FORM VERSUS SUBSTANCE: A COMPARISON OF BRAZIL'S TAX SYSTEM TO THE TAX SYSTEM OF THE UNITED STATES OF AMERICA

ROBERTO GRECO DE SOUZA FERREIRA¹

I. INTRODUCTION

When faced with numerous lawful alternatives to reach the same desired result, individuals and legal entities most likely will choose the one for which they will incur the least income tax liability, regardless of their culture or education. This is known as tax planning. It considers the tax implications of business decisions, usually with the goal of minimizing tax liability. Reducing tax liability is more realistic in a global and capitalist world where money is essential to successfully carry on any business.

In any country, tax planning strategies encounter boundaries that are sometimes extremely difficult to draw. For instance, there is a gray area between tax avoidance, which is a legal tax saving, and tax exasion, which is illegal. Regarding tax avoidance, it is impossible to assure that this kind of a procedure will always be acceptable by the government within the taxpayer's country. Furthermore, if a transaction is considered to be part of a tax avoidance plan, there is a chance that it will not be considered for income tax purposes and instead, the government will successfully recast it, looking beyond the form of the transaction to reach the true intention of the taxpayer. This is known as the substance-over-form doctrine.

This paper will focus on making a comparative analysis²

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2. It is important to note that: "[c]omparative study is, however, notoriously difficult. Full understanding of a foreign tax system may require mastery not only of a foreign language, but also of foreign business and legal cultures. It would be the work of a lifetime for a single individual to achieve that level of understanding of the nine income taxes compared in this volume." ALVIN C. WARREN, JR., Preface to HUGE
between the substance-over-form doctrines of Brazil and of the United States of America, addressing several legal issues involving the so-called "tax avoidance" plan. In the United States, the substance-over-form doctrine was developed as a result of many years of Supreme Court case law and precedent, while this same doctrine was adopted in Brazil by the enactment of Complementary Law No. 104 of January 10, 2001.

To address the legal issues involving the circumstances in which both the United States Internal Revenue Service (IRS) and the Brazilian equivalent agency (Secretaria da Receita Federal) may invoke the substance-over-form doctrine for income tax purposes, it is essential to compare and contrast the legal traditions of Brazil and the United States. Furthermore, it is worthwhile briefing the tax system of each country, so that the situations in which the substance-over-form doctrine comes into play may be fully understood.

Part II discusses the significant differences between civil law and common law traditions. The characteristics of the legal tradition developed within a country most likely will interfere with the construction of the substance-over-form doctrine for tax purposes. In this regard, while the Brazilian tax system is totally dependent upon statutory law, the American tax system depends not only upon statutory law, but also upon case law.

Part III focuses on the structure of the tax system of both countries since the applicability of the substance-over-form doctrine is strictly related not only to the legal tradition of each country but, as a consequence of the elected legal tradition, to the structure of the tax system. The Brazilian Constitution sets forth tax rules that must be followed by all political entities. The most important rule is the principle of legality, under which no one will


3. See United States v. Phellis, 257 U.S. 156 (1921); Gregory v. Helvering, 293 U.S. 465 (1935). In such cases, the Supreme Court put extreme weight on the substance rather than the form used by the taxpayers. Several relevant Supreme Court cases in which the substance-over-form doctrine came into play will be discussed throughout this work.


5. The Secretaria da Receita Federal [Internal Revenue Service], created in 1968 (Decreto No. 63.659, de 20 de novembro de 1968, D.O.U. de 21.11.1968), is a federal organ subordinated to the Finance Ministry. Its main purpose is to enforce, among other federal taxes, the voluntary fulfillment of income tax obligations, taking audit, collection, and assessment measures when appropriate.
be forced to do or to refrain from doing anything unless by virtue of statutory law.\textsuperscript{6} Compared to the Brazilian tax system, the American tax system is much more flexible. Because the U.S. Constitution does not enumerate all taxes that may be imposed by each level of the government, but rather imposes principles of taxation, the political entities have more freedom to enact statutory laws levying taxes.

Part IV makes a distinction between tax evasion and tax avoidance. This distinction is especially relevant to understand the Brazilian substance-over-form doctrine. Part V focuses on the development of the substance-over-form doctrine in both countries. Since this theory is very broad in the United States, some transactions in which the application of the substance-over-form doctrine has been confronted by courts are discussed in detail. These include: transactions characterized as part gift and part sale; related party transactions; transactions recast as like-kind exchanges; and transactions dealing with entitlement to depreciation deductions. Likewise, this section will also address the position taken by Brazilian courts with respect to this doctrine.

Part VI concludes that Brazil and the United States have adopted the substance-over-form doctrine to disregard the form of certain transactions for tax purposes. Nonetheless, due to the differences between the legal traditions of both countries, the substance-over-form doctrine in the United States is much more accepted by courts than the substance-over-form doctrine in Brazil. Moreover, while in the United States such a doctrine governs a variety of situations in which the structure of a transaction is made solely for tax avoidance purposes, the same principle is not accepted in Brazil, where both courts and the government may disregard the form of the transaction when there is evidence of tax evasion.

II. CIVIL LAW VERSUS COMMON LAW

A. The Brazilian Civil Law Tradition

There are two categories of legal traditions around the world: civil law and common law traditions.\textsuperscript{7} Civil law is codified law

\begin{itemize}
\item \textsuperscript{6} Constituição Federal [C.F.] [Brazilian Constitution] (1988) (Braz.). See discussion \textit{infra} p. 11 and note 26.
\item \textsuperscript{7} The majority of authorities understand that there are only two legal traditions: civil law and common law. See Charles F. Abernathy, \textit{Law in the United States Cases and Materials} 18 (International Law Institute, 1995). Some authorities, however, believe that, in addition to civil law and common law, a third
\end{itemize}
("code-based law") because, as the name intuitively indicates, it is based on codified statutes. Common law is case law ("case-based law"), because it is based on prior judicial decisions that create a body of law. While Brazil is an example of a civil law country, the United States is an example of a common law country. Moreover, the Brazilian civil law tradition was extremely influenced by Roman law, while the United States common law tradition was influenced by the English system of common law.

