SOVEREIGNTY
AND THE INTERNATIONAL TAX LAW

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ABSTRACT

This article discusses the various manifestations of sovereignty in International Tax Law. There are several ways to violate the tax sovereignty of states and the main form of combat is the adoption of anti-avoidance rules.

KEY WORDS: international tax law, sovereignty, anti-avoidance rule**.**

A SOBERANIA E O DIREITO TRIBUTÁRIO INTERNACIONAL

RESUMO

O presente artigo expõe as formas de manifestação da soberania no Direito Tributário Internacional. Existem diversas maneiras de se violar a soberania tributária dos Estados e a principal forma de combate é a adoção das normas anti-elisivas.

PALAVRAS-CHAVE: direito tributário internacional. Soberania. Norma anti-elisiva

INTRODUCTION

Tax sovereignty is an aspect of sovereignty in its broadest sense and in International Tax Law it can be analyzed both from the perspective of domestic tax laws or from the Bilateral Income Tax Treaties (BITT). It is up to the International Public Law to determine if the conection to sovereignty is either “strong” or “weak”.

As for the domestic tax laws, what matters most is to know how far they can reachmulti-localized situations. Very often, thelimit will only be determined in the specific case. Will violate sovereignty, for example, a brazilian tax authority seeking to tax a non-

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resident of a country who obtains income in foreign territory, because in this case there is no connection to the national territory.

Regarding the BITT, the very ability of states to celebrate them already implies a manifestation of sovereignty tax. The partial or total reliefof certain income also expresses sovereignty.

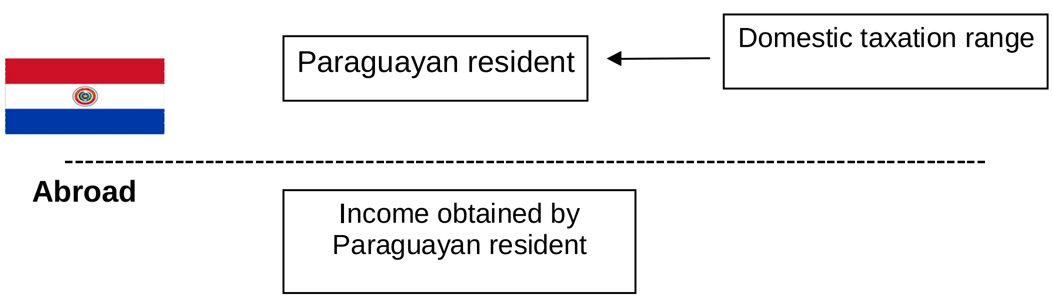
2. Territoriality and worldwide principles

From tax sovereignty two major principles of international taxation can be extracted: territoriality and worldwide.

2.1 Territoriality principle

The territoriality principle, based on territorial sovereignty, means that taxation will be imposed on events that occur in the territory of a given country, even if the income beneficiary is a non-resident.

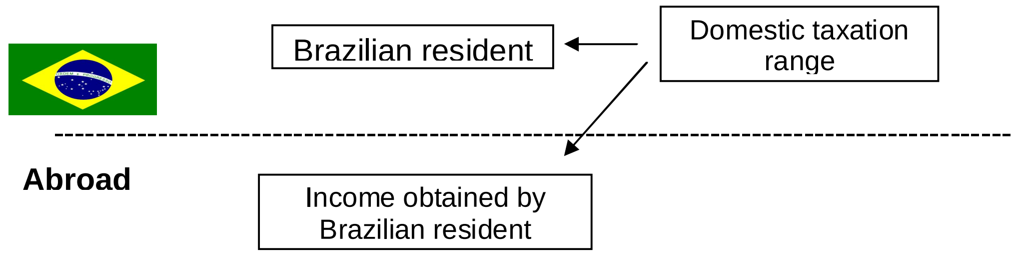
The state which adopts the territoriality principledoes not tax income obtained abroad by its residents. Jurisdictions that are eminently importers of capital tend to adopt this principle. In Latin America, Paraguay is an example of a country that adopts the territoriality. Below, an illustration of the effects of the principlein study:



As one can see, the taxation based on the territoriality principle does not cause the phenomenon of double international taxation of income. After all, if every state taxed only income obtained in its territory, the problem of overlapping taxation juristiction would not exist.

