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## THE PHENOMENON OF TAX AVOIDANCE AND ANTI-ABUSE MEASURE

**Abstract:** This article deals with the problem of tax avoidance and anti-abuse measures. Starting with the distinction between the concepts of tax planning, tax avoidance and tax evasion, the authors focus their attention on the tax avoidance phenomenon, that is, situations in which the taxpayer succeeds in avoiding some or all of the tax by using mechanisms, which were drawn up by the legislator for entirely different purposes, in an anomalous and abusive way. In tax avoidance, tax liability never arises.

This is followed by an analysis of the increasing internationalisation and integration of economies, characterised by the ever-easier movement of people and capital and the development of multinational companies and, consequently, the development of abusive practices. This scenario means it is now clear that tax avoidance is no longer a domestic affair, but rather must be discussed on an international level. The authors then take a brief look at the two areas which have the greatest impact on international tax avoidance: one related to the contravention of domestic legislation – so-called “tax havens” – and the other defined by the contravention of international rules – the abuse of double taxation conventions, known as “treaty shopping”.

Lastly, the authors present the Portuguese legal system’s framework of measures to counteract tax avoidance, offering a brief analysis of the presumptions and legal fictions, tax law interpretation theories and specific anti-abuse rules (such as the reversal of the burden of proof provisions; controlled foreign company type provisions; thin-capitalisation resulting from special relationships with non-residents; the exclusion of the application of the taxation system for mergers, divisions, transfers of assets and exchanges of shares; the prevalence of substance over form in derivative financial instruments and transfer pricing). Special attention is given to the general anti-abuse clause and its assumptions, consequences and procedure.

**SOMMARIO:** I. Tax avoidance: concept and related issues – 1. Introduction – 2. Tax planning – 3. Tax avoidance – 4. Tax evasion – 5. Sham Transactions – 6. Abuse of rights – 7. Indirect transaction – 8. *Fraudem legem* – 9. Conclusions – II. Territorial scope of tax avoidance – 2.1. Introduction – 2.2. Tax havens – 2.3. Abuse of Tax Conventions to Avoid Double Taxation (Treaty shopping) – 2.3.1. Direct Conduit Scheme – 2.3.2. Stepping Stone Conduit Scheme – 2.3.3. Bilateral Relations – 2.3.4. Counteracting measures – III. Measures to avoid or reduce tax avoidance – 3.1. Preliminary considerations – 3.2. Presumption and legal fiction – 3.3. Interpretation of tax law – 3.4. Specific anti-abuse rules – 3.4.1. Adjustments by virtue of relations with entities subject to a low-tax system (payments to non-residents and international tax transparency) – 3.4.2. Thin-capitalisation resulting from special relationships with non-residents – 3.4.3. Exclusion of the application of the taxation system for mergers, divisions, transfers of assets and exchanges of shares – 3.4.4. Prevalence of substance over form in derivative financial instruments – 3.4.5. Transfer pricing – 3.4.6. The general anti-abuse clause – 3.4.6.1. Assumptions – 3.4.6.2. Consequences – 3.4.6.3. Procedure – 3.5. Other measures – IV. Conclusion

## 1. – *Tax avoidance: concept and related issues*

### 1. – *Introduction*

Nowadays societies leave the role of dealing with their many needs to the State and other public authorities and high revenues are essential to carrying out this role.

There are few States whose revenue is principally earned from its own property and business activity. Examples include Monaco, Macao or Dubai where most public revenue comes from gambling activities or the oil industry. This leaves the majority of States where public needs are essentially paid for by taxes.

Furthermore, today taxes are not simply a source of revenue. They are also a vehicle for achieving other economic, social and environmental objectives. In particular, taxes are vehicles for the redistribution of wealth, the promotion of equality between citizens, as a guide on how to behave and for environmental protection.

Accordingly, it is clear that anybody who avoids taxes or commits tax fraud is breaching the essential principles of equality, legality, fair distribution of income and wealth, fair competition and solidarity in the field of taxes.

To properly analyse these issues, it is essential to draw a clear distinction between the concepts of “tax planning” and “tax evasion” (in the broad sense).

In fact, these two concepts are not confusing since tax planning (saving) is a taxpayer’s right based on the constitutional principle of freedom of business initiative. This type of tax saving is no more than economic rationality and good management and is often promoted by the State itself through the provision of tax relief, the ability to carry forward losses, tax exemptions, tax deductions or tax benefits.

Accordingly, we have based our analysis on three distinct concepts: tax planning, tax avoidance and unlawful tax evasion (tax fraud) with the anti-abuse rules falling only within the second. It should be noted that this definition of concepts is simply a proposal of the authors and is not based on any specific doctrine.

## 2. – Tax planning

The first part of our analysis covers acts and transactions aimed at saving tax which are lawful, arising as they do from the exercise of contractual and individual freedom.

As we have said, there is no legal sanction against a taxpayer who seeks to reduce his or her tax burden legally. In fact, such an approach is expressly or implicitly encouraged by the State itself<sup>1</sup> in establishing and regulating tax relief.

According to Sá Gomes<sup>2</sup>, “the rationality of management of business activities assumes that, in principle, those in businesses must minimise the commercial, industrial, financial and tax costs of their activity. This being the case, sound tax management obviously requires the minimisation of tax costs, which doctrine calls tax economy or tax savings, without prejudice to strict compliance with taxation laws by economic operators”. In line with this, Marcus de Sousa<sup>3</sup> claims that “it is the duty of every director to maximise losses. For this reason, tax planning is as necessary to business management as any other planning, whether marketing, sales, staff training, external trade, etc. (...). Without good tax planning, it will be very difficult to compete in a globalised market and to ensure good return on invested capital”.

So we are dealing here with taxpayers’ actions, such as the setting up of a business in the provinces instead of a large metropolitan area to obtain a lower rate of corporate income tax (IRC)<sup>4</sup>; the building or upkeep of childcare facilities in companies to obtain a 140%<sup>5</sup> deduction in their costs or the channelling of capital into real estate investment funds. The main characteristics of these funds are the sharing of risk and professional asset management and they are rewarded by the State with tax exemptions in respect of Municipal Real Estate Tax (IMI) and Tax on Transfers for Value of Real Estate (IMT)<sup>6</sup>.

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<sup>1</sup> Amongst many examples of this approach are the incentives granted to businesses that establish themselves outside the major metropolitan areas, to patronage, to small and medium-sized companies or for urban renewal.

<sup>2</sup> N. De Sá Gomes, *Evasão Fiscal, Infracção Fiscal e Processo Penal Fisca* I, Lisbon, 2000, 22-23.

<sup>3</sup> M.V. G. De Souza, *Elisão e evasão fiscal*, in *Boletim Jurídico*, Uberaba/MG, Year 3, 127 (available at: <http://www.boletimjuridico.com.br/doutrina/texto.asp?id=636>).

<sup>4</sup> Cf. art. 43 of Portuguese Tax Benefits Statute (EBF).

<sup>5</sup> Cf. art. 43 of Portuguese IRC Code (CIRC).

<sup>6</sup> Cf. art. 49 of EBF.

### 3. – *Tax avoidance*

The activities described above are different to legal tax evasion (tax avoidance), that is, from the legal acts and transactions aimed at securing the application of a more beneficial tax framework than that intended for a specific event by the tax legislation, even if the economic objective is the same.

In effect, we are dealing with attempts to circumvent the law: situations in which a given economic result achieved through the usual legal means would give rise to a tax liability, but in which the taxpayer succeeds in avoiding some or all of the tax by using anomalous and abusive mechanisms drawn up by the legislator for entirely different purposes

This approach shares its purpose to avoid tax and its economic outcome with tax fraud. The difference comes in the point at which they are carried out and the means used to reduce the tax.

In fact, in tax avoidance, tax liability never arises. This is because either the taxable event does not occur, or if it does, the duty to pay tax does not arise. An example of this is the application of a tax exemption. Conversely, in this context taxpayers continue to use only lawful means of tax avoidance by taking advantage of legal loopholes or inconsistencies to achieve their objective.

Tax avoidance is therefore essentially characterised by the elaborate and unusual methods used to reach the economic objective. This would amount to *extra legem* “planning” or “activities” *in fraudem legem*.

### 4. – *Tax evasion*

Finally, there is unlawful tax evasion (tax fraud). This is an issue of illegal tax saving, achieved through clandestine business transactions or transactions taking place in a parallel economy. There are also fraudulent tax practices such as non-payment of due taxes, false representation, false accounting, wilful destruction of accounting records, false invoicing or failure to pay over withholding taxes owed by third parties (abuse of trust).

These tax evasion practices are different from the *in fraudem legem* practices mentioned above as in this case the agent is directly breaking the law, whereas in tax avoidance he is acting against the spirit of the law while still obeying the letter of the law<sup>7</sup>. We are dealing with the failure to obey tax

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<sup>7</sup> On this issue, L.M. T de Menezes Leitão, *A Evasão e a Fraude Fiscais face à Teoria da Interpretação da Lei Fiscal*, in *Estudos de Direito Fiscal*, Coimbra 1999, 9

legislation which amounts to a crime<sup>8</sup> and is punishable under criminal tax law by a fine or imprisonment, or as an administrative offence punishable by a fine<sup>9</sup>.

