RDTI Atual 07

IBDT | INSTITUTO BRASILEIRO DE DIREITO TRIBUTÁRIO
Revista Direito Tributário Internacional Atual
e-ISSN 2595-7155

PRINCIPAL PURPOSE TEST IN BRAZILIAN TAX TREATIES[1]

João Francisco Bianco

Professor at the Brazilian Institute of Tax Law. Visiting Professor at University of Minho

DOI: http://dx.doi.org/10.46801/2595-7155-rdtia-n7-12

Action 15 of the Base Erosion and Profit Shifting (BEPS) project was dedicated to implement concrete solutions for governments to close loopholes in tax treaties that were being used to create opportunities for double non taxation, through the exploit of gaps and mismatches in tax rules by taxpayers.

The result was the publication of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). The MLI is a multilateral tax treaty that modifies and complements bilateral double tax treaties in force. It works as a flexible and simplified way to change the wording of bilateral treaties, without the renegotiation of individual treaties. Countries that agree with the changes proposed by the MLI in their bilateral treaties may simply adhere to the multilateral text. If the other contracting States of the bilateral treaties also adhere to the MLI, all the bilateral treaties are automatically modified without the need to change them individually.

The general objectives of the MLI are to curb the use of hybrid mismatch arrangements, to prevent treaty abuse, to regulate artificial avoidance of permanent establishments and to improve the mechanisms of dispute resolution between countries. Part III of the MLI deals specifically with treaty abuse. Its article 7.1 introduces the idea of a test to be applied to the taxpayer in order to determine if the arrangement adopted is or is not abusive. It is called the "*principal purpose test*" (PPT).

The wording of article 7.1 of the MLI reads as follows:

> Article 7 – Prevention of Treaty Abuse
> 1. Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any

1 Este texto é um resumo da conferência proferida pelo autor em maio de 2019 em encontro organizado pelo Tax Knowledge Sharing Group do International Bureau of Fiscal Documentation – IBFD em Amsterdam.

> arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of the Covered Tax Agreement.

In simple words, article 7.1 determines that if one of the principal purposes of the arrangement adopted by the taxpayer was to obtain a benefit under the tax treaty, then that benefit will not be granted. Therefore, the test is applied to determine the objective of the arrangement adopted. If one of the principal objectives was to obtain a treaty benefit, then the consequence is the denial of the application of the benefit. In other words, if only one objective of the arrangement (among many others) is tax related, this fact will suffice to determine the impossibility of the application of the treaty benefit.

The last sentence of the article gives the taxpayer an opportunity to prove that the benefit obtained was in accordance with the objective and purpose of the treaty. Should that be the case, then the benefit will be granted. But it is reasonable to conclude that such exception will be very difficult to be applied in practice.

Article 7.4, on the other hand, regulates what is being called the "*discretionary relief*". It has a long and confusing wording but essentially it determines that if a benefit under a tax treaty is denied, because the arrangement fails to pass the PPT, the competent authority shall grant another benefit regulated by the treaty, if such benefit would have been granted in the absence of the arrangement.

An example may clarify the objective of the article.

Let's assume that dividends payed from country A to a resident in country B are subject to the withholding income tax (WHT) of 30%, according to domestic law, but limited to 15% according to the tax treaty signed between the two countries. And let's suppose that capital gains earned by a resident in country B derived from the sale of assets located in country A are subject to WHT of 5% according to domestic law.

Now let's assume that a resident in country B is going to receive dividends from its subsidiary in country A and wants to reduce the incidence of the WHT to 5%. The taxpayer then adopts a series of arrangements that "*transforms*" the legal nature of the dividends into capital gain, in order to apply the 5% WHT regulated by domestic law in force in country A.

Tax authorities in country A, however, may apply the PPT and conclude that the arrangements to "*transform*" the nature of the dividends failed the test, because the tax benefit (reduction of WHT) was one of the principal purposes sought by the taxpayer with the arrangements. According to article 7.1 of the MLI, under these circumstances, the benefit dealt with by the tax treaty will not be granted.

At this point one could conclude that in such case the money remitted from country A to the resident in country B would be subject to a WHT of 30%, because it would be requalified as dividends. And since the arrangement failed to pass the PPT, it would be impossible to apply the tax treaty as a whole and domestic law in country A would have to be applied.

But article 7.4 does not allow such conclusion.

Actually, article 7.1 only denies the application of the specific benefit sought by the taxpayer with the abusive arrangement. And article 7.4 allows the application of another benefit under the tax treaty that would be applied in the absence of the arrangement. Going back to our example, the taxpayer used an abusive arrangement to "*transform*" dividends into capital gain. He failed to pass the PPT. Therefore, the amount payed would be requalified as dividends and would be subject to tax as dividends and not as capital gain. And as dividends, according to the tax treaty, they would be subject to WHT of 15%. That would be the rate applicable to the case and not the 30% as regulated by the domestic law.

If the consequence of the failure to pass the PPT were the denial of the application of the treaty as a whole, the WHT applicable would be of 30% according to the domestic law in country A. But article 7.4 allows the application of another treaty benefit as if the arrangement had never been used. In our example the treaty allows the application of the WHT at the rate of 15% on the payment of dividends from country A to a resident in country B. Therefore that second treaty benefit would be applicable.

We may then conclude that the failure to pass the PPT does not prevent the application of the treaty as a whole. Any other treaty benefit may be applied as if the arrangement had never been used. This conclusion derives from the literal wording of article 7.4.