2.2 Worldwide principle

The worldwide principle of taxation, adopted by Brazil, reaches income obtained by Brazilian residents abroad, as seen below:



As seen above, the statewhich adopts the worldwideprinciple goes beyond territorial taxation. When two or more states adopt the worldwide income, the possibilityof international double taxation arises. However, the development of international economic activities should not take it as a hindrance[2]. As Antonio Borges de Moura explains, the issue is not just economic, but financial, cultural, socio-political, of justice and equity[3].

The phenomenon of international juridical doubletaxation arises because two or more states bearers oftax sovereignty undergo the same taxpayer, for the same object, simultaneously, to similar taxes[4]. When this occurs, the motion of capital and people, the technology transfer and the exchange of goods and services are disadvantaged.

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[2] According to the late Klaus Vogel, Double Taxation law is a branch of what is commonly called International Tax Law. See the classic work: *Klaus Vogel on Double Taxation Conventions: a Commentary to the OECD-, UM- and US Model Conventions for de Avoidance of Doublé Taxation if Income and Capital with Particular Reference to German Treaty Practice.* Deventer: Kluwer Law and Taxation Publishers, 1991, p. 3.
[3] BORGES, Antônio de Moura. Convenções sobre Dupla Tributação Internacional entre Estados Desenvolvidos e Estados em Desenvolvimento In: *Revista Notícia do Direito Brasileiro. Nova Série.* Brasília: Universidade de Brasília, LTr, 1996, p. 77.
[4] The economic double taxation differs from the legal one because it has a diversity of contributors, as it happens with taxing a legal entity in the State "A" and its partners in the State "B", although the equity increase is only one. The Convention Against Double Taxation, in general, do not address the international economic double taxation.

The Customary International Law does not prohibit double taxation[5]. Consequently, the wayfound by International Law to mitigate it was the introduction of rules to establish which of the states involved should give up its right to tax[6].

The Bilateral Income Tax Treaty , a sort of international agreement on tax matters, seeks not only to eliminate international juridical double taxation on income (e.g. royalties, interest and dividends), but also to take care of other issues dear to the maintenance of sovereignty, such as theprevention of tax evasion (e.g. treaty shopping combat and the beneficial owner clause) and the non-discrimination.

3. Violations to tax sovereignty andanti-avoidance rules

States' sovereignty is constantly threatened when taxpayers and/or jurisdictions decide to develop unfair tax practices such as: transfer pricing, triangular transactions (*treaty shopping*)[7], exemption from or substantial reductionofforeign companies' income taxation, privileged tax regimes, absolute guarantee of banking secrecy, thin capitalization of companies, etc.

Anti-avoidance rules, these being on the BITTs or on domestic tax rules, have the practical effect of neutralizing the violation of the sovereignty of States tax. What follows is an analysis of some practices considered to be detrimental to the sovereignty and the related anti-avoidance rules.

3.1 Tax haven countries and privileged tax regimes

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[5] VOGEL, Klaus. Op Cit, p. 4. As well observed by Claudio Sacchetto, a legal system incomplete as is the international, does not allow a systematic elaboration of its sources in terms exclusively "positive". International custom, consisting of constant and uniform behavior practiced by states is an unwritten source of international law. SACHETO, Claudio. Las Fuentes del Derecho Internacional Tributario. In: UCKMAR, Victor (Org.). *Curso de Derecho Tributario Internacional*. Bogotá: Temis, 2003, p. 37 e 38.

[6] Regarding the subject, Ottmar Buhler already stated textually: "It can not be found in the TDI a general clause that declares materially illicit the double taxation; on the contrary, it appears clearly the express maintenance of the double imposition in the cases of smaller matters when no agreement regarding those is reached". BUHLER, Ottmar. *Principios de Derecho Internacional Tributario*. Madri: Editorial de Derecho Financiero, 1968, p. 79.

[7] One needs to know if the connecting factors such as residence, the source of production or the payment are identified substantially in a particular case, in order to avoid the abuse of configuring a connection.

While most states use the concept of sovereignty to justify taxation, other jurisdictions take advantage of the same concept to dispense a substantial part or all of the tax incidence, as happens with tax haven countries. Accordingly:

> "However, it is curious to note, it is in name of fiscal sovereignty that exist tax systems that do not use any unilateral measure aimed at avoiding avoidance practices such as treaty shopping andtransfer pricing. [...]. Moreover, it is in name of tax sovereignty that exist the so-called countries with favorable taxation".
> (BASSANEZE, João Marcello Trajumas. Pluritributação Internacional: Origem, Conceito e Medidas Unilaterais Destinadas à sua Eliminação. *In Direito Internacional Aplicado*. TÔRRES, Heleno Taveira. São Paulo: Quartier Latin, 2003, p. 439).