As in many civil law countries, Brazilian statutory law, or legislation, is systematically codified. Accordingly, the Brazilian category of legal tradition exists. That is the socialist law. See John Henry Merryman, The Civil Law Tradition, An Introduction to the Legal Systems of Western Europe and Latin America 1 (Stanford University Press, 2d ed. 1985).

<table>
<thead>
<tr>
<th>Code Law</th>
<th>Common Law</th>
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<tbody>
<tr>
<td>Legislature creates law</td>
<td>Courts create law</td>
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<tr>
<td>Law changes as legislature changes</td>
<td>Law evolves over time</td>
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<tr>
<td>Courts find law scientifically</td>
<td>Experience and practicality, some logic, guide courts</td>
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<tr>
<td>Law is integrated in code</td>
<td>Law is diffuse, incomplete</td>
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<td>Law is pervasive</td>
<td>Law is interstitial</td>
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<td>Law is collection of doctrines</td>
<td>Law is collection of results</td>
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<tr>
<td>Law is known from written code</td>
<td>Law is known internally by citizens, social osmosis</td>
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<tr>
<td>Security resides in certainty</td>
<td>Security may reside in uncertainty</td>
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<tr>
<td>Government makes law</td>
<td>Law reflects citizens' values</td>
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<tr>
<td>The code speaks; no case precedent</td>
<td>Case precedents disclose law</td>
</tr>
<tr>
<td>Law professors know law best</td>
<td>Professors affect law little</td>
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9. It should be pointed out that the sole purpose of this comparative analysis of the differences between the Brazilian civil law and the United States common law traditions is to correctly understand the differences of substance-over-form doctrines developed by both countries. Therefore, there is no aim at making a comparison concerning the historical achievement of both legal traditions. Nonetheless, for historical development of civil law and common law traditions, including some comparisons between both traditions, see F. H. Lawson, A Common Lawyer Looks at the Civil Law (Ann Arbor, University of Michigan Law School, 1953); Raul Lozano Merino, Proceedings of the Ninth Annual Conference on Legal Aspects of Doing Business in Latin America: New Approaches: Looking to the Twenty-First Century, 11 Fla. J. Int'l L. 1, 50-6 (1996); Mary Ann Glendon, Michael Wallace Gordon & Christopher Osakwe, Comparative Legal Traditions, Text, Materials and Cases (American Casebook Series, West Publishing Co., 2d ed., 1994).

10. Although there are a variety of codes in Brazil, the most important of these codes are the following: Código Civil [C.C.], Lei No. 10.406, de 10 de janeiro de 2002, D.O.U. de 11.01.2001. Código Comercial [C.C.O.], Lei No. 556, de 25 de junho de 1850, C.L.BR 1850 v. 001. Código de Processo Civil [C.P.C.], Lei 5.869, de 11 de janeiro de 1973, D.O.U. de 17.01.1973. Código Penal [C.P.], Decreto-lei No. 2.848, de 7 de dezembro de 1940, D.O.U. de 31.12.1940. Código de Processo Penal [C.P.P.], Decreto-lei No. 3.689, de 2 de outubro de 1941, D.O.U. de 13.10.1941. Código Tributário Nacional [C.T.N.], Lei No. 5.172, de 25 de outubro de 1966, D.O.U. de
legal system absolutely depends upon statutory law, which, in turn, constitutes the principal source of law. Nevertheless, when statutory law is silent or obscure on a particular topic, Brazilian courts have an essential role in resolving disputes by using other sources of law including analogy, customs, and the general principles of law. Customs and the general principles of law, however, only may be used when analogy cannot. Therefore, there is a hierarchy for the use of these supplementary sources of law. Analogy must be used first, customs second, and general principles of law third. This principle is based on the fact that written law is supreme in Brazil.

When Brazilian judges apply the principle of analogy to resolve a conflict, they do not disregard the law. Instead, they use the law applicable to similar cases and apply it to a concrete case. The principle of analogy is widely applicable to tax law except when its application results in the assessment of a tax not imposed by statutory law. Furthermore, customs only are relevant as a supplementary source of law when they do not conflict with statutory law. Moreover, in order to be used, customs must be subject to continuous and widespread use. When Brazilian judges are unable to apply either analogy or customs to resolve a particular dispute due to the obscurity of the statutory law, they may use the general principles of positive law to resolve it.
In addition to analogy, customs, and the general principles of law, Brazilian judges also may use treatises, legal periodicals, and case law to resolve judicial disputes. Besides resolving disputes, Brazilian case law’s main purpose is to interpret legislation and regulations to achieve a uniform understanding. Nonetheless, Brazilian judges do not necessarily have to follow precedents emanating from higher courts. The doctrine of stare decisis does not exist in the Brazilian legal system, but a decision emanating from the Brazilian Supreme Court most likely will persuade lower courts.6

Furthermore, as a general rule, the fundamental role of Brazilian case law is to apply the existing statutory law to a concrete case. Judges are, however, faced with the responsibility of interpreting the law. As pointed out by Antonio Chaves “[i]t is not the specific function of the judges to interpret the law. But, in the performance of their duties, they have to resolve the cases submitted to them, which they can only do by determining the scope of the legislative rules in question.”7

B. The United States Common Law Tradition

As in any other common law tradition, case law is traditionally the primary source for U.S. law, playing an essential role in constructing a body of principles — “body of laws.”8 Moreover, American case law is governed by the doctrine of stare decisis. Therefore, as a general rule, decisions emanating from higher courts are binding on lower courts, an important difference from the Brazilian legal standpoint.

It should be noted, however, that statutory law in the United States is also a relevant source of law. In most situations, case law is founded on certain principles which give unity to the system. They are the principles which guide the legislator. It is to these principles that the legal interpreter should have recourse in the first instance. In order to attain such principles, the progressive comparison, generalization and abstraction of all positive law in force in a country is essential”).

