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Substantially Similar Taxes (Art. 2(4) OECD-MA): Some Brazilian Issues

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Introduction

While tax legislation is subject to continuous changes, tax treaties are an interesting tool whereby Contracting States offer investors some degree of legal certainty, especially where there is a recognition that internal law should not override tax treaties' provisions. Article 2(4) of OECD-MA can be seen as a provision intended to assure the continuity of tax treaties over time, since it provides for the application of treaties' rules for taxes created after the date of their signature, provided such taxes are "identical or substantially similar" to the ones enrolled therein.

This idea of legal certainty, however, may be jeopardized when one asks whether a tax is "identical or substantially similar" to previous existing ones. Vogel refers to this problem, suggesting that one should consider whether the new tax has "typical" features of pre-existing ones[1]. However, how to determine the "typical" characteristics of previous existing taxes? Brazilian legislation offers several examples, where such discussion can be better understood.

CSL: interpretative provision or override?

The first case to be analysed is the Social Contribution on Profits (CSL), which was created through Law No. 7,689/1988, immediately after the enactment Brazilian 1988 Federal Constitution. When one compares CSL to the pre-existing Income Tax on Corporations (IRPJ), the similarity is immediate. The respective tax events and tax basis are very similar. As a matter of fact, CSL was created to substitute part of the pre-existing IRPJ. This can be evidenced by the fact that, at that time, IRPJ used to reach the maximum rate of 33%. This rate was reduced to 25% but simultaneously CSL charged 8% of the profits. Thus, from a taxpayer's perspective nothing changed: instead of paying 33% IRPJ, he/she would pay 15% IRPJ plus 8% CSL. The only effect would be in the balance between the Union, States and Municipalities in Brazil: while IRPJ is a tax collected by the Union whose revenue must be shared with States and Municipalities, CSL is collected by the Union and not shared with other entities. In such sense, the creation of CSL had an enormous effect on the distribution of revenues among public entities, but no effect for taxpayers. Due to this substitutive effect, it is hard to deny that the CSL should be considered an "identical or substantially similar" tax, "subsequently imposed in addition to" the income tax, for the purpose of interpreting the taxes covered provision. Therefore, one can claim that the treaties concluded before the creation of the CSL should be interpreted as comprising the CSL, as it is an "identical or substantially similar" tax, "subsequently imposed in addition to" the income tax.

The Brazilian tax policy has always been to expressly include the federal tax on income or on earnings of any kind, which encompasses IRPJ. For treaties previous to the enactment of CSL, therefore, there was a legitimate discussion on whether or not CSL would be included in Article 2(4). Brazilian Administrative Court has decided cases for[2] and against[3] the inclusion of the CSL within the scope of Art. 2(4). In relation to tax treaties signed after 1988, one should immediately conclude that CSL is not a "subsequent" tax. Accordingly, four tax treaties expressly included a provision by which the CSL is considered to be comprised by Art. 2(3)[4]. On the other hand, several other treaties signed after the enactment of the CSL did not list CSL among the taxes covered[5]. It would be fair to conclude, therefore, that CSL is not comprised in such treaties.

Surprisingly, however, in December 2015, Law No. 13,202 was enacted and Art. 11 of this Law established that it should be interpreted that the CSL is also to be comprised by the tax treaties. According to the Brazilian Tax Code, laws with a mere interpretative content may be applied retroactively. In the case of treaties signed before 1988[6] (therefore, when CSL did not exist), one could agree with such interpretation, since CSL is "substantially similar" to the income tax. However, in the case of treaties signed after 1988 not including CSL[7], some problems may arise from this provision. The main issue is that, as this is domestic legislation, other Contracting-States may not accept to give credit related to the CSL, by interpreting that the CSL is not within the scope of the treaty. Accordingly, internal legislation may not override tax provisions. The unilateral approach followed by Brazil is not binding for the other Contracting State, and there is the risk that the other Contracting State (correctly) understands that the CSL is not covered by the treaty.

CIDE: a case of treaty dodging?

Another case to be considered when one examines Brazilian legislation is the CIDE on royatlies.

Brazilian legislation traditionally used to tax income received by non residents concerning to services, including technical assistance and royalties on a 25% rate. As a rule, however, this rate should be reduced to 15% in case a tax treaty would be in force, since Brazilian treaty policy has been to provide for the extension of Article 12 (royalties) to technical services.

In 2000, however, Law No. 10,168 was enacted, creating a new tax: CIDE. CIDEs are contributions aimed at financing Government's interventions in the economy. In this case, a CIDE was created in order to grant Federal Government with funds to offer subsidies to the development of local technology.