Tax haven countries and privileged tax regimes, whose laws provide, in most cases, absolute banking secrecy, end up eroding the tax base of other states, distortisng trade and investment patterns and underminingfairness, neutrality and broad social acceptanceof tax systems (see *OECD Report on Harmful Tax Competition – An Emerging Global Issue - 1998*)[8]. When dealing with measures to neutralize unfair tax competition, OECD says governments can not stand back while their tax bases are eroding through the actions of countries that offer taxpayers ways to reduce taxes that would, otherwise, be collected for these same governments.

Therefore, the abuse of sovereignty by some states, through unfair tax regimes, could end up violating the sovereignty of other tax jurisdictions. As noted by Michael Graetz, the sovereignty of a nation may be usurped by another's tax policy[9].

3.2 Transfer Pricing

Transferpricing is the mechanism used by the taxpayer to manipulate the allocation of revenues or expenses between parties residing in different tax jurisdictions, in order to, in Brazil, reduce the payment of Imposto de Renda (IR) and Contribuição Social sobre o Lucro Líquido (CSSL). For those who practice such transfer, what is sought is essentially the following:

Country with higher tax	Country with lower tax

[8] Se the full report on the work of Kees Van Raad: *Materials on International & EC Tax Law 2009/2010*(9a. ed. – vol. 1). Rotterdam: International Tax Center Leiden, 2009, p. 1406-1507.
[9] GRAETZ, Michael. *Foundations of International Income Taxation*. Nova Iorque: Foundation Press, 2003, p. 487

burden	**burden**
Lower revenue	Higher revenue
Larger expense	Lower expense

The legal imposition of controling transfer princing intends to prevent, thus, the allocation of losses in that state that submits higher tax burden compared to another more appealing to allocate profits[10]. Therefore, it can happen that the underpricing of exports or the overpricing of imports - when prices are, therefore, different from those existing in a free competition system - cause the following result: basis of calculationtransference to countries with lower taxation or postponement of the payment of taxes.

To Adilson Rodrigues Pires, transfer price is characterized by the divergence between the price of a certain merchandise, established between interdependent companies, in an operation of foreign trade (import or export), and thetest value, understood as the price firmed by independent companies[11]. Similarly, Luis Eduardo Schoueri teaches that the transfer pricing legislation fulfills the function of converting values expressed in "real group" to "real market", which allows the comparison between taxpayers with equal economic capacity[12].

Alejandro C. Altamirano believes that the issue of transfer pricing merges into a real distribution problem and that it is exactly the fact that States save their own ability to contribute in situations in which the will of the economic agent (the taxpayer), in contrast, moves away from the light beam of imposition, in order to, intentionally, make the tax burden uneven[13]. For the Argentine theoretician, the various definitions on the topic have a single common denominator: the countries' desire to annul the loss of ability to pay.

The arm`s length principle fights the basis of calculation transference to countries with lower taxation or the postponement of the payment of taxes - true distortions in international

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[10] Ávila, Márcio. *Preços de Transferência na Indústria do Petróleo* (*Tranfer Price*). Rio de Janeiro: Interciência, 2010, p. 3.
[11] PIRES, Adilson Rodrigues. Controle do Preço de Transferência e as Operações de Comércio Exterior. In *Tributos e Preços de Transferência* (2º vol.) – coord. SCHOUERI, Luís Eduardo e ROCHA, Valdir de Oliveira. São Paulo: Dialética, 1999, p. 12.
[12] SCHOUERI, Luis Eduardo. *Preçosde Transferência no Direito Tributário Brasileiro* (2ª ed.). São Paulo: Dialética, 2006, p 15.
[13] ALTAMIRANO. Alejandro C. Precios de Transferencia. In *III Coloquio Internacional de Derecho Tributário*. Buenos Aires: La Ley-IOB Thomson, 2001, p. 546 e 549.