In tax planning taxpayers' acts are supported by the State and in tax fraud they are punished by the legal system. Therefore, we must conclude that the fight against abusive practices and the development of anti-avoidance measures only makes sense in the area of tax avoidance (or so-called lawful tax evasion).

Accordingly, insofar as it relates to tax avoidance and its prevention, our analysis will focus on the behaviour of taxpayers which is characterised by the following elements:

- a) the use of legal procedures that, even though lawful, appear to be inappropriate or unusual for the achievement of the intended economic result;
- b) the use of those legal procedures is intended to harm the Treasury (if the economic choice is made for other reasons, there is no tax avoidance); and
- c) the achievement, through the use of the said anomalous legal procedures, of an economic result which is the same as or more beneficial than would have been achieved through normal legal means, if such use is not taxed or is taxed at a lower rate<sup>10</sup>.

Having defined the concept of tax evasion in the broad sense (tax avoidance and tax fraud), it now falls to us to distinguish this concept from and compare it with some most common concepts of current legal systems so as to clear up any doubts that might complicate the following.

##### 5. – *Sham transactions*

A sham transaction is one in which the real and the stated intentions of the parties are different as a result of a conspiracy between them intended to deceive third parties. In many cases the aggrieved third party is the State which loses tax revenue.

<sup>8</sup> The crime of tax fraud is punished by the legal system in light of the reduction in tax revenue or the achievement of unjustified tax benefits thereby protecting, in particular, the Public Treasury.

<sup>9</sup> See, in this context, *Regime Geral das Infrações Tributárias Português* (RGIT), in particular articles 103 to 105 and 113 ff.

<sup>10</sup> Here we closely follow the system proposed by L.M. T de Menezes Leitão, *A Evasão e a Fraude Fiscais face à Teoria da Interpretação da Lei Fiscal*, in *Estudos de Direito Fiscal*, Coimbra 1999, 28.

The sham may be absolute or relative. It is absolute if there is nothing more than the sham transaction. Such sham transactions are often set up with the simple aim of triggering the application of rules that provide for tax exemptions or benefits. The sham is relative if there are two distinct transactions: a simulated one with taxable events that lead to the payment of no tax or of lower tax and a hidden transaction corresponding to the reality of the situation.

As a general rule legal systems establish that absolute sham transactions will be considered null and void and disregarded. In this respect, see article 240(2) of the Portuguese Civil Code (CC). With regard to relative sham transactions, article 39 of the Portuguese General Taxation Law (LGT) provides that the sham transaction must be considered null and void and tax charged on the real legal event<sup>11</sup>.

However, such transactions are not to be confused with the so-called anomalous or unusual transactions or transactions with a lower tax burden which chosen and used out by a taxpayer with a view to paying less tax. As a matter of fact, according to Calvão da Silva<sup>12</sup>, “those transactions devoid of real economic substance, carried out with the sole purpose of obtaining a tax benefit are placed within the concept of sham transaction. Nevertheless, they must not be treated as sham transactions since they are, in effect, intended and carried out by the parties, although they may conceal an objective which may be the same as that in sham transactions – the reduction or exclusion of the tax burden. Sham transactions differ in that they are not really intended by the parties. They are mere appearances or fictions created to conceal the true reality which is the intended transaction”.

Consequently, a distinction must be made between sham cases, where there is a divergence between the real and the declared intention aimed at deceiving the Treasury and which fall within the scope of tax fraud (Article

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<sup>11</sup> Note that article 39 (2) of LGT also provides - without prejudice to the power granted to the tax authorities by the law to adjust the taxable amount - the taxation of the real legal act included in an authentic document depends on a judicial decision declaring its nullity. In spite of this provision, J.L. Saldanha Sanches, *Os Limites do Planeamento Fiscal*, Lisbon, 2006, 79 ff., has drawn attention to the fact that this solution seriously limits the tax authorities' powers as the need for a prior judicial declaration of nullity makes the system too complex. This is reflected in the usefulness of the procedure. Thus, the author holds that this situation has led to case law that substantially reduces the scope of the rule by considering that the existence of a deed of transfer does not prevent the Administration from adjusting the declared price if it obtains evidence supporting its decision: cf. Judgements of the Portuguese Supreme Administrative Court of 26 February 2003 – Case n. 089/83 and of 19 February 2003 case n. 01757/02.

<sup>12</sup> J.N. Calvão da Silva, *Elisão Fiscal e Cláusula Geral Anti-abuso*, in *Revista da Ordem dos Advogados*, Year 66, Vol.II, September 2006, 791 ff.

103 of RGIT), and cases of lawful tax evasion (tax avoidance). In fact, in this latter case, the transactions are actually intended by the parties even if they are an instrument and a precondition for achieving a result that normally does not correspond to its typical structure so, in this case, we cannot speak of a sham transaction.

#### 6. – Abuse of rights

Article 334 of the Portuguese Civil Code provides that “the exercise of a right is unlawful when the holder manifestly exceeds the limits set by good faith, public policy and the social or economic objective of the right”. According to Menezes Cordeiro<sup>13</sup>, the principle of abuse of rights is a safety valve for the value of justice, a remedy to safeguard the prevalence of the legal system over the legislator’s misadventures and the skilfulness of the parties. Accordingly, the concept of abuse of right should only be used in exceptional circumstances where there is a clear breach of fundamental values. Otherwise it may amount to a threat to the essential value of legal certainty<sup>14</sup>.

Some authors such as Trigo de Negreiros<sup>15</sup> or Bacelar Gouveia<sup>16</sup> have, for different reasons, claimed that the phenomenon of abuse of right covers tax avoidance, on the grounds that the taxpayer would be abusing the freedom to choose the type of transaction granted to him by the legal system, by using that freedom to escape tax. However, that theory seems inapplicable and distinct from tax avoidance. In fact, as already mentioned,

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<sup>13</sup> A. Menezes Cordeiro, *Tratado de Direito Civil Portuguesa*, Parte Geral, Tomo I, Coimbra, 1999, 191 ff.

<sup>14</sup> In support of this idea, see J.N. Calvão da Silva, *Elisão Fiscal e Clausula Geral Anti-abuso*, in *Revista da Ordem dos Advogados*, Ano 66, vol. II, September 2006, 791 ff, to the fact that today case law has made the use of this principle quite common. Therefore, instead of having recourse to it only in serious circumstances justifying a solution contrary to the *ius strictum*, we have been confronted with a true case law by emotion which is seriously harmful in terms of both legal certainty and foreseeability. In the tax area, see in this respect the annotation to the judgement of 21 June 1995 of the Portuguese Supreme Administrative Court produced by J.L. Saldanha Sanches, *A Interpretação da Lei Fiscal e o Abuso de Direito*, in *Revista Fisco*, 74/75, 99 ff., and by the same author, *Abuso de direito e abuso da jurisprudência*, in *Revista Fiscalidade*, 4, 2000, 53 ff.

<sup>15</sup> M.F. Trigo de Negreiros, *A “evasão” legítima e o abuso do direito no sistema jurídico português*, in *Revista Ciência e Técnica Fiscal*, 151, 1971.

<sup>16</sup> J. Bacelar Gouveia, *A evasão fiscal na interpretação e integração da lei fiscal*, in *Revista Ciência e Técnica Fiscal*, 373, 1994, 41.

the application of the principle of abuse of right depends directly on the existence a right that is being abused.

However, in the case of tax avoidance there is no true subjective right, only the freedom of the taxpayer to choose the type of transaction that is most advantageous in terms of tax. This freedom is a "general normative permission forming part of the individuals right to make decisions affecting his or her own legal situation"<sup>17</sup>, and therefore not susceptible to abuse.

### 7. – *Indirect transaction*

Indirect transactions are those in which the parties use a legal type of transaction to achieve a goal that is not the normal goal of this type of agreement but which can be achieved by using it. Accordingly, there is a difference between the typical goal of the transaction and the indirect goal that is, in fact, sought.

It is indisputable that tax avoidance is all about achieving a certain economic result, which if obtained through common legal means, would give rise to a tax liability. However, the taxpayer achieves this result indirectly through other transactions which are intended for other purposes and, therefore, subject to different taxation.

Nevertheless, it is our understanding that this legal concept and the concept of tax avoidance are not one and the same thing. This is because we cannot forget that the parties may have recourse to innominate transactions, in which there is no misrepresentation of the structure or the typical goal of the transaction and such misrepresentation is a key element of the concept. On the other hand, we must bear in mind that, even not assuming the typical purposes of a nominate transaction, the taxpayer may have valid economic and commercial aims other than merely improving their tax situation.

Therefore, we can conclude that indirect transactions may in certain circumstances constitute a kind of tax avoidance, although they necessarily have a narrower scope.