16. The doctrine of stare decisis is defined in BLACK’S LAW DICTIONARY 1414 (7th ed. 1999) as follows: “[t]he doctrine of precedent, under which it is necessary for a court to follow earlier judicial decisions when the same points arise again in litigation.”


18. See Johnson v. McIntosh, 21 U.S. 543 (1823). This Supreme Court case, decided in the early nineteenth-century, illustrates common law tradition of possession or occupancy as the basis of property ownership. The opinion, delivered by Chief Justice John Marshall, ruled that the “doctrine of first possession,” meaning a definitive declaration of one’s intent to appropriate the land, prevails as the theory of property ownership.
law significantly influences the interpretation and even the enactment of statutory law. Because of the great importance of case law and statutory law, the American common law tradition is both an adaptable statutory code and an instrument of lawmaking, or a kind of hybrid system. As pointed out by one commentator:

Yet because American law is a mixture of code-based law and common law, additional unique problems can arise. Two are very important. First, statutes, as we shall see, often use words, phrases, or concepts from the common law, so that statutory law incorporates common law ideas. Interpretation of the code, therefore, will often require knowledge of the traditional, centuries-old common law. Second, American judges continue to be influenced by the common law’s idea that consistency in the application of law must be demonstrated in each decision. Therefore, American judges will attempt to explain their decisions in the context of prior judicial decisions, many of them quite recently decided cases. These recent decisions, therefore, also affect the court’s judgment: they are not “centuries-old common law,” but they are nevertheless a part of the judge-made law that influences the court’s ultimate decision.\(^9\)

C. Differences between the Brazilian Civil Law and the United States Common Law Traditions

The most important distinction between the Brazilian civil law tradition and the American common law tradition is the different approach given to statutory law. In Brazil, statutory law is the basis of tax law and, therefore, also the basis of the substance-over-form doctrine. The same principle cannot be applied in the United States, however, where both case law and statutory law are the basis of tax law. Moreover, while anti-avoidance rules have developed from statutory law in Brazil, anti-avoidance rules initially developed from case law in the United States.

One commentator explained this distinction:

The civil law tradition is based largely upon Roman law. One of the basic differences between the civil and common law traditions is the attitude toward legislation. Legislation is largely codified in the civil law tradition. While we have codes in the common law, they are not the same kind of codes. The codes in the United States, for example, are less complete, less systematic, and less organic than those

\(^9\) ABERNATHY, supra note 7, at 4.
III. BRAZILIAN TAX SYSTEM VERSUS AMERICAN TAX SYSTEM

A. Overview of the Brazilian Tax System

The Federal Constitution, as the supreme law of Brazilian society, is the most important source of Brazilian tax law.\(^2\) Besides delineating the form and limitations of the three government branches (legislative, judiciary and executive) and securing the rights of its citizens, the Brazilian Constitution establishes in extensive detail what kind of taxes may be imposed by each level of government of the federative system. Unlike the United States, all rules (without exception) related to Brazil's tax system are set forth in the Brazilian Constitution. Such unique characteristic leads to the conclusion that Brazil has an extremely rigid and centralized constitutional tax system.\(^2\) Accordingly, in Brazil, political entities maintain tax jurisdiction only to the extent granted by the Federal Constitution.\(^2\)

As a corollary to the strictness of the Brazilian constitutional tax system, the Federal Constitution imposes a variety of limitations on the taxing power of the political entities. These limita-

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21. C.F. art. 145-162 (Braz.).
22. See, e.g., ROQUE ANTONIO CARRAZZA, CURSO DE DIREITO CONSTITUCIONAL TRIBUTÁRIO [Course on Constitutional Tax Law] 287-296 (Malheiros, 1997) (addressing this unique characteristic of the Brazilian tax law).
23. C.F. art. 145 (Braz.) (stating that "[t]he Federal Government, the States, the Federal District and the Municipalities may levy the following tributes: I - taxes; II - fees, by virtue of the exercise of police power or for effective or potential use of specific and divisible public services rendered to taxpayers or place at their disposition; III - assessments for public works. § 1°: Whenever possible, taxes shall be personal and shall vary with the economic capacity of the taxpayer. To make these objectives effective, the tax administration may identify the patrimony, income and economic activities of the taxpayer, respecting individual rights and the terms of the law. § 2°: Fees may not be calculated on the same basis as taxes").
tions are "constitutional limitations on the power to tax."\textsuperscript{24} The purpose of the existing constitutional limitations on taxing power is to safeguard certain fundamental rights and guarantees of taxpayers, such as liberty, equality, security and property.

The most relevant constitutional limitation on the power to tax, most likely resulting from the Brazilian civil law tradition, is the legality principle (\textit{nullum tributum sine lege}), under which, as a general rule, taxes may only be imposed pursuant to statutory law.\textsuperscript{25} Therefore, the federal government, the states, the federal district and the municipalities may only impose taxes, or even increase or amend taxes, by means of statutory law.\textsuperscript{26} Moreover, in the field of taxation, the legality principle does not permit exceptions. This means that even for extraordinary cases, such as the imposition of a tax for a public calamity or a tax for a foreign war, the legality principle must be respected. If not respected, the imposition of a tax not in accordance with the legality principle will be unconstitutional.\textsuperscript{27}

As a consequence of the legality principle in tax law, the Brazilian Constitution also sets forth a variety of limitations on the power to tax. Pursuant to the non-retroactivity principle, no tax may be imposed when the taxable event occurred prior to the law's taking effect. Furthermore, according to the anteriority principle

\textsuperscript{24} \textit{Flávio Bauer Novelli}, \textit{Notes on the Brazilian Tax System}, in \textit{A Panorama of Brazilian Law} 63 (North-South Center and Editora Esplanada Ltda., 1992) (defining constitutional limitations on the power to tax as follows: "[s]uch limitations consist of prohibitions or restrictions – that is to say, in duties to abstain – which the Federal Constitution itself sets up directly, in order to safeguard certain fundamental rights [liberty, equality, security, property, etc]. Thus, the true meaning of these limitations can only be properly determined by reference to the same fundamental rights whose exercise they are designed to guarantee").