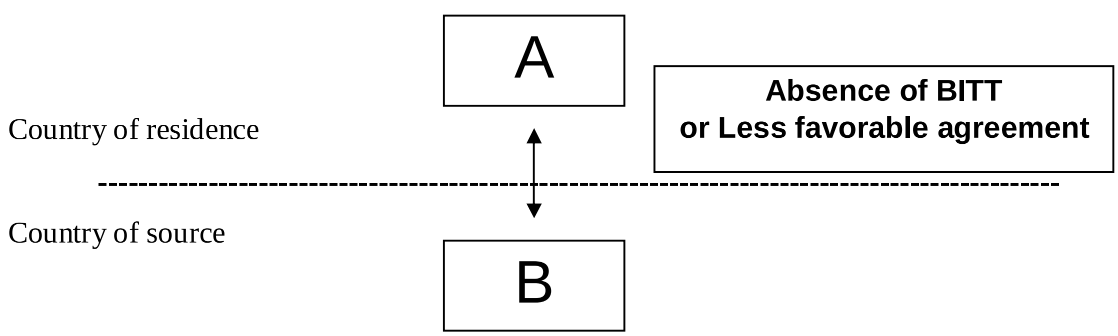
taxation -, imposing the bound parties with the obligation of following the prices under normal market conditions, i.e., those developed between independent parties. The aim is, therefore, to restrain the subtraction of taxable income of those countries where wealth was actually produced.

3.3 Triangular operations

Triangular operations, also known as treaty shopping, consist in finding, by a non-resident fellow (read: conduit company) relative to signatory States of certain BITT, the lowest possible tax in a particular international operation.

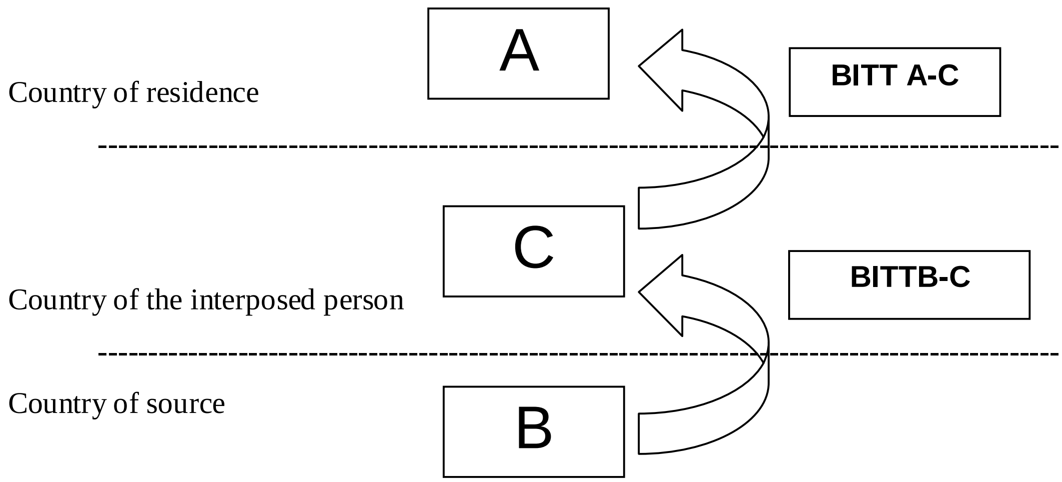
It is possible to display an overview of the following phases of treaty shopping:

1st phase: finding that the States originally related to the international operation did not agree to a BITT or that the Convention in force is less favorable;



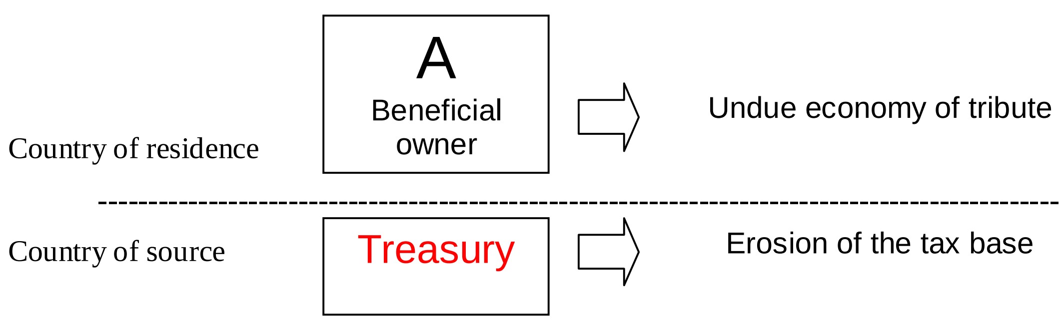
As a consequence of the structure above, the retention of income tax at source in the country of "B" will occur fully or in a large part.

2nd phase: seeking for jurisdictions that celebrated a BITTwith the country where the source of income is situated and, eventually, with the country of residence. In this jurisdiction it will be interposed an individual or a legal entity.