### 8. – *Fraudem legem*

The leading Portuguese jurist Manuel de Andrade taught that "illegal transactions are those that openly and clearly contravene a legal provision.

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<sup>17</sup> L.M.T. de Menezes Leitão, *A Evasão e a Fraude Fiscais face à Teoria da Interpretação da Lei Fiscal*, in *Estudos de Direito Fiscal*, Coimbra 1999, 30.

Acts in *fraudem legem* (...) are done in an attempt to circumvent a legal prohibition, trying to reach the same result by means other than those specifically addressed and prohibited by law – their aim is to defeat the law”. The former is an act, which is against the letter of the law and the latter, against the spirit of the law where the illegality arises not from the means used, which are legal, but from the result obtained which is not.

As we consider that the taxpayer is avoiding tax whenever he does something under a specific rule and achieves results the same as those provided for under a different rule and this choice is determined by the desire to avoid the application of that other rule (and the consequent tax), we must conclude that these are acts that circumvent the law as acting against the spirit of a tax law is no more than a case of offending the general spirit of the law.

### 9. – Conclusions

The points set out above are summarised in this table:

**TABLE 1**

<p><b>TAX EVASION</b> Tax Evasion <i>Contra legem</i></p>	<p>Underground and parallel economy Fraudulent practices Non-payment of overdue taxes Wilful destruction of accounting records False invoicing</p>
<p><b>TAX AVOIDANCE</b> Tax Avoidance <i>In fraudem legem</i></p>	<p>Unusual means Lawful but abusive avoidance practice Less tax burdensome transactions</p>
<p><b>TAX PLANNING</b> <i>Intra legem</i></p>	<p>Tax benefits Deferment of acts Sound management practices</p>

## II. – *Territorial scope of tax avoidance*

### 2.1. – Introduction

The internationalisation and integration of economies are realities of our times and globalisation is a key factor in properly understanding the last century. In relation to the movement of money on an international level, the doctrine of globalisation backs up the theory that “capital has no homeland and moves at a great speed to wherever more favourable conditions are offered”<sup>18</sup>. This means we must be aware that economic internationalisation also requires us to re-evaluate a question which up to now has been dealt with by that of individual States: the problem of tax avoidance.

A variety of factors can be singled out as being responsible for the phenomenon of tax avoidance, especially in the light of the increasing and ever-easier movement of people and capital, the development of multinational companies and the development and growing complexity of abusive practices. These practices have developed as a consequence of the anti-abuse policies of the States, as well as the infinite capacity of taxpayers to find new ways to circumvent and defeat the applicable legislation.

As already mentioned, the negative impact of tax avoidance on the legal system is clear and undeniable. This impact must be analysed not only on a strictly domestic level, but also on an international level.

This means that today, it is not enough to draw attention to the increase in the tax burden<sup>19</sup> in every country and the subsequent material breach of the principle of fairness between complying and non-complying taxpayers as consequences of tax avoidance. At the same time we must also stress the serious implications of this phenomenon in relation to the balance of trade with the exterior and the distortion of international (unfair) competition and movement of capital.

In this respect, it may be said that the fight against international tax avoidance is no longer a far away reality or a mere theoretical discussion but is becoming more and more important in international discussions.

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<sup>18</sup> L.M.T. de Menezes Leitão, *O controle e combate às práticas tributárias nocivas*, in *Estudos de Direito Fiscal*, Vol. II, Coimbra 2007, 87 ff.

<sup>19</sup> In a report presented in 1998 – *Harmful Tax Competition: An Emerging Global Issue*, Paris, OCDE 1998, the Organization for Economic Cooperation and Development (OECD) has stressed the consequences of this situation, with particular attention on the increase in administrative costs in supervising taxes and the targeting of the tax burden by the State towards factors with less mobility such as employment, property and consumption.

Accordingly, tax avoidance must be debated and fought on an international level.

In fact, as this phenomenon is one in which capital mobility is essentially the result of the adoption by a number of States of (harmful) tax competition measures, it is clear that joint cohesive action by the various States plays a role of the utmost importance in the fight against the existence of preferential tax systems, which are a distorting factor in any context of economic integration<sup>20</sup>.

Therefore, in this study we draw attention to the significant role of the OECD, with particular reference to the 1998 Report "Harmful Tax Competition: An Emerging Global Issue", which is an important instrument of analysis and reaction to the problem of harmful international tax competition. The same applies to the work carried out by the European Union<sup>21</sup>, with special reference to the approval by the Council of the European Union and by the Ministers of Finances of the Member States of the Code of Conduct on Business Taxation<sup>22</sup> on 1 December 1997.

We will now take a brief look at the two areas which have the greatest impact on international tax avoidance: one related to the contravention of domestic legislation – so-called "tax havens" – and the other defined by the contravention of international rules – the abuse of double taxation conventions, known as "treaty shopping".

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<sup>20</sup>Note, as doctrine has warned (L.M.T. de Menezes Leitão, *O controle e combate às práticas tributárias nocivas*, in *Estudos de Direito Fiscal*, Vol. II, Coimbra 2007, 87 ff.), it cannot be said definitely that any differentiated taxation level, in a comparison between the different States, is harmful in itself. In fact, there may be a number of reasons for such phenomenon, such as the intention to create incentives for certain activities or even a different operation of the tax system. It is therefore important to make a distinction between these two situations and those cases where the States are trying to attract in an aggressive way capital flows and income without there being any connection whatsoever with that State, encouraging tax fraud ("poaching", to use the Anglo-Saxon term).

<sup>21</sup>See, in this respect, A. C. dos Santos, and C. Celorico Palma, *A regulação internacional da concorrência fiscal prejudicial*, in *Ciência e Técnica Fiscal*, 395, July-September 1999, 9-36.

<sup>22</sup>Besides this Code of Conduct, it is important to stress other Commission initiatives, such as the Communication of the Commission to the Council, the European Parliament and the Economic and Social Committee of 23 October 2001, published in *Revista Ciência e Técnica Fiscal* 404, October-December 2001, 151-225 – "Towards an Internal Market without tax obstacles. A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities".

## 2.2. – *Tax havens*

One of the most common current methods of tax avoidance is the use of tax havens with three essential goals: holding passive investments as capital deposits, fictitious establishment of specific income and placing of taxpayers' transactions (namely bank accounts) outside the scope and the scrutiny of the tax authorities of the States of origin<sup>23</sup>.

As to the means used to achieve those goals, doctrine<sup>24</sup> has come to identify the following as the most relevant uses of tax havens: (i) the transfer to those territories of residence in the case of an individual or registered office in the case of a company, (ii) the establishment in the haven of a base company whose sole purpose is, for taxation reasons, to receive income that would be directly obtained by a taxpayer, putting it outside the scope of the tax that would be charged on it in the country of residence, and (iii) the establishment transfer pricing by transferring goods and services to a non-independent subject at an "abnormally" low price that, for some reason, evades tax, or by acquiring such goods and services in similar conditions at an artificially high price.

Under the doctrine, "within multinational groups in which companies are under the same control, this technique allows the transfer of profits from tax jurisdictions with high taxation to those with low taxation"<sup>25</sup>.

Accordingly, under the well-known definition by Beauchamp<sup>26</sup>, a tax haven must be understood as a "country or territory that gives tax benefits to individuals or companies enabling them to avoid taxation in their country of origin or to benefit from a more favourable tax system than in that country, mainly in respect of income and inheritance tax". So it is clear that this is, in effect, a relative concept as any country may be a tax haven in relation to another if its budgetary structure is based on lower taxation. Consequently, the precise definition of what a tax haven<sup>27</sup> is assumes particular relevance.

<sup>23</sup> Cf. L.M.T. de Menezes Leitão, *O controle e combate às práticas tributárias nocivas*, in *Estudos de Direito Fiscal*, Vol. II, Coimbra 2007, 90.

<sup>24</sup> Cf. L.M. T. de Menezes Leitão, *Evasão e Fraude Fiscal Internacional*, in *Estudos de Direito Fiscal*, Coimbra 1999, 26 ff.

<sup>25</sup> Cf. L.M.T. de Menezes Leitão, *Evasão e Fraude Fiscal Internacional*, in *Estudos de Direito Fiscal*, Coimbra 1999, 130.

<sup>26</sup> A. Beauchamp, *Guide Mondial des Paradis Fiscaux*, Paris, Grasset, 1981, 39.

<sup>27</sup> Here, the distinction between tax havens and low tax pressure zones is particularly acute and incisive, that is, those States where tax pressure is lower because the revenue needs are also lower, which should not be classified as tax havens, since they are not aimed at creating harmful tax competition. Such lower revenue needs may result from lower expenditures or from the existence of other sources of wealth, as is the case in Dubai or Saudi Arabia. Particular focus is therefore put on the importance of the

If not, States may introduce measures which are anti-international competition rather than anti-avoidance for the wrong reasons. For this reason, the above-mentioned 1998 OECD Report recommends the identification of tax havens on the basis of the following factors:

- a) No taxation or merely nominal taxation, creating a system that is particularly attractive to non-residents for abusive purposes;
- b) Existing laws or administrative practices that obstruct or even prevent the exchange of information on such non-resident taxpayers with other States;
- c) Limited transparency at the domestic operational level which enables the establishment of illegal practices such as money laundering or tax evasion; and
- d) The lack of requirement for permanent establishment and economic substance, thereby encouraging movement of money solely for taxation reasons<sup>28</sup>.