\textsuperscript{25} With respect to the importance of the legality principle in the Brazilian tax system, see \textit{Hugo de Brito Machado}, \textit{Curso de Direito Tributário} [Course on Tax Law] 34 (Malheiros 18a. edição) (2000); \textit{Ives Gandara da Silva Martins}, \textit{Comentários à Constituição de 1988} [Comments to the Constitution of 1988], volume 3 99-100 (Saraiva) (1994).

\textsuperscript{26} C.F, art. 150, I (Braz.) (stating that: "Without prejudice to any other guarantees ensured to the taxpayers, the Federal Government, the States, the Federal District and the Municipalities are prohibited from: I – imposing or increasing a tax without a law that does so").

\textsuperscript{27} Emphasizing the importance of the principle of legality in the Brazilian tax law, Article 97 of the National Tax Code provides that: "Only a law shall: I – institute or extinguish taxes; II – increase or decrease taxes ("..."); III – define the taxable event for the main tax obligation ("..."); IV – set the tax rate and its calculation basis ("..."); V – establish penalties for acts or omissions contrary to its provisions or other violations defined therein; VI – establish the conditions for excluding, suspending and canceling tax credits or waiving or reducing penalties." C.T.N., Lei No. 5.172, de outubro de 1966.
(ex post facto), no tax may be levied unless it is imposed by a law that came into effect before the beginning of the fiscal year.\textsuperscript{28} Although not applicable to income tax, it should be noted that the Federal Constitution imposes some exceptions to the application of the anteriority principle.\textsuperscript{29}

Taking these principles into consideration, the Brazilian Constitution allows the Federal Government to impose taxes on:

- importation of foreign products;
- exportation abroad of national or nationalized products;
- income and benefits of any nature;
- industrialized products;
- credit transactions, foreign exchange operations, insurance or transactions relating to negotiable instruments or securities;
- ownership of rural property;
- large fortunes;
- residual jurisdiction taxes;
- war;
- compulsory loans; and
- social contributions, contributions regarding intervention in the economic domain and contributions in the interest of professional or economic categories.\textsuperscript{30}

The states and the federal district are allowed to impose taxes on:

- transfers by death and donations of any property or rights;
- transactions relating to circulation of goods and the performance interstate and inter-municipal transportation and communication services, even if the transactions and performance begin abroad; and
- ownership of automotive vehicles.\textsuperscript{31}

Finally, the municipalities are allowed to levy taxes upon:

- urban land and buildings;
- any type of non-gratuitous inter vivos transfers of real property, whether natural or by physical accession, and any in rem rights to real property, except for guarantees, as well as the assignment of rights to its acquisition; and
- services of any nature, with the exception of interstate and inter-municipal transportation and communication

\textsuperscript{28} C.F. art. 150, III (Braz.).
\textsuperscript{29} Id. arts. 150, § 1°, and 195, § 6°.
\textsuperscript{30} Id. arts. 148, 149, 153, and 154.
\textsuperscript{31} Id. art. 155.
services.\textsuperscript{32}

Even though the Brazilian tax system is inserted into the Federal Constitution, another infra-constitutional statute, the Brazilian National Tax Code is the second source of the Brazilian tax system.\textsuperscript{33} The Brazilian National Tax Code has the force of a complementary law, serving as an intermediate law between the Federal Constitution and the statutory laws (ordinary laws) enacted by each level of the government with the aim at imposing taxes. Because it works as a complementary law, the National Tax Code plays an important role in the Brazilian tax system.\textsuperscript{34} The main purpose of the National Tax Code is to dictate some general rules related to definitions of taxpayers and taxes, tax obligation, and tax administration. The National Tax Code must be observed by all tax authorities within the country. Nonetheless, due to extensive tax rules imposed by the Federal Constitution, some commentators have argued that the Brazilian National Tax Code has no relevant purpose.\textsuperscript{35}

Pursuant to the National Tax Code, the income taxable event is defined as "the acquisition of legal or economic availability:

- of income, being the product of capital, labor or a combination of both; and

\textsuperscript{32} Id. art. 156.

\textsuperscript{33} C.T.N. [National Tax Code], Lei No. 5.172, de 25 de outubro de 1966, D.O.U. de 27.10.1966.

\textsuperscript{34} Article 146 of the Constitution states that: "A complementary law shall: I - deal with conflicts of taxing power among the Federal Government, the States, the Federal District and the Municipalities; II - regulate the constitutional limitations on the taxing power; III - establish general rules for tax legislation, particularly as to: a) the definition of taxes and their types, as well as, with respect to taxes specified in this Constitution, the definition of the respective taxable events, basis for calculation and taxpayers; b) tax liability, assessment, credit, limitations periods and laches; and c) adequate tax treatment for the cooperative acts performed by cooperative entities." See C.F. art. 146 (Braz.).

\textsuperscript{35} See, e.g., CARRAZZA, supra note 22, at 494-96. But see, e.g., IVEs GANDRA DA SILVA MARTINS, INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, MONETARY INDEXATION IN BRAZIL 33-5 (1978) (stating that: "It is systematic law since it offers to Brazil's taxation system the possibility of a mechanism capable of transmitting the guidelines [general rules] from the Constitution [i.e., its structure], as well as allowing, at second level of priority, settlement of conflicts that might possibly occur between bodies of the Federation and also, at a third level, [regulation of] the Constitutional limits on the power to tax [a rule duly explained in the text of the Constitution]. Clearly, the general rules of tax law, which are impossible to elucidate in the Constitution, take greater priority in being represented in a complementary law. In other words, the establishment of general rules of tax law, by means of a complementary law, represents a guarantee of taxpayers and the certainty that the tax collection authorities, through their legislative bodies, will not embark upon destabilizing legal adventures").
• of gains of any nature, being increases in patrimony not
comprehended within the previous item.\textsuperscript{36}
Furthermore, and more important to the analysis of the develop-
ment of the substance-over-form doctrine in Brazil for income tax
purposes, the National Tax Code has been amended by the enact-
ment of Complementary Law No. 104. This law authorizes the tax
authorities to disregard certain transactions structured by the
taxpayer in such a way as to conceal the occurrence of a taxable
event.\textsuperscript{37}

\textbf{B. Overview of the American Tax System}

The starting point to examine the American tax system is the
Federal Constitution, also known as the “supreme law of the
land.” In the United States, the power of each level of government
to levy taxes is explicitly or implicitly granted by the Federal Con-
stitution. Unlike the Brazilian approach, all rules of the United
States tax system are not set forth in the Federal Constitution.
Moreover, although the Federal Constitution grants tax jurisdic-
tion to the political entities, it does not enumerate what taxes may
be imposed by each level of government.

