- (7) DAVID, Renée. “**Les Grands Systèmes du Droit Contemporains**”, 11th edition, 2002.
- (8) NOGUEIRA, Ruy Barbosa. “**Curso de Direito Tributário**”. São Paulo: Saraiva, 1995.
- (9) TORRES, Ricardo Lobo. “**Teoria dos Direitos Fundamentais**”. Rio de Janeiro : Renovar, 1999.
- (10) CANTO, Gilberto de Ulhoa. “**Evasão e Elisão Fiscal**”. *Um Tema Atual*. Revista de Direito Tributário, no.. 63, 1993, São Paulo.
- (11) DÓRIA, Antônio R. Sampaio. “**Elisão e Evasão Fiscal**”. 2. ed..São Paulo: Bushatsky, 1977.
- (12) FALCÃO, Amílcar. “**Fato Gerador da Obrigação Tributária**”. Rio de Janeiro: Forense, 1994.
- (13) GRECO, Marco Aurélio. “**Planejamento Tributário**”. São Paulo: Dialética, 2008.
- (14) HUCK, Hermes Marcelo. “**Evasão e Elisão**”. São Paulo : Saraiva, 1997.
- (15) The Constitution of the Brazilian Federative Republic, 1988.
- (16) art. 5, item II, Constitution of the Brazilian Federative Republic, 1988
- (17) art. 145, par.1, Constitution of the Brazilian Federative Republic, 1988
- (18) art. 5, item I and art. 150, item II, Constitution of the Brazilian Federative Republic, 1988
- (19) “Code Général des Impôts”, CGI, 1948, see www.legifrance.gouv.fr
- (20) “Livre des Procédures Fiscales”, consolidated version 2010, see www.legifrance.gouv.fr
- (21) RIBEIRO, Ricardo Lódi. “**Justiça, Interpretação e Elisão Tributária**”, R.J.: Lumen Juris, 2003.
- (22) MONTEIRO, Clovis W. de Barros. “**Curso de Direito Civil**”. São Paulo: Saraiva, 1989.
- (23) U.S. v. Isham, 84 U.S. (17 Wall.) 496, 21 L. Ed. 728 (873)

- (24) SEARS, John H. Minimizing Taxes. Vernon Law Book Co., USA, 1922.
- (25) Bullen v. State of Wisconsin, U.S. Supreme Court, 240 U.S. 625 (1916)
- (26) Nelson v. Commissioner (Tax Ct. Memo. 1997).
- (27) Ransom v. City of Burlington, Supreme Court of Iowa, 1900.
- (28) Weeks v. Sibley, U.S. District Court of Texas, 1920
- (29) U.S. v. Wigglesworth, 834 US Supreme Court, 1842
- (30) U.S. v. Phellis, US Supreme Court, 257 US 156 (1921)
- (31) Gregory v. Helvering, US Supreme Court, 293 U.S. 465 (1935)
- (32) Commissioner v. Newman, 159 F. 2D 848, 850-851 (2d. Cir.1947)
- (33) Morsmann v. Commissioner, 1937
- (34) LOWE, John Blake. Minimizing Taxes on Incomes and Estates: Tax Avoidance v. Tax Evasion, 1937.
- (35) Burnet v. Commonwealth of Investment Co., US Supreme Court, 287 U.S. 415 (1932)
- (36) FREEMAN, Harold and Norman. The Tax Practice Deskbook. Little Brown and Co., 1960.
- (37) WATSON, Camilla E.. Tax Procedure and Tax Fraud in a Nutshell, Thomson West, 3rd ed., 2006.
- (38) Knetsch v. United States, US Supreme Court, 364 U.S. 361 (1960)
- (39) Goldstein v. Commissioner of Internal Revenue, US Court of Appeals 2nd Circuit, 364 F.2d 734 66-2
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