It has been observed in comparative law that to deal with this situation, as a general rule different States choose one of three solutions when they introduce this concept in their legal systems: (i) a definition based on factors of comparison with their own tax system, (ii) an absolute concept of tax havens, or (iii) a case-by-case listing (the so-called "blacklists"). However, all three options are to some extent insufficient.

As far as the ways of fighting this phenomenon used by the different States are concerned, it should be noted first of all that this will be an internal fight as tax jurisdiction is an integral part of sovereignty.

With this in mind, we should consider the measures usually used by States in order to try to prevent the use of tax havens: general anti-avoidance provisions, the establishment of foreign exchange control and mandatory withholding of tax on transfers abroad, the creation of provisions against base companies, specifically by attributing income earned by such companies to the resident partners who control them, as well as the

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intentional element, that is, the deliberate wish to receive in a deceitful way capital flows and income proceeding from other States with which there is an effective connection.

<sup>28</sup> For another proposal on what determines the existence of a tax haven, see R. Gordon, *Tax havens and their use by United States Taxpayers – An overview* 1981. The Author believes that tax havens may be identified according to the following characteristics: a globally favourable tax system, legislation and administrative practices safeguard the businesses and property of non-residents and secrecy for their business activities, protection of banking and trade secrecy, an extremely liberal foreign exchange policy favouring the easy recycling of capital, disproportionate importance of the banking sector and promotion and advertising actions by the States as off-shore financial centres.

introduction of legislative giving powers to the tax authorities to adjust of taxable profit by reason of special relations with another taxpayer.

2.3. – *Abuse of tax conventions to avoid double taxation (Treaty shopping)*

The second important form of international tax avoidance is the abusive use of double taxation conventions (DTCs) the secondary purpose of which is precisely to prevent international tax avoidance and fraud.

As a matter of fact, there has been an increase in so-called treaty shopping. This is when a taxpayer contrives to analyse provisions of double taxation agreements and chooses the most favourable in order to obtain benefits that were not intended for him.

As stated at the beginning of this study, it is essential to distinguish between what only amounts to tax planning and what constitutes tax evasion (in the broad sense). To do this in relation to DTCs it is crucial to understand which choices made by a taxpayer fall within the scope of good tax management practices and which go beyond that scope.

To make the distinction we believe it is fundamental to draw attention, on the one hand, to the creation by taxpayers of contrived relationships and, on the other, the subsequent unlawful acquisition of benefits.

Tax avoidance occurs whenever the spirit of the law is breached in respect of the connection elements required for the taxation of income<sup>29</sup>.

For a better understanding of this reality we set out below three examples of strategies used by “tax avoiders” in the practice of “treaty shopping”, following closely the framework proposed by Menezes Leitão in “*Evasão e Fraude Fiscal Internacional*”<sup>30</sup>.

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<sup>29</sup> According to M. Teixeira de Abreu, *Os preços de transferência no quadro da evasão fiscal internacional*, in *Ciência e Técnica Fiscal*, 358 (April-June 1990), 109 ff., in favour of the establishment of limits to the use of these conventions and recognition of possible abusive practices, the purpose of DTCs is the avoidance of double taxation and not the avoidance of taxation in itself. Furthermore, DTCs are agreements concluded between two countries with their negotiation based on a mutual sacrifice of tax revenue by those states and not by third-party states, which by virtue of obtaining benefits by way of such tax schemes are not interested in negotiating this kind of treaty.

<sup>30</sup> L.M.T. de Menezes Leitão, *Evasão e Fraude Fiscal Internacional*, in *Estudos de Direito Fiscal*, Coimbra 1999, 134 ff.

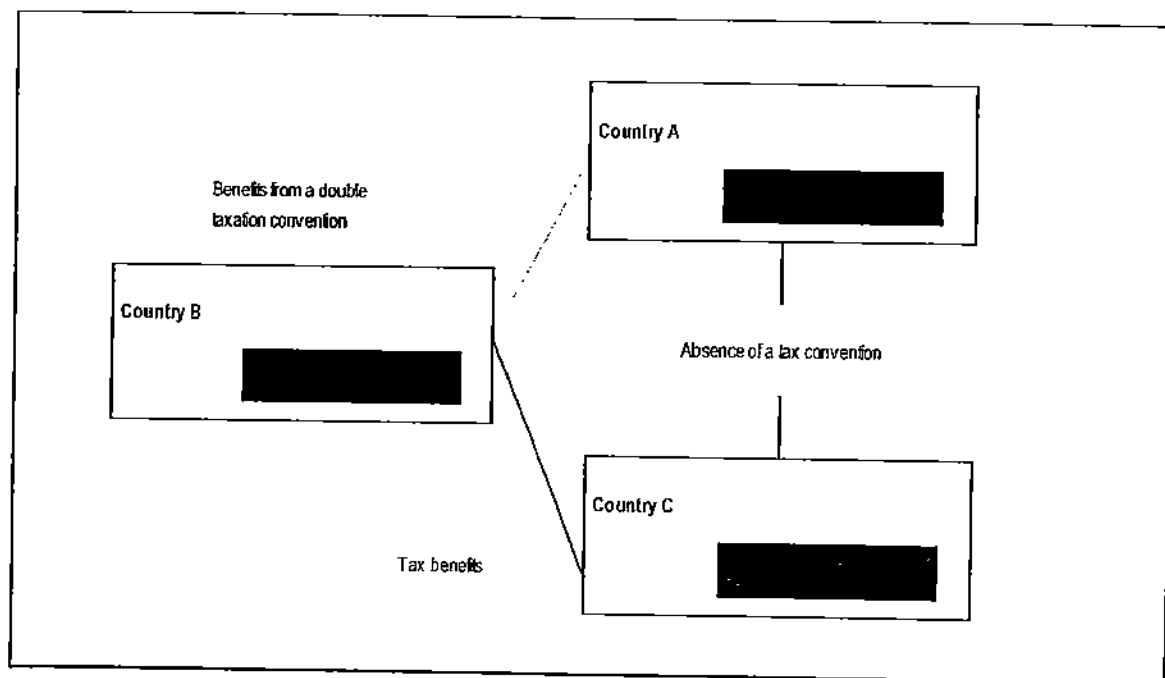
To begin with, it is important to point out that there are three typical strategies for “treaty shopping”: the direct conduit scheme, the stepping stone conduit scheme and bilateral relations<sup>31</sup>.

### 2.3.1. – *Direct conduit scheme*

A typical example of the direct conduit scheme is the case where there is a tax convention between countries A and B that grants an exemption from withholding at source for income earned in A to both individuals and companies resident in B. Then, in the absence of any convention with country C, a resident of country C establishes a company in country B and transfers assets and rights giving rise to dividends, interest or royalties in A to the new company and payments to it escape withholding. Then, having taking advantage of tax benefits, the company may transfer its income back to company C.

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<sup>31</sup> See, for other examples of schemes used to take advantage of DTC benefits, M. Teixeira de Abreu, *Os preços de transferência no quadro da evasão fiscal internacional*, in *Ciência e Técnica Fiscal*, 358 (April-June 1990), 132 ff. To be noted that the Author bases his analysis on the schemes already studied by the OECD in a 1987 publication, “*International Tax Avoidance and Evasion: Four related studies*” – OECD – *Issues in International Taxation*, n. 1.