Pursuant to Article I, Section 8 of the United States Constitu-
tion, Congress has broad powers to assess taxes. It provides that
“[t]he Congress shall have Power to Lay and Collect Taxes,
Duties, Imposts, and Excises, to pay Debts and provide for the
Common Defense and General Welfare of the United States; but
all Duties, Imposts, and Excises shall be uniform throughout the
United States.”\textsuperscript{38} The Federal Constitution goes even further,
determining that Congress may “make all Laws which shall be
necessary and proper for carrying into the Execution the foregoing
Powers, and all other Powers vested by this Constitution in the
Government of the United States, or in any Department of Officer
thereof.”\textsuperscript{39}

It is worth noting that the power of Congress to impose

\textsuperscript{36} See C.T.N. art. 43 (Braz). It should be noted that in accordance with the rules
granted by both the Constitution and the National Tax Code to the federal
government to impose income tax, many statutory laws (the so-called ordinary laws)
have been enacted by the Brazilian Congress over the years. These laws were
consolidated into the Income Tax Regulations approved by Federal Decree No. 3.000
of March 26, 1999 (Decreto No. 3.000, de 26 de março de 1999, D.O.U. de 29.03.1999).
\textsuperscript{37} See Lei Complementar No. 104, de 10 de janeiro de 2001, D.O.U. de
11.01.2001.
\textsuperscript{38} U.S. CONST. art. I, § 8, cl. 1.
\textsuperscript{39} Id. at art. I, § 8, cl. 18.
income tax also comes from Article I, Section 8 of the United States Constitution. Nevertheless, the Sixteenth Amendment also makes available extensive powers to Congress to impose federal income tax to the extent that Congress is not required to apportion the income tax among the states. It should also be noted, however, that the U.S. Constitution grants political entities very broad power to collect taxes while imposing limits on the power to tax, the most relevant being the due process, equal protection, uniformity, and the commerce clauses.

Despite the imposition of certain barriers on the power to tax, the U.S. Constitution, especially in the federal taxation area, rarely interferes with the liberty of Congress to exercise its prescribed taxation power. For example, in 1868, the United States Supreme Court, addressing the federal government's broad power to tax, pointed out that:

It is given in the Constitution, with only one exception and only two qualifications. Congress cannot tax exports, and it must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity. Thus limited, and thus only, it reaches every subject, and may be exercised at discretion.

Based on the tax jurisdiction granted by the Constitution, the United States Congress has enacted statutory laws imposing the federal income tax since 1913. The most significant income tax

40. See Boris I. Bittker et al., Federal Income Taxation of Individuals 1-6 (1988) (citing the Brushaber Supreme Court case which ruled that the power of Congress to impose income tax derives from Article I, Section 8 of the United States Constitution rather than from the Sixteenth Amendment).

41. U.S. Const. amend. XVI ("The Congress shall have power to lay and collect taxes on incomes, from whatever source derived without apportionment among the several States, and without regard to any census or enumeration"). Note that before the enactment of the Sixteenth Amendment to the Constitution, the United States Supreme Court held in Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601 (1895), that the earlier version of the federal income tax was unconstitutional on the ground of violating of Article I, Section 9, Clause 4 of the United States Constitution which stated: "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken." Accordingly, after the decision in Pollock v. Farmers' Loan & Trust, the Sixteenth Amendment replaced Article I, Section 9, Clause 4 of the United States Constitution, allowing the imposition of a federal income tax without apportioning that tax among the states.


43. License Tax Cases, 72 U.S. 462, 471 (1868).
reform occurred with the enactment of the Tax Reform Act of 1986.\textsuperscript{44} Despite the earlier development of the substance-over-form doctrine by the United States Supreme Court, Congress adopted Section 7701(l) of the Internal Revenue Code in 1993. Section 7701(l) authorizes the Secretary of the IRS to "prescribe regulations recharacterizing any multiple party financing transaction as a transaction directly among any two or more of such parties when the Secretary determines that such recharacterization is appropriate to present avoidance of any tax by this title."\textsuperscript{45}

\textbf{C. Differences between Brazilian and American Tax Systems}

In comparison, the Brazilian tax system is much more rigid than the American tax system. Taking into account the principles and rules set forth in the Constitution, the Brazilian Congress and other levels of the government do not have broad power to impose taxes. The United States Congress, on the other hand, has almost unlimited power to impose taxes. Furthermore, while the Brazilian Constitution enumerates all taxes that may be imposed by each level of the government, the United States Constitution does not attempt to do so. Therefore, while the detailed allocation of tax jurisdiction by the Brazilian Constitution prevents two levels of government from imposing the same tax over the same act, transaction or activity, the same phenomenon does not occur in the United States tax system where, for example, both the federal government and the states may impose state and federal income taxes.

In the same view, although both constitutions subject tax jurisdiction to constitutional limits, the limits imposed by the Brazilian Constitution are much more extensive and strict in comparison to the limits imposed by the United States Constitution. For example, the non-retroactivity principle is absolute in Brazil. It is explicitly set forth in the Brazilian Constitution.\textsuperscript{46} In the United States, on the other hand, the non-retroactivity principle is not absolute. In \textit{Welch v. Henry},\textsuperscript{47} the United States Supreme Court, analyzing the extent to which the non-retroactivity principle might be applied, ruled that "[i]n each case it is necessary to consider the nature of the tax and the circumstances in which it is

\textsuperscript{45} 26 U.S.C.A. § 7701(l).
\textsuperscript{46} C.F. art. 150, III (Braz.).
\textsuperscript{47} Welch v. Henry, 305 U.S. 134 (1938).
laid before it can be said that its retroactive application is so harsh and oppressive as to transgress the constitutional limitation." Moreover, considering the foregoing approach, the United States Supreme Court has admitted the application of any law increasing the tax rate for the entire current taxable year in which the law was passed, despite the law being passed later in the same year.