As a result of this structure, the withholding of income tax at source in the country of "B" will occur in a limited way or will not even exist, under the terms of the BITT agreed with the country of "C". Any possible tax collected in the country of source shall be deemed filed in the country of the interpost person, according to the method used to avoid double taxation provided in the Convention. The same procedure must be observed in the transfer of income from "C" to "A", except for the peculiarities of the Convention signed between the two last countries.

As "C" was interposed in the juristiction that concluded aBITT with both the state of the source and the state of residence,it becomes relevant the issue of the beneficial owner of the income, which is not "C", but "A". After all, the practice of treaty shopping ends up provoking the following situation:



The practice of treaty shopping leads to the creation of rules aiming to control it (the beneficial owner clause), in order to dismiss the interposed person and put away any tax benefits that would be granted to one if one were, substantially, a tax resident.

As an example, at the recent Convention concluded between Brazil and Peru (Legislative Decree No. 500/09 and Decree 7.020/09), it was possible to identify ten mentions to the term "beneficial owner" in its text, which demonstrates the concern in fighting the interposition of artificial individuals or legal entities with the sole purpose of tax savings[14].

Article 10 - Dividends: "1. Dividends paid by a corporation resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State. 2. However, such dividends may also be taxed in the Contracting State in which the paying corporation resides according to the laws of that State, but if the **beneficial owner** of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: a) 10 percent of the gross amount of the dividends if the **beneficial owner** is a corporation which controls, directly or indirectly, at least 20 percent of the voting shares of the corporation to pay dividends; (...). 4. The provisions of paragraphs 1 and 2 shall not apply if the **beneficial owner** of the dividends, being a resident of a Contracting State, has in the other Contracting State where the paying corporation resides, an active business through an establishment permanently situated therein, or provides in that other State independent personal services through a fixed base situated therein, and the holding by the dividend is effectively connected with such permanent establishment or fixed base. In this case shall be applied the provisions of Article 7 or Article 14, according the circumstances. "

Article 11 - Interest: 1. "Interest arised in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. 2. However, such interest may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the **beneficial owner** of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 15 percent of the gross amount of the interest. (...). 4. The provisions of paragraphs 1 and 2 shall not apply if the **beneficial owner** of the interest, being a resident of a Contracting State, carries, in the other Contracting State in which the interest arises, business activity through a permanent establishment situated therein, or provides independent personal services through a fixed base situated in that State, and the credit in relation to which the interest is paid is effectively connected with such permanent establishment or fixed base. In such circumstances, shall be applied the provisions of Article 7 or Article 14, as appropriate. 7. When by reason of a special relationship existente between the payer and the **beneficial owner** or between them and third parties, the amount of interest paid, considering the credit for which they are due, exceed what would be agreed between the debtor and creditor in the absence of such relationship the provisions of this Article shall apply only to the latter amount. In this case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, having regard to the other provisions of this Convention. "

ARTICLE 12 - Royalties: 1. "Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. 2. However, such royalties may also be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the **beneficial owner** is a resident of the other Contracting State, the tax so charged shall not exceed 15 percent of gross amount of the royalties. (...). 4. The provisions of paragraphs 1 and 2 shall not apply if the **beneficial owner** of the royalties, being a resident of a Contracting State, carries, in the other Contracting State in whi
ch the royalties arise, an active business through a permanent establishment situated therein, or provides in that other State independent personal services through a fixed base situated in that State, and the good or the right generator of royalties is effectively connected with such permanent establishment or fixed base. In such cases shall be applied the provisions of Article 7 or Article 14 according to circumstances. (...). 6. Where by reason of a special relationship between the payer and the **beneficial owner** or between them and third parties, the amount of the royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would be agreed between the debtor and **beneficial owner** in the absence of such relationship, the provisions of this Article shall apply only to the latter amount. In this case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, having regard to the other provisions of this Convention. "

Conclusion

Unfair tax practices are a constant threat to the tax sovereignty of States. Transfer pricing, triangular transactions, tax haven countries, privileged tax regimes, jurisdictions with absolute guarantee of banking secrecy, capitalization companies, etc.., are all forms of corrodingof the tax bases of numerous jurisdictions.

This is a problem of global concern that must be studied and tackled through anti-avoidance rules, these being either provided for in the agreements to avoid double taxation or in the domestic tax rules of each state. This is the only way to protect State’s tax sovereignty and to fight unfair tax competition internationally.

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