TABLE 2<sup>32</sup>

### 2.3.2. – Stepping stone conduit scheme

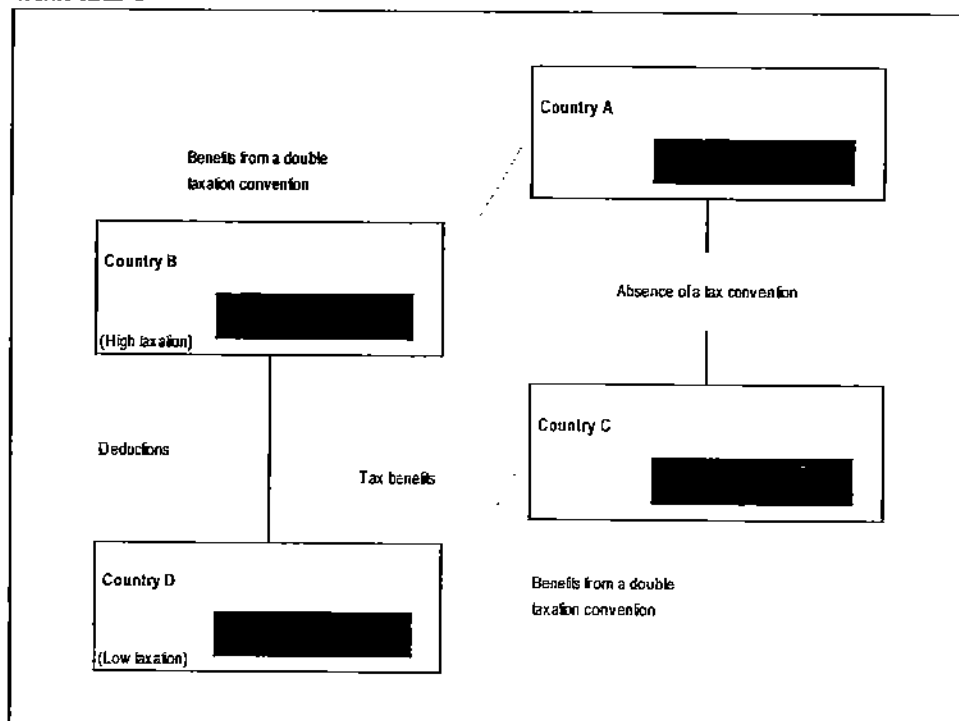
In this scheme we make two presumptions: there is no DTC between country A and country C and there is a DTC between countries A and B that allows an exemption from withholding at source for income earned by residents of country B. To this situation we add two further assumptions: high taxes in country A (although this country widely accepts consistent deductions on income paid to foreign entities) and the existence of a treaty between country C and a country D, where the tax system of country D is favourable to all companies or to a certain type of company. The treaty grants benefits to income earned in country D by residents of country C.

In this case, a company resident in country C that earns income in A may avoid taxation in A through the establishment of a company resident in B which receives income from dividends, interest or royalties paid by residents in A. Subsequently, the company resident in B makes payments as such to a company resident in D which are deducted from its income, thereby generating high income in the company resident in D which is,

<sup>32</sup> The graphics used in this work (Table 2, 3 and 4) are extracted from the text by L.M. de Menezes Leitão, *Evasão e Fraude Fiscal Internacional*, in *Estudos de Direito Fiscal*, Coimbra 1999, 126 ff.

however, subject to very low taxation. In turn, this company transfers this income to a resident in C, taking advantage of the benefits of another treaty made between C and D.

TABLE 3



### 2.3.3. – Bilateral relations

Finally, we look at an example of the practice of international tax avoidance between residents of States that have entered into a DTC but where those residents abuse the treaty that exists.

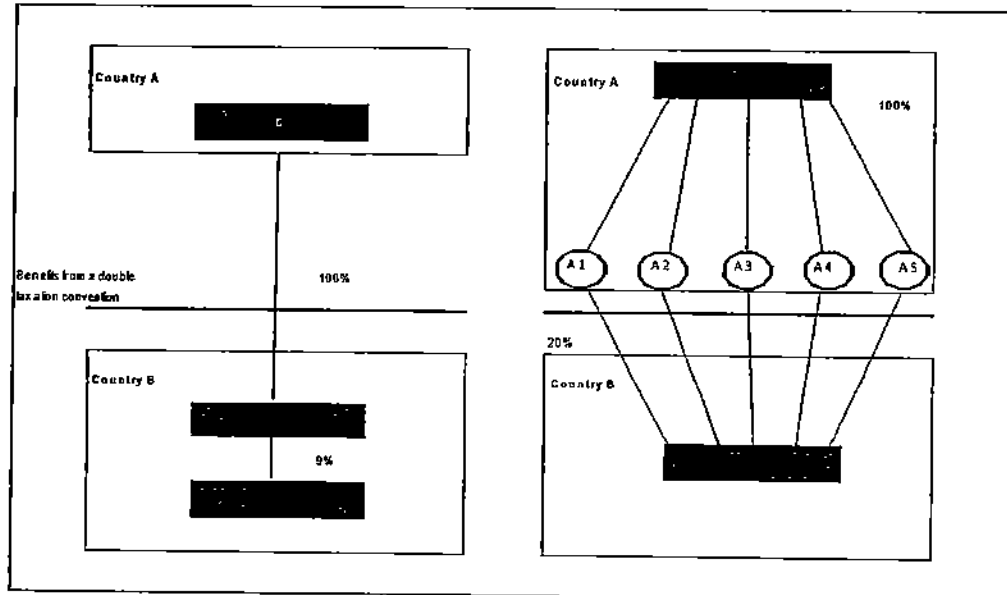
In looking at this situation, Menezes Leitão refers to two typical cases: the case of a holding in the same State and the case of quintet structures.

In the first case, it is significant that certain treaties require a minimum percentage for the holding by a resident of a State in the companies resident in the other State. Accordingly, to eliminate economic double taxation on distributed profits, a resident of a State who does not have that percentage in his holdings in the other State, may establish a 100% holding in that other State to which he transfers his holding. By doing this he complies with the treaty preconditions for the elimination of economic double taxation.

In the case of a quintet structure, the author understands that this is only known in Germany, since treaties entered into by this country often contain a

provision for the treaty not to apply in the case of payment of dividends to a foreign company that holds at least 25% of the capital of the German company. Thus, a foreign company that owns 100% of a German company may establish five companies in its own State among which it distributes the holdings in the German company in order to maintain the application of the treaty.

TABLE 4



#### 2.3.4. – Counteracting measures

Having indicated some of the most common forms of tax avoidance through the abusive use of DTCs, it is now important to make a brief reference to some of the means of response available. As already mentioned, the illegal acquisition of benefits is characterised by the fact that it is achieved not through contravention of domestic rules, but rather through contravention of the rules of international public law. This means it is easy to understand that the States face increased difficulties in their response to the above-mentioned avoidance practices, particularly because of well-established principle of *pacta sunt servanda* ("agreements must be kept").

We now turn to two distinct procedures to fight tax avoidance: the first, which is within the scope of domestic law and rarely used<sup>33</sup>, since such

<sup>33</sup> Reference is made here to its use by Switzerland and the United States of America.

measures give rise to problems related to the prevalence of public international law over national law and, the other, under the treaties themselves.

In the latter case many States have chosen to include special provisions designed to counteract this practice in their DTCs through recourse to the legal concept of beneficial owner. On this theme, we refer to the OECD Model Convention, which requires that benefits in connection with the taxation of dividends and interest are allowed on condition that the recipient of the dividend or interest is the beneficial owner of such income<sup>34</sup>. Similarly, we refer to the clause contained in the United States Model Convention on "limitation of benefits" which seeks to prevent the application of the agreement to artificial residents in any State, which is party to the Agreement<sup>35</sup>.

### III. – *Measures to avoid or reduce tax avoidance*

#### 3.1. – *Preliminary considerations*

After defining the concept of tax avoidance and analysing the increasing number of cases at the international level, we now move on to discuss anti-abuse measures.

We must draw attention to the fact that that this issue is particularly sensitive because it leads to a confrontation between distinct structural principles of the rule of law. This means that while, on the one hand, we have the principles of certainty of law and legality of tax (and its corollaries of closed typicity, limitation and exclusivity) imposing relevant restrictions on the adoption of anti-abuse measures as well as requiring special care in safeguarding the rights and legitimate expectations of individuals, on the other hand, we find such principles as equity, taxpaying capacity and the (effective) fight against tax fraud and tax avoidance.

In light of the above, it is clear that this is an issue that finds in comparative law its solution in different theories – the doctrine of the

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<sup>34</sup> See, in this respect, the criticism by J.L. Saldanha Sanches, *Os limites do planeamento fiscal*, Coimbra, 2006, 411 and 412, where the author holds that the option for the concept of "beneficial owner" instead of the notion of "fraudulent transaction", with a view to a greater clearness is illusory to the extent that the former is also a *de facto* concept and not a legal concept.

<sup>35</sup> See, as an example, art. 17 of the Convention between Portugal and the United States, where besides the concept of "beneficial owner" there is a long list of those cases in which there is, or is not, the right to benefit from the convention benefits.

equivalent economic result, the prevalence of the underlying reality over the form, the abuse of law<sup>36</sup>, the business purpose<sup>37</sup> – always aimed at ensuring the fight against tax avoidance is legitimately carried out, and is not excessively burdensome for the taxpayer's guarantees. Thus, we consider it especially opportune to present the Portuguese legal system's framework of measures to counteract tax avoidance, which are characterised by the diversity and quantity of the means established by the legislator.

A brief analysis of each of them is presented below:

### 3.2. – *Presumptions and legal fictions*

Under article 349 of the Portuguese Civil Code, presumptions are “assumptions drawn by the law or a judge from a known fact to assert an unknown fact”. Therefore, presumptions are a valuable instrument in those cases where providing direct evidence of a given fact is very difficult or even impossible. They are anchored in a principle of legal practicability and are also a way of fighting tax avoidance<sup>38</sup>. It should be noted that, notwithstanding the relevance of this legal concept, the provision of absolute presumptions is not compatible with the principle of taxpaying capacity. This situation led to the introduction of article 73 of the General Taxation Law (LGT) that reads: “the presumptions enshrined in the tax liability rules must always allow proof to the contrary to be adduced”. On this point, see Judgement no. 348/97 of 29 April of the Portuguese Constitutional Court where the court held the *iuris et de iure* tax presumptions to be unconstitutional.