Another relevant aspect for comparison purposes is the difference between the legal tradition of the two countries, mainly the complete dependence of the Brazilian legal system upon statutory law and upon the legality principle and the primary reliance of the United States legal system on case law. Having examined some of the differences of each tax system, we can now understand how the substance-over-form doctrine has developed in both countries, as well as the situations in which the unique characteristics of each country most likely will interfere with the application of such doctrine.

IV. Tax Avoidance versus Tax Evasion

Although the main purpose of this paper is to compare the substance-over-form doctrine, an anti-avoidance mechanism, developed in Brazil and the United States, it also is very important to make a distinction between tax evasion and tax avoidance, as well as to analyze how Brazil and the United States have dealt with such that distinction. Generally speaking, while tax avoidance is defined as “the act of taking advantage of legally available tax-planning opportunities to minimize one’s tax liability,” tax evasion is “the willful attempt to defeat or circumvent the tax law in order to illegally reduce one’s tax liability.” In other words, while tax avoidance is a legal way of saving taxes, tax evasion is illegal.

Regardless of the differences between the Brazilian and the American legal traditions, as well as the particularities of the structure of each tax system, both countries have the same attitude regarding tax evasion. The same cannot be said with respect to tax avoidance. Because Brazil and the United States have different legal systems, the most relevant difference being the char-

48. Id. at 147.
50. BLACK'S LAW DICTIONARY 1473-74 (7th ed. 1999).
acteristic of their legal system traditions, tax avoidance is treated differently in each country.

A. Tax Evasion in the United States of America

In the United States, tax evasion, which is fraudulent, is punishable in both civil and criminal contexts. While the civil sanctions include payment of the tax plus fines, which are determined by tax authorities, criminal sanctions consist of penal charges imposed through a criminal process. Moreover, "[u]nlike the civil penalty, which usually applies only to the taxpayer himself, the criminal provisions punish anyone engaging in the defined offense, thus permitting the government to prosecute persons aiding a corrupt taxpayer." Generally speaking, an attempt to defeat or evade tax involves some fraudulent act, such as recording transactions with nonexistent people or entities, not recording sales, operating bank accounts in false names, and so forth.

B. Tax Evasion in Brazil

In Brazil, tax evasion is defined as any fraudulent or simulated actions taken by taxpayers with the aim at evading, reducing, or delaying the payment of tax. In this regard, any taxpayer's conduct with the purpose of hiding an act that is foreseen as a tax event certainly will be considered an illegal behavior and, therefore, punishable in both criminal and civil areas.

Fraud is defined as any malicious action or omission with the aim of obstructing or delaying, totally or partially, the occurrence of a tax event, excluding or modifying its essential characteristics

51. See I.R.C. § 6672 (1994) (imposing a penalty equal to the total amount of the tax evaded). See also I.R.C. § 7201 (1994) (imposing, upon conviction, a fine of not more than $100,000 ($500,000 in the case of a corporation), or imprisonment of not more than 5 years, or both, together with the costs of prosecution).

52. BITTKER, supra note 40, at 45-24, 25 (emphasis in original).

53. See Spies v. United States 317 U.S. 492, 499 (1943) (ruling that "conduct such as keeping a double set of books, making false entries or alterations, or false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income, handling of one's affairs to avoid making the records usual in transactions of the kind" constitute act of tax evasion).


55. See Lei No. 9.430, de 27 de dezembro de 1996, D.O.U. de 30.12.96, art. 44, II (imposing a penalty equivalent to 150% of the total amount of the tax evaded). See also Lei No. 8.137, de 27 de dezembro de 1990, D.O.U. de 28.12.90 (imposing criminal charges, including imprisonment of not more than five years, on the taxpayer who uses any illegal device for reducing his tax liability).
in order to reduce the amount of the due tax, or avoiding or postponing it.\textsuperscript{56} A typical example of tax fraud occurs when a taxpayer records facts that are not true for the sole purpose of not paying taxes.\textsuperscript{57}

The definition of simulation is not found in any Brazilian tax statutes,\textsuperscript{58} but rather in the Brazilian Civil Code, emphasizing that simulation occurs (i) whenever the legal acts appear to confer or transfer rights to persons other than those to whom the rights are actually conferred or transferred; (ii) whenever the legal acts contain an untruthful declaration, confession, condition or clause; and (iii) whenever the particular instruments are pre or post-dated.\textsuperscript{59} Simulation occurs when there is no connection between the transaction that the parties really intend to accomplish and the transaction that in fact is accomplished. For example, instead of structuring a purchase agreement, the parties structure (simulate) a donation agreement, hiding the payment of the purchase price.\textsuperscript{60}

Although fraud and simulation are two types of tax evasion, there is a clear distinction between the two. In the case of fraud, the illegality is totally evident. Whereas in the case of simulation, the acts are apparently legal due to the malicious devices used by the taxpayer that hide the real or true act.\textsuperscript{61}

\textbf{C. Tax Avoidance in the United States of America}

In the United States, in principle, the taxpayer has the right to arrange his affairs to pay less tax.\textsuperscript{62} Nonetheless, this right is

\textsuperscript{56} Lei No. 4.502, de 30 de novembro de 1964, D.O.U. de 30.11.1964, art. 72.
\textsuperscript{58} Different from the United States tax law prospective, the Brazilian tax law cannot change the definition of terms derived from the civil law. Such principle is set forth in Article 110 of the National Tax Code.
\textsuperscript{60} Amaro, \textit{supra} note 57, at 53.
\textsuperscript{61} Dória, \textit{supra} note 54, at 42.
\textsuperscript{62} See Commissioner v. Newman, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, L., dissenting) (stating that: "Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant"); Gregory v. Helvering, 293 U.S. 465, 469 (1935) (explaining that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted").
In this sense, one commentator has pointed out that:

If the right was based on a source more profound than a mere statute, modifying it might be more troublesome. We would not want to limit fundamental rights or values. But the right cannot be found in any such source. For example, there is no right to engage in tax planning in the Constitution or any other foundational documents of our society. And the right to alter behavior to minimize taxes is not a basic principle of moral philosophy. Tax planning does not, for example, rank with the freedom of thought, speech, association, religion, or other principles supported by moral philosophers.