From an economical perspective, the CIDE on royalties is not different from the income tax paid on source upon royalty payments. Accordingly, CIDE and income tax are due on the same moment and have the same tax base. As another evidence of the coincidence between both taxes, when CIDE was enacted, the income tax, which was generally due at a 25% rate (except in case of tax treaties, as mentioned above) was reduced to 15% and simultaneously, CIDE was due at a 10% rate. Once again, one could say that from a taxpayer's perspective, nothing changed: instead of paying 25% income tax, there would be a 15% income tax and a 10% CIDE. One could therefore argue that the 15% tax treaty limit should apply.

However, this economic analysis is not confirmed by a juridical analysis. As a matter of fact, CIDE is technically not an income tax, but rather a consumption tax. CIDE's taxpayer is not the recipient of the income, but rather the payer of royalties and technical assistance. Therefore, one cannot say that CIDE is a "typical" income tax. If one would apply the "identical or substantially similar" test, one would conclude that CIDE is a new tax, not included in the scope of Article 2 (4) of OECD-MA.

This brings an interesting question concerning to treaty dodging. Accordingly, it is very common that literature refers to abuses practiced by taxpayers. Very little has been said, however, when States themselves abuse. It is not unreasonable to argue that Brazil has abused in this case. The abuse would derive from the fact that Brazil reduced its income tax to 15%, which coincidentally is the usual limit that tax treaties allow the source State (Brazil) to tax payments made to foreign beneficiaries of such income and, at the same time, Brazil was able to collect the remaining 10%, not as income tax, but as CIDE.

Taxes on Services

A final example may be referred when one takes into consideration the expansion of the scope of the Brazilian tax on Services (ISS) to services imported from abroad.

ISS is not a federal tax. It is due to the Municipalities. Brazil does not have a unified consumption tax. There is a State tax, similar to VAT, due to States, the so-called ICMS. However, ICMS does not cover services, except for communication and transport. Services are generally subject to another consumption tax, the ISS. Traditionally ISS was only due in the case of services provided locally. Services derived from abroad were subject to income tax at source, but not to ISS. This scenario changed when Complementary Law No. 116/2003 extended the ISS scope: according to that law, services provided from abroad would also be subject to ISS.

Once again, the "identical or substantially similar test" should apply. On one hand, one could argue that ISS is due on the same moment income tax at source is paid. Moreover, the tax base is identical for both cases. However ISS is not an income tax, but rather a consumption tax. If one would apply Vogel's approach, one would conclude that Complementary Law No. 116/2003 did not aim at creating a new tax, or at expanding the income tax, but it has merely expanded the territorial scope of the ISS. In other words, it is a "typical" ISS, not a "typical" income tax.

Once again, one can see that the expansion of the ISS has represented an economic double taxation, but not a juridical double taxation, since ISS is due by the consumer of the service, not by the recipient of the income. In this case, however, it is very difficult to argue that Brazil has abused, since ISS pre-existed in the Brazilian system and, more important, the enactment of Complementary Law No. 116/2003 was not followed by a reduction of another tax.

[1] See Klaus Vogel and Moris Lehner, *Doppelbesteuerungsabkommen: der Bundesrepublik Deutschland auf dem Gebiet der Steuern vom Einkommen und Vermögen,* Munich: Beck, 2003, p. 326.

[2] CARF, Proceeding no. 327.000112/2005-31, Appellate decision 148.709, Rapporteur Councilor Sandra Maria Faroni, Decided on Oct. 19, 2006; CARF, Proceeding no. 19515.002971/2004-54, Appellate decision 1102-00.089, Rapporteur Councilor Sandra Maria

Faroni, Decided on Nov. 5, 2009; and CARF, Proceeding no. 10980.722855/2011-13, Appellate decision 1101-000.902, Rapporteur Councilor Edeli Pereira Bessa, Decided on June 13, 2013.

[3] CARF, Proceeding no. 10880.729239/2011-11, Appellate decision 1102-001.247, Rapporteur Councilor João Otávio Oppermann Thomé, Decided on Nov. 25, 2014; and CARF, Proceeding no. 10980.724003/2011-61, Appellate decision 1401-001.396, Rapporteur Councilor Fernando Luiz Gomes de Mattos, Decided on March 4, 2015.

[4] Belgium (1972), Portugal (2000), Trinidad and Tobago (2008) and Turkey (2010).

[5] Korea (1989), Netherlands (1990), China (1991), Finland (1996), Chile (2001), Israel (2001), Ukraine (2002), Mexico (2003), South Africa (2003), Venezuela (2005) and Peru (2006).

[6] Japan (1967), France (1971), Denmark (1974), Spain (1974), Austria (1975), Sweden (1975), Italy (1978), Luxembourg (1978), Argentina (1980), Norway (1980), Ecuador (1983), Philippines (1983), Canada (1984), Czech Republic and Slovakia (1986), Hungary (1986) and India (1988).

[7] Korea (1989), Netherlands (1990), China (1991), Finland (1996), Chile (2001), Israel (2001), Ukraine (2002), Mexico (2003), South Africa (2003), Venezuela (2005) and Peru (2006).

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