### 3.3. – *Interpretation of tax law*

Over the last few decades countless positions have been presented on the interpretation of tax law, with different authors considering that a solution could be found to the problem of fighting tax avoidance simply

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<sup>36</sup> The abuse of law clause can be found in such countries as France, Germany, the Netherlands and Switzerland.

<sup>37</sup> The business purpose doctrine, according to which no tax relevance is attributed to those practices aimed only at tax purposes, is applied, in particular, in the United States of America and Canada.

<sup>38</sup> See, as an example of the so-called taxation through presumption, the presumptions provided for in articles 6 and 40 of the Portuguese Personal Income Tax Code (CIRS), and articles 80 and 86 of the Value Added Tax Code (CIVA).

through the interpretation and application of tax laws. However, according to the LGT, the problem and the solution are not so linear and tax laws must be interpreted like any others. They should not be subject to special rules of interpretation, with the prohibition on their analogical application standing out only for reasons arising from the principle of legality<sup>39</sup>.

Thus, the principle *in dubio pro fisco* must be rejected as an interpretative principle. Under this principle, tax laws should be interpreted in favour of the taxation authorities because of the general interest of the State prevail over those of private individuals. According to Sá Gomes<sup>40</sup> this idea is based on the incorrect assumption that collective interests override those of private individuals.

We must also set aside the functional interpretation theory under which the reason for or purpose of the tax should be taken into account. This theory seems to have had the merit of attesting to the importance of the teleological aspect of the interpretation of the law. However, it incorporates an element that is common to the interpretation of law in general, meaning it has no independent relevance.

Also rejected is the theory of economic consideration, which establishes that the effective economic basis – a real assumption of taxpaying capacity, subject of the tax rule – prevails over external legal forms. According to Menezes Leitão<sup>41</sup>, “the rule that the sole aim of taxation is the economic result and never any legal transaction does not result directly from tax law”. In this way, the author establishes a distinction between functional types, which are essentially determined by the economic result, and structural types in which the legislator seeks to observe a specific typical legal structure as this is the usual way to achieve this economic result, in which case this theory will not apply.

Finally, we also reject the theory of teleological interpretation as a means of fighting tax avoidance. This theory is defended in Portugal by Pamplona Corte-Real<sup>42</sup>, for whom *fraudem legem* – in the sense of achieving the same economic result by a distinct legal procedure – would always go against the spirit of tax law through the respect of its letter. In fact, if the

<sup>39</sup> Cf. art. 11 (4) of LGT.

<sup>40</sup> N. De Sá Gomes, *A interpretação das leis fiscais*, in *Ciência e Técnica Fiscal*, 79 (1965), 7 ff.

<sup>41</sup> L.M.T. de Menezes Leitão, *A Evasão e a Fraude Fiscais face à Teoria da Interpretação da Lei Fiscal*, in *Estudos de Direito Fiscal*, Coimbra 1999, 9 ff.

<sup>42</sup> Cf. C. Pamplona Corte-Real, *A interpretação extensiva como meio de reprimir a fraudem legem no Direito Fiscal português*, Paper presented in *IV Jornadas Luso-Hispano-Americanas de Estudos Tributários*, Lisbon, offprint of *Ciência e Técnica Fiscal*, 1972.

State makes taxation subject a particular legal structure, allowing taxation of another distinct structure which produces the same economic result by interpretation does not mean the spirit of law is being reconstructed. Rather, it means an application of the tax rule by analogy, something which is prohibited in the Portuguese legal system<sup>43</sup>.

We must therefore conclude as we started: we cannot “accept a methodological preconception in tax interpretation theory in order to prevent situations of avoidance”<sup>44</sup>. On the contrary, the methodological interpretation approach set out in the general rules of the Civil Code (art. 9) should be followed. Here the literal, historic, systematic and teleological elements are taken into account. As Saldanha Sanches<sup>45</sup> says, “the simple fact that there is interpretation of tax law (...) means all the conditions exist to lead to an application of the law that, among other possible and desirable results (such as the prevention of literal interpretations that deny taxpayers’ fundamental rights and go against the rationality that is needed in the application of tax law), may lead to a neutralisation of operations intended to defraud tax law by the simple fact that it is an interpretation”. We would add that it may help the fight against *fraudem legem*, although it is by no means enough.

### 3.4. – *Specific anti-abuse rules*

Here we address the definition of rules aimed at fighting tax avoidance with regard to some specific activities which, even though legal, the legislator considers to be of risk and potentially suspect, and so specifically makes provision for different ways to fight them.

#### 3.4.1. – *Adjustments by virtue of relationships with entities subject to a low-tax system (payments to non-residents and international tax transparency)*

In this context the Portuguese legal system has recourse to the reversal of the burden of proof (reverse charge) and controlled foreign companies (CFC) type provisions.

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<sup>43</sup> Cf. Article 11(4) LGT.

<sup>44</sup> L.M.T. de Menezes Leitão, *A Evasão e a Fraude Fiscais face à Teoria da Interpretação da Lei Fiscal*, in *Estudos de Direito Fiscal*, Coimbra 1999, 42

<sup>45</sup> J.L. Saldanha Sanches, *Os limites do planeamento fiscal*, Coimbra 2006, 48.

The first of these measures was introduced into the Portuguese legal system on the basis of inspiration from similar provisions in the Belgian and French systems. This measure does not allow amounts paid or due to residents outside Portuguese territory, where they are subject to a clearly more favourable tax system, to be considered as deductible charges for the purpose of determining taxable profit. It should be noted that this provision is not absolute, as the legislator provided for the possibility for the taxpayer to produce evidence that such expenses correspond to operations effectively carried out and that such operations are not of an unusual character or excessive amount, but that it is a balanced agreement (based on the real importance of the benefits conferred and fair remuneration for the same in light of market prices). In order to prove this situation, all means permitted by law may be used (the system of free evidence)<sup>46</sup>. Doctrine<sup>47</sup> holds this measure to be proportionate and correct as experience shows, as a general rule, that these operations are structured with a view to simulation and tax avoidance. Therefore, there is no justification for requiring a case-by-case inspection by the tax authorities. This means the burden of proving the facts moves to the private individual who is the subject of the relationship that benefits from more favourable conditions<sup>48</sup>.

We now turn to CFC-type provisions<sup>49</sup>. These are rules that apply when profits are earned by base companies (companies subject to a more favourable tax regime) controlled by partners resident in Portuguese territory. In this situation, the provisions attribute the profits to those partners even when there are no distributed profits<sup>50</sup> (the principle of tax transparency – *piercing the veil*).

In both cases, particular emphasis is placed on the existence of special relationships with companies established in countries where they benefit from more favourable tax regimes – tax havens.

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<sup>46</sup> Cf. Article 65 CIRC.

<sup>47</sup> L.M.T. de Menezes Leitão, *A aplicação de medidas anti-abuso na luta contra a evasão fiscal*, in *Revista Fisco* no. 107/108 (March 2003) 35 ff.

<sup>48</sup> This burden of proof is not discharged simply by exhibiting documents or contracts, which may be forged, or a statement of the amount paid. The actual supply of services, loans granted, etc must be clearly established.

<sup>49</sup> For a historic overview of this principle, see L.M.T. de Menezes Leitão, *A introdução na legislação Portuguesa de medidas destinadas a reprimir a evasão fiscal internacional: o Decreto-Lei no. 37/95, de 14 de Fevereiro*, in *Estudos de Direito Fiscal*, Coimbra 1999, 169 ff.

<sup>50</sup> Cf. Article 66 CIRC. Special attention should be paid to the provisions of paragraph 4, where the legislator excludes those situations that in his opinion are situations with a risk of tax evasion from this regime.

We refer back to the points already made on this issue, adding a reference to the system of identification of tax havens that is firmly established in the Portuguese legal system. Tax havens are currently defined by the legislator in accordance with three alternative criteria: a territory included in a list approved by order of Ministry of Finance; a territory where a resident entity is not subject to income tax identical or similar to IRS and IRC and a territory where the amount of tax paid is equal to, or lower than, sixty per cent of what would be due if such entity were resident in Portugal<sup>51 52</sup>.

#### 3.4.2. – *Thin-capitalisation resulting from special relationships with non-residents*

Another specific measure to be considered in the Portuguese legal system is the one related to thin-capitalisation. The legislator adopted this measure to deal with those cases where a company adopts an abusive approach to its financing. This relates specifically to cases where a non-resident company is a partner and a creditor of a resident company and the taxation system applicable is more favourable to the payment of interest than the distribution of profits. This means that the more attractive option is to build up the own resources of the resident company with financing through loans, leading to the erosion of the basis for assessment<sup>53</sup>.

In these cases the legislator provides for the limitation of the level of debt owed by resident companies to non-resident companies with which they have a special relationship. The maximum debt allowed is an amount equal to twice the value of the holding in its own capital, although it is possible for this amount to be exceeded if the taxpayer produces well-founded reasons to do so<sup>54</sup>.