To summarize, no moral or philosophical basis for the right to tax plan has yet been articulated. There is no constitutional right. There is not even an explicit statutory right. There is, in short, no basis for a right to tax plan other than statements made up out of thin air by a few judges using questionable theories of statutory interpretation. Congress can limit or expand the scope of the right to tax plan with the stroke of a pen. If it is desirable to restrict tax planning, it should be restricted notwithstanding that doing so would reduce the scope of allowable planning permitted under current law.

Moreover, even though the taxpayer may take advantage of a legal mechanism to minimize his income tax burden, depending on the characteristic and motive of the transaction chosen by him to avoid income tax, the substance-over-form doctrine may come into play to ignore the form of the transaction, reaching its genuine substance. Therefore, although tax avoidance is legal, it will not be permitted in some circumstances, such as when the principal or sole purpose of the transaction entered by the taxpayer is to minimize tax liability.

63. See Gregory, 293 U.S. at 469 (stating that "the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended"); Commissioner v. National Alfalfa Dehydrating & Mill Co., 417 U.S. 134, 149 (1974) (recognizing that "while a taxpayer is free to organize his affairs as he chooses, nevertheless, once having done so, he must accept the tax consequences of his choice, whether contemplated or not . . . and may not enjoy the benefit of some other route he might have chosen to follow but did not") (internal citations omitted).


65. See Walter J. Blum, How the Courts, Congress and the IRS Try to Limit Legal Tax Avoidance, 10 J. Tax’n 300, 301 (1959) (advising that: "[t]he taxpayer is to lose if
D. Tax Avoidance in Brazil

In Brazil, the situation in which the taxpayer has the right of arranging his affairs to pay less tax, except in the case of fraud or simulation, has been widely accepted by commentators. Every Brazilian tax planning arrangement relies on the importance of the principle of legality that prevents the tax authorities from imposing tax on activities that do not correspond to any taxable events set forth in the statutory tax law. Accordingly, pursuant to the principle of legality, any taxpayer is allowed to take all necessary steps permitted by law to reduce his tax liability provided that the taxable event has not yet occurred.

Unlike the United States tax system, the Brazilian system, which is strongly based on the principle of legality, allows the taxpayer to enter into a transaction with the sole aim at reducing his tax burden. Therefore, under Brazilian law, the government cannot disregard a transaction (duly permitted by law) simply because the taxpayer structured the transaction for tax avoidance purposes.

In addition, as a corollary to the principle of legality, the Brazilian Civil Code states that any legal act to be validly performed requires a licit and possible subject matter, competent parties, and, more importantly, a form determined or not forbidden by law. Having chosen a form that is not forbidden by law to structure his transaction, the taxpayer cannot, in any circumstance, be compelled to pay more taxes because the tax authorities believe that the form chosen by the taxpayer should be ignored. In this regard, the Brazilian Constitution, stating that "the law shall not injure the vested right, the perfect juridical act and the res judicata" protects legal acts.

It should be noted that, besides the substance-over-form doctrine, many theories that restrict tax avoidance, such as abuse of law and economic interpretation of law (business purpose), are likely incompatible with the Brazilian tax system because it is primarily based on the principle of legality. This is so even though tax avoidance is found to be a principal purpose, or he is to lose only if it is found to be the principal purpose, or only if it is found to be a major purpose").


68. C.F. art. 5, XXXVI (Braz.).
the same theories are applicable in many countries, including in the United States.\(^{69}\)

V. THE SUBSTANCE-OVER-FORM DOCTRINE

A. The substance-over-form doctrine in the United States: The case law

The substance-over-form doctrine in which, as a general rule, the taxpayer relies on the form of the transaction and the government relies on the substance of the transaction, essentially has developed from court decisions in the United States.\(^{70}\) As such, the substance-over-form is viewed as a case law doctrine, instead of a statutory law doctrine. Many commentators have suggested that the substance-over-form doctrine originated in 1935 when the United States Supreme Court decided in *Gregory v. Helvering* that the tax implications of certain transactions are strictly dependent upon their substance rather than on the mere form chosen by the taxpayer.\(^{71}\)

In *Gregory v. Helvering*, the taxpayer, Mrs. Gregory, owned all of the shares of United Mortgage Corporation ("United"), which, in turn, owned 1,000 shares of Monitor Securities Corpora-

\(^{69}\) The majority of Brazilian commentators have argued that abuse of law and the economic interpretation of law (business purpose) cannot be acceptable to the Brazilian legal system, mainly due to the principle of legality, which, in turn, prohibits the use of analogy for imposing a tax not established by law. That is to say, a transaction will only be disrespected for tax purposes when it is structured by means of fraudulent or simulated behaviors. See Luciano da Silva Amaro, *Direito Tributário Brasileiro* [Brazilian Tax Law] 217-22 (Saraiva 8th edition) (2002); Sacha Calmon Navarro Coelho, *Os Limites Atuais do Planejamento Tributário* [Current Limits to Tax Planning], in *O Planejamento Tributário e a Lei Complementar 104, [Tax Planning and Complementary Law 104] 301-02 (Dialética) (2001) (analyzing the application of the business purpose doctrine to the Brazilian tax system, concluding that such doctrine is only applicable to common law traditions and not to the Brazilian civil law tradition that is totally dependent upon the principle of legality); Alberto Xavier, *Tipicidade da Tributação, Simulação e Norma Antielisiva* [Taxation, Simulation and Tax Avoidance Law], 107 (Dialética) (2001). But see Amilcar de Araújo Falcão, *Introdução ao Direito Tributário* [Introduction to Tax Law] (Forense) (1997); Marco Aurélio Greco, *Planejamento Fiscal e Interpretação da Lei Tributária* [Tax Planning and Interpretation of Tax Law], 71-86 (Dialética) (1998).