THE BRAZILIAN PERSPECTIVE

Brazil has not signed the MLI. It has decided to renegotiate each of its bilateral treaties with its treaty partners on an individual basis, considering that the country does not have a long list of treaties. But despite of that, the option of the Brazilian government does not mean that the structure of the MLI was rejected. On the contrary, Brazil has adopted the MLI wording in all of its recently signed treaties, such as Singapore and Switzerland. And the protocol of the existing treaty with Argentina was amended in order to reflect the changes provided by the MLI.

The adoption of the PPT in the recent Brazilian treaties raises some interesting issues.

First of all we may mention the subjectivity of the text. Brazil is a country with a long standing tradition of application of the rule of law. And the tax law has to be very specific in order to allow the tax to be collected. Abuse of law, substance over form, business purpose and other concepts adopted by common law countries have never been popular in Brazil and judicial courts are still reluctant to apply them in tax matters.

IBDT | INSTITUTO BRASILEIRO DE DIREITO TRIBUTÁRIO
Revista Direito Tributário Internacional Atual
e-ISSN 2595-7155

The possibility to deny the application of the treaty benefit even if the taxpayer had many other economic reasons to adopt the arrangement (taxation being one of them) may also cause some discomfort to judges. Judicial Courts are used to requalifying transactions adopted by taxpayers only if they are a sham. It should be noted that Brazil does not have a general anti avoidance rule (GAAR). Therefore the application of article 7.1 of the MLI will certainly be challenged before the Judicial Courts and the results are uncertain.

Second of all we may mention the absence of article 7.4 in some of the treaties recently signed by Brazil (with Argentina and Switzerland, for example). Strangely enough, Brazilian treaty negotiators adopted the exact wording of the PPT clause (7.1) as it is written in the MLI but did not adopt the so called *"discretionary relief"*.

This fact immediately raises two interesting questions.

First: may we consider that the discretionary relief clause is implicit in the PPT? In other words, tax authorities are obliged to submit the arrangement to another treaty benefit even if such procedure is not expressly allowed by the treaty? Or should they simply apply internal law and disregard the existence of the treaty considering that the arrangement failed to pass the PPT?

This is certainly a controversial discussion. My view is that the absence of article 7.4 does not allow tax authorities to deny the application of any other tax treaty benefit to the arrangement that failed the PPT. On one hand article 7.1 clearly determines that "*a benefit shall not be granted*" if the arrangement fails the PPT. It is only *"a benefit"* that shall not be granted and not the entire treaty. If the objective of the negotiator was to deny the application of the entire treaty to the abusive arrangement, then article 7.1 should read as "*no benefit shall be granted*" or "*this tax treaty shall not be applicable*" if the arrangement fails the PPT. On the other hand even a systematic interpretation of Part III of the MLI does not allow a different conclusion. It is perfectly possible to deny the application of a benefit to an abusive arrangement, based on article 7.1, requalify the arrangement and then apply the treaty to the requalified item of income. Nothing in the text of the MLI authorizes anything different. If the intention of the negotiators was to deny the application of the whole treaty, it would have to be expressly mentioned.

Second: considering that the answer to the first question is affirmative, then may tax authorities requalify the arrangement in the absence of a GAAR in the Brazilian tax system?

Tax authorities argue that Brazil actually has a GAAR. It is the sole paragraph of article 116 of the National Tax Code. The majority of the authors disagree. The provision does not have a clear wording and it allows different interpretations of its content. It also depends on further regulation. Despite of that, the requalification by tax authorities of arrangements adopted by taxpayers is being applied. The jurisprudence of the

administrative tax court is full of cases involving the application of the business purpose test, but Judicial Courts have not examined the issue yet. As can be seen, there is a lot of uncertainty involving the matter. And the PPT ads more variables to the discussion.

The Brazilian Supreme Court has a consolidated understanding that tax treaties prevail over internal law, due to the literal wording of article 98 of the National Tax Code. And that Court has also decided that international treaties (in general, not tax treaties) do not prevail over the Constitution and cannot regulate matters that can only be dealt with by complementary law (ADIn n. 1.480-3, de 04.09.1997). The National tax Code, for instance, is a complementary law.

In order to clarify the international reader, it is important to say that the Brazilian Constitution does not create taxes, it only authorizes the creation of taxes and distributes tax competences among the Federal Government, the States, the Municipalities and the Federal District. The National Tax Code is a complementary law and does not create taxes as well. It only regulates the conditions to be observed by the competent legislators to create taxes. Only the ordinary law is able to create taxes.

Based on that Supreme Court decision, we may conclude that a tax treaty prevails over ordinary law, but not over the Constitution and not over the National Tax Code. The Supreme Court decision mentioned above examined a case involving the application of an international treaty on labor law. But the reasoning adopted by the court may be perfectly applied to treaties dealing with taxation. There is no reason to conclude differently.

If we consider the sole paragraph of article 116 of the National Tax Code to be a GAAR, then PPT will be in accordance with that complementary law and it will be applicable by tax authorities. On the other hand, if we consider that the sole paragraph of article 116 is not a GAAR, then only sham transactions may be disregarded by tax authorities. Valid arrangements according to private law, even if adopted only for tax reasons, may not be requalified by tax authorities in the absence of a GAAR.

My personal opinion is that the sole paragraph of article 116 is not a GAAR. Therefore Brazilian tax system does not authorize tax authorities to requalify valid arrangements for tax purposes just because they failed to have a business purpose. And the PPT foreseen in a tax treaty will not be able to change this conclusion because the Brazilian Supreme Court has already decided that international treaties do not prevail over complementary law. Anyway the subject is highly controversial and final decision will come only by the Superior Courts.