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<sup>51</sup> For a critical analysis of this system, see L.M.T. De Menezes Leitão, *O controle e combate às práticas tributárias nocivas*, in *Estudos de Direito Fiscal*, Vol. II, Coimbra 2007, 93 ff.

<sup>52</sup> Cf. Article 65 (2) CIRC.

<sup>53</sup> L.M.T. de Menezes Leitão, *A aplicação de medidas anti-abuso na luta contra a evasão fiscal*, in *Fisco* 107/108 (March 2003) 35 ff.

<sup>54</sup> Cf. Article 67 CIRC.

3.4.3. – *Exclusion of the application of the taxation system for mergers, divisions, transfers of assets and exchanges of shares*

At issue here is the tax neutrality system for mergers, divisions, transfers of assets and exchanges of shares which exists in Portuguese legal system as a consequence of the transposition of Directive 90/434/EEC<sup>55</sup>. The Portuguese legislator felt it necessary to create an exception to this regime so that it will not apply when it is clear that the main purpose or one of the main purposes of the operation to which the Directive applies is tax avoidance. Accordingly, and in order to make this rule more precise, the legislator also clarifies that it must be clear that the motives for the operations are tax-based whenever the whole of the income of the companies involved is not subject to the same IRC (company tax) system. The same applies if the operations have not been carried out for economically valid reasons such as restructuring or rationalisation of the business activities of the companies involved.

3.4.4. – *Prevalence of substance over form in derivative financial instruments*

Another specific rule that merits our attention is the one set out in article 49 (10) of the IRC Code which provides that where “in one or more operations the substance differs from the form, the tax administration may re-characterise the point in time, the source and the nature of payments and receipts and costs arising out of the operation”.

Some questions do arise in relation to the neglect of form in favour of substance and in relation to respect for the principle of tax legality.

However, in our opinion this solution presents some special features that make its adoption essential. In fact, due regard must be had to the fact that we are dealing with derivative financial instruments. This is a sector, which is highly susceptible to tax avoidance as it is particularly easy for economic agents to manipulate taxable income. As Menezes Leitão warns us<sup>56</sup>, “it is recognised that derivative financial instruments may be used to reproduce almost all conventional transactions. This allows the operator an economically neutral or quasi-neutral choice between the conventional transaction and the derivative financial instrument and the basis for this

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<sup>55</sup>As modified by Directive 2005/19/EC, of 17 February 2005.

<sup>56</sup>L.M.T. D de Menezes Leitão, *A aplicação de medidas anti-abuso na luta contra a evasão fiscal*, in *Fisco* 107/108 (March 2003) 35 ff.

choice may be taxation alone. Taxation which is in fact based on the form of the instrument, without taking into consideration its substance, would undoubtedly lead to very significant tax distortions”.

### 3.4.5. – *Transfer pricing*

Finally, a brief reference to transfer pricing, a typical form of tax avoidance both at the national and international level.

According to article 63 (1) of the CIRC, “in commercial operations specifically including operations, or a series of operations, related to goods, rights or services, as well as in financial operations between a taxpayer and any other entity, whether or not subject to IRC, with which the taxpayer has a special relationship<sup>57</sup>, the parties must agree, accept and practice terms or conditions substantially identical to those which would normally be agreed, accepted and practiced between independent entities in comparable operations”.

If this does not happen, the tax authorities have powers to make all necessary adjustments to determine the taxable profits by adjusting the transfer prices to those that would normally be used if the operations had been carried out between independent parties in the same or similar economic and contractual conditions (the “arm’s length” criterion)<sup>58 59</sup>.

<sup>57</sup> It must be understood that there is a special relationship between two entities when one of them has the power to exercise, directly or indirectly, a substantial influence over the management decisions of the other. Cf. Article 63 (4) CIRC, where the legislator presents some examples of this kind of relationship. Of particular significance is the importance of the application of these rules within the scope of multinational companies, a phenomenon that has been expanding increasingly over the last few decades. Here, the typical organisational structure with subsidiaries established in different countries, which are subject to a certain level control by the parent-company while at the same time having considerable autonomy in the decision-making process at the internal level, favours this kind of situations. On this subject, see M. Teixeira de Abreu, *Os preços de transferência no quadro da evasão fiscal internacional*, in *Revista Ciência e Técnica Fiscal*, 358 (April-June 1990), 109 ff.

<sup>58</sup> Cf. Article 63 of IRC Code. On this topic, see also article 138 of the CIRC, added by the 2008 State Budgetary Law, following the OECD recommendations, which provides for the possibility for taxpayers to conclude, upon request to the General Directorate for Taxation (Direcção Geral dos Impostos), advance pricing arrangements (APAs), under which a binding form for the taxable person and the tax authorities will be established for a period of time not exceeding three years, methods capable of ensuring the definition of the terms and conditions that would be normally agreed upon between independent entities, in the operations to be carried out with entities with which they have a special relationship, or in operations between the head-office and the permanent

### 3.4.6. – *The general anti-abuse clause*

At this point, it is important to analyse the role played in this context by general anti-abuse clauses whose introduction in the different legal systems has often been the subject of controversy and strong doctrinal criticism. However, these clauses are today enshrined in the legal systems of most States including Portugal – article 38 LGT – and play role in the fight against abusive practices not covered by specific provisions.

We begin with a brief historical review to enable a better understanding of the present wording of this clause.

The general anti-abuse clause was introduced in Portugal for the first time in 1998 in the LGT. Subsequently, after some criticism of the doctrine, it was included in the Code of Tax Procedure. The original wording deemed “any legal acts or operations to be ineffective if it can be established they were solely or mainly carried out with the purpose of reducing or eliminating taxation that would be due for legal acts or operations with an equivalent economic result, in which case taxation will be charged on the latter”.

However, the provision was the subject of heavy criticism, with particular emphasis on the questions raised by Leite de Campos<sup>60</sup>, who felt the provision resulted in a lack of effect of the legal acts or operations concerned not just in the area of tax but in civil law in general. He also felt it resulted in an obligation on the taxpayer to conclude operations subject to a higher tax. These circumstances would lead to a breach of the taxpayer’s freedom of economic initiative and a breach of the principle of legal certainty and reliability. As a result he concluded the provision to be unconstitutional.

After accepting some criticism, that clause was re-drawn to declare – “ineffective in terms of taxation any legal acts or operations essentially or principally aimed, by deceitful or fraudulent means and with abuse of legal processes, at the reduction, elimination or timely deferral of taxes that would be due as a result of legal acts or operations with an identical economic purpose, or aimed at obtaining tax benefits that would not be achievable in whole or in part without recourse to such means. Tax will be charged in

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establishments, including intra-group supplies of services and cost contribution arrangements (CCA).

<sup>59</sup> On this subject, see also Portaria n. 1446-C/2001, of 21 December, in force since 1 January 2002, with the same purpose of fighting against the manipulation of prices of transactions, thereby avoiding the relocation of profits and losses solely and mainly by taxation reasons.

<sup>60</sup> D. Leite de Campos, and M. Leite de Campos, *Direito Tributário*, Coimbra 2000, 178 ff.

accordance with the rules applying in its absence and without the tax benefits referred to". It is clear that this new wording is far more complex but also more demanding and better able to protect the taxpayer.

To reach a better understanding of the rule, we will now try to break it down and analyse its different components - namely the assumptions, the consequences and the procedure - in order to reach a decision on whether or not its use is admissible as a means of fighting tax avoidance.

#### 3.4.6.1. – *Assumptions*

In its present wording, the applicability of the rule under consideration depends on the cumulative establishment of two requirements: (i) a means requirement in that the acts or operations concerned must be based on deceitful and fraudulent schemes with abuse of legal processes; and (ii) a requirement in terms of objective in that it is essential that there is the intention to reduce or eliminate tax.

Accordingly, the taxpayer's acts are submitted to the so-called "test of abuse of legal processes", it being understood that the use of uncommon and unusual processes, which can only be explained for tax reasons, amounts to a limit on the freedom of taxpayers to enter in contractual relations and make other decisions affecting their legal situation.

However, recourse to uncommon processes alone is not enough. The tax authorities must prove that the intention of the taxpayer that underlies the deceitful operation was, essentially or exclusively, to reduce or to eliminate taxation. Such evidence consists of showing that there is no economic reason for the operation that was carried out. This is what the Anglo-Saxon doctrine and jurisprudence call the "business purpose test" where it is important to substantiate the legitimate commercial reasons for the use of an unusual means and show that its uncommon nature does not imply that is inappropriate for the intended economic result but is rather no more than a new, imaginative way to carry out normal management actions.

#### 3.4.6.2. – *Consequences*

As regards the consequences of the taxpayer's actions referred to above, article 38 of the LGT states that such behaviour "has no effect in terms of tax". This means the taxpayer's actions continue to have full effect - and usually produce results - in private law. Furthermore, it is understood that

such behaviour is also legal in tax law but does not produce the effective results in such law and these results are disregarded.