\(^{70}\) Although the taxpayer will most likely rely on the form of the transaction, in a few cases the taxpayer also relies on its substance. See Helvering v. Lazarus, 308 U.S. 252 (1939).

tion ("Monitor"). The purpose of the transaction structured by the taxpayer was to bail-out the Monitor shares as capital gain, instead of dividend distribution. To achieve this result, a new corporation, Averill Corporation ("Averill"), was created by the taxpayer who transferred the Monitor shares in exchange for shares of Averill. Subsequently, United distributed Averill's stock to the taxpayer in a transaction that, pursuant to the law in force at that time, was qualified as a tax-free corporate reorganization. Immediately thereafter, Averill was liquidated by distributing the Monitor shares to the taxpayer who sold such shares recognizing long-term capital gain on the sale.

The United States Supreme Court held that a tax-free reorganization did not occur and disregarded the form of the transaction on the ground that "[t]he whole undertaking ... was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else." Although this case was not an authentic application of the substance-over-form doctrine, since the court also placed great weight on the lack of business purpose for the taxpayer structuring the transaction in the way it was structured, it is worth noting that the Court has suggested that the substance-over-form doctrine most likely will come into play when form does not reflect its substance.

It should also be noted that, prior to Gregory v. Helvering, the United States Supreme Court had already articulated the importance of the substance-over-form doctrine, stating that: "[w]e recognize the importance of regarding matters of substance and disregarding forms in applying the provisions of the Sixteenth Amendment and income tax laws enacted thereunder. In a number of cases besides those just cited we have under varying conditions followed the rule." The substance-over-form doctrine is one of the most complex and controversial subjects of United States corporate tax law.

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72. Gregory, 293 U.S. at 470.
74. See Marvin A. Chirelstein, Learned Hand's Contribution to the Law of Tax Avoidance, 77 YALE L.J. 440 (1968) (suggesting that the substance-over-form doctrine is extremely complex because "[t]he courts themselves follow no single and consistent set of rules in deciding when to accept and when to disregard the taxpayer's choice of form, although there is a conclusory commonplace for either type of determination"); Saul Levmore, Recharacterizations and the Nature of Theory in Corporate Tax Law, 136 U. PA. L. REV. 1019 (1988) (stating that "[a] source of continuing controversy and mystery in corporate tax law is the acceptability of certain recharacterizations of taxpayer transactions and the unsuitability of others in the eyes of both the courts and the Internal Revenue Service ... Although it is generally understood that
The first reason for this controversy is that courts have developed a principle in which form prevails sometimes, but not always. Accordingly, it is troublesome to assure when the substance-over-form doctrine will be successfully applied to a specified transaction. There is no universal set of principles that can be applied to decide all tax disputes involving substance-over-form issues. Second, since in most circumstances the substance-over-form doctrine is invoked together with other judicial doctrines of income taxation, such as the business purpose and step transaction doctrines, it makes the analysis and reach of the substance-over-form doctrine difficult. Generally speaking, while the substance-over-form doctrine disregards the form of a transaction, the step transaction doctrine combines a series of transactions into a single transaction. Furthermore, under the business purpose doctrine, all transactions will only be respected for tax purposes, if it was not designed exclusively for tax avoidance purposes.

Assuming that the taxpayer may elect one of several forms that have the same economic consequence to structure his transaction, when the substance-over-form doctrine comes into play, and the government ignores the form chosen by the taxpayer, the transaction will be taxed as the most costly of the possible. In taxpayers may be held to the form in which they cast a transaction if this form is agreeable to the Commissioner of Internal Revenue, little is known about those types of forms that taxpayers may employ successfully to escape various taxes or the extent of the Commissioner’s power to recharacterize various taxpayer maneuvers); Lewis R. Steinberg, Form, Substance and Directionality in Subchapter C, 52 Tax Law. 457 (1999) (understanding the complexity of the subject suggesting the following: “[i]n teaching law students and young tax associates, I often point out that there are two fundamental principles in Subchapter C of the Code: ‘Substance controls, form does not’ and ‘form controls, substance does not. This intentionally paradoxical formulation is intended to convey one of the great challenges of practicing in the corporate tax area (or, for that matter, in most areas of the federal income tax law): when will the transactional form selected by the parties control the tax consequences to them?”).  

75. See Blum, supra note 65, at 300. The author has suggested that: “If the courts were to hold the view that form always must prevail (unless the legislature has specified otherwise), tax dodging would be too easy, the public would soon become disturbed, and the voluntary compliance foundation of our system would be weakened. If the courts were to take the extreme opposite view that form need never prevail (unless explicitly provided by statute), tax law would become too uncertain, and the resulting chaos would materially impede business and financial operations.”

76. BITTKER, supra note 40, at 1-28. The authors have stated that: “A related source of difficulty is the common judicial practice of citing the substance-over-form doctrine in combination with other broad concepts (e.g., the business purpose and step transaction doctrines and the requirement of an accurate accounting method), thus obscuring the independent force of each of these grounds of decision.”

77. Boris I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME,
this regard, the substance-over-form doctrine is explained by the following statement: “two transactions that achieve the same underlying result should not be taxed differently simply because they are achieved through different legal steps.”

For purposes of illustrating of this rationale, in *Minnesota Tea Co. v. Helvering*, a case where cash was received by the corporate taxpayer and later distributed to its shareholders for the pre-arranged purpose that the shareholders would use the cash to discharge corporate debts, the United States Supreme Court held that cash was not distributed to the shareholders, but rather taxable to the taxpayer. The Supreme Court reasoned that:

The