Therefore, “if there is evidence that the legal acts or operations were performed solely or principally with the aim of excluding or reducing the tax burden, there may be a “disregard of the legal character”, a “piercing of the veil”, “leading to tax being charged in accordance with the rules applying in the absence of such deceitful acts or operations, with none of the said tax benefits arising”<sup>61</sup>.

However, such disregard is dependent on the tax authorities demonstrating the deceitfulness of the operation in question. This task has been regulated in minute detail by the by the legislator in light of the values at issue. According to some authors including Sá Gomes, “we are dealing with genuine and visible operations that are also (...) legal operations, since tax laws do not establish any penalty other than adjustment by the tax authorities of the taxable income declared by taxpayers. No compensatory interest is payable and no administrative offence proceedings for the application fines are issued”<sup>62</sup>.

#### 3.4.6.3. – Procedure

The much discussed problems that this kind of clause brings about in the areas of legal certainty and reliability, contractual freedom, free will and the principle of legality led the Portuguese legislator to decide to subject the payment of tax based on anti-abuse provisions to a procedure specifically established for that purpose. This procedure is set out in article 63 of the Portuguese Code of Tax Procedure and Process (CPPT). The CPPT specifically provides that the provisions may only be applied after the taxpayer has been heard and with the prior and mandatory authorisation the head of the service responsible for the matter or the officer to whom this duty has been delegated. This authorisation is subject to special duties to provide grounds for the authorisation and which may be appealed in independent proceedings. Furthermore, where the taxpayer requested a binding ruling from the tax authorities on proposed acts and operations and did not receive an answer within 90 days (giving rise to the assumption of a positive outcome), a special three-year period is established after which the

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<sup>61</sup> J.N. Calvão da Silva, *Elisão Fiscal e Cláusula Geral Anti-abuso*, in *Revista da Ordem dos Advogados*, Year 66, Vol.II, September 2006, 791 ff.

<sup>62</sup> N. Sá Gomes, *Evasão Fiscal, Infracção Fiscal e Processo Penal Fiscal*, in *Ciência e Técnica Fiscal*, 177, Lisbon, 1997, 74 ff.

procedure expires and tax authorities may not apply the anti-abuse provisions.

We may then conclude that, although the anti-abuse clause generally has an economic perspective and follows a principle of the prevalence of substance over form, the risks and criticisms which are usually presented in relation to these theories, and which involve general provisions of this kind are here partly mitigated, since, although the intention of the rule and the problems it seeks to solve are the same, the conditions that characterise its application are much stricter (in light of the real presuppositions underlying its application, as well as the procedure provided for in article 63 of the CPPT), thereby allowing a more careful demarcation of the exercise of powers attributed to the authorities.

### 3.5. – *Other measures*

Finally, after analysing the anti-avoidance measures currently in force in the Portuguese legal system, we believe it is important to stress the increasing relevance that this issue has had and the increasing efforts being made by the Portuguese legislator to find solutions to the problem. With this in mind, we would draw attention to two recent measures: a forthcoming report on the fight against fraud and tax avoidance, and the new law on abusive tax planning.

With regard to the first measure, article 95 of the 2008 Portuguese State Budget Law requires the Government to submit a detailed report on the evolution of the fight against tax fraud and avoidance in all areas of tax to the Parliament, explaining the results achieved. This report should include relevant statistical data on tax inspections carried out and any tax offences arising out of those inspections. It should also include results obtained through the various legal mechanisms used in the fight against tax fraud and avoidance as well as an appraisal on the adequacy of those mechanisms<sup>63</sup>.

The intention to impose a more effective commitment in the fight against tax avoidance on the tax authorities is clear and there is pressure for the anti-abusive measures to be real measures producing definitive effects rather than just more written rules.

With regard to the second measure, reference should be made to Decree-Law 29/2008 of 25 February. As in other legal systems such as those of the United States of America, the United Kingdom and Canada, this provision

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<sup>63</sup> The report on activities carried out in the fight against tax avoidance and evasion was presented on 3 March 2009.

imposes some reporting, information and clarification duties on the tax authorities in relation to aggressive tax planning schemes or activities.

In fact, the Seoul Declaration of September 2006, which was the result of a meeting promoted by the OECD between the tax authorities of a number of countries, gave an express warning about the rapid growth of aggressive tax planning schemes. It also warned of the connection between such tax minimisation practices and the involvement of tax intermediaries, in particular tax advisors. Attention was also drawn to the fact that tax consultancy is exercised without any kind of regulation as the line between compliance with tax law and the unlimited exploitation of the law's frailties is a thin one.

As a result, the Portuguese legislator has created a new framework based on the existence of a duty upon those who use or organise operations and transactions aimed exclusively or mainly at obtaining tax benefits to report to the tax authorities. Information must be provided on an anonymous basis. Its main purpose is the creation of a database describing the different forms of abusive planning. This information is to be published at a later date with reference to those schemes deemed to be abusive by the Directorate General of Taxation (DGCI)<sup>64</sup>. This was an attempt to enhance transparency and justice the tax system and to acknowledge the major role played by the assessment and collection of tax revenue in economic and social development, an essential duty of citizenship.

Although the Government fight against tax fraud and avoidance is praiseworthy, we must draw attention to some problems resulting from this law.

There has been a lot of criticism as, although its target is so-called "aggressive" tax planning, the truth is that the objective scope of the law is too broad in its terms. It includes the obligation to report any scheme or activity aimed exclusively or mainly at obtaining a tax benefit, that is to say, all or any economic situations where a solution is chosen that results in a less tax being paid<sup>65</sup>.

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<sup>64</sup> The purpose of Decree-Law 29/2008, of 25 February is not merely regulatory but also provides for penalties (fines) in case of a failure compliance with such duties.

<sup>65</sup> Although in practice there are few tax planning schemes not covered by the reporting duty, the legislator tried to restrict the tax planning situations covered by the reporting duty by considering them as situations that (i) imply the participation of an entity subject to a privileged tax regime, being considered as such the entity whose territory of residence is in the list approved by a ministerial order from the Minister of Finance, or if it is not liable there to income tax identical or similar to IRS or IRC, or also if the tax effectively paid is equal to or lower than 60% of the tax that would be due if such entity were considered resident in the Portuguese territory; (ii) imply the

On the other hand, a number of considerations have been made concerning the subjective scope of the duty to report. This formula is also too broad and affects financing and credit institutions, chartered accountants, lawyers and certified public auditors, the latter two only when acting in their capacity as organisers and not as mere legal advisors<sup>66</sup>. In summary, the following negative factors can be identified: the undue consideration of costs inherent to the creation of excessive and imprecise ancillary duties and the absence of a legal provision which is sufficiently accurate and thorough for operations that may qualify as abusive. This also puts at risk other equally essential principles such as the principle of adequacy and necessity inherent to the constitutional principle of proportionality.

#### IV. – *Conclusion*

Today we live in a world where taxes play a decisive role in State organisation and in meeting collective needs. However, this reality also tends to be accompanied by ever more elaborate forms of tax avoidance and it falls to the States, both individually and jointly, to work towards its prevention.

All this means that we are now faced with a great number of anti-avoidance measures adapted to the realities of each country with specific measures targeting typical situations as well as general anti-avoidance clauses. These measures have caused and are still causing heated academic debate since the measures are not consensual. Instead they find themselves in an “enclave” between the principle of legality, legal certainty and reliability and the value of justice, the principle of equity, tax-paying capacity and fight against tax fraud and tax avoidance.

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participation of a wholly or partly exempt entity; (iii) involve financial insurance operations capable of giving rise to an income requalification, or the change of the beneficial owner, in particular, financial leasing, hybrid and derived financial instruments, or contracts on financial instruments; (iv) or imply the use of tax losses. Regardless of the above, tax planning schemes that are proposed with an exclusion or limitation of responsibility clause in favour of its promoter will always be subject to the reporting duty.

<sup>66</sup> There will be an exclusion for reporting duties falling within the scope of “advice on tax planning or action by a lawyer or solicitor or by a firm of lawyers or solicitors in the context of assessing the legal situation of a client, in the field of legal consultancy, in the exercise of his defence or representation for a client involved in legal proceedings, including advice on how to bring or avoid proceedings, regardless of whether such information was obtained before, during or after such proceedings, as well as within the scope of any other act performed by a lawyer or a solicitor.”

In the light of the above arguments, we believe that ultimately anti-abuse rules will be what the tax authorities and the courts make of them. Saldanha Sanches<sup>67</sup> says of the general anti-avoidance clause, but also with application to all means of fighting abusive tax planning, which could interfere with the individual's right to legal autonomy, "the original sins of its uneasy birth and the drafting errors in its formulation are, however, the least important. The text of the rule is nothing more than a starting point, but an indispensable one all the same. The general anti-avoidance clause is an imperfect instrument even if can be legitimised later through proper application". Therefore, all the criticisms and risks and the advantages and acclaim described above will always be dependent on confirmation through the use and the application made of those rules.

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<sup>67</sup> J.L. Saldanha Sanches, *Os Limites do Planeamento Fiscal*, Coimbra 2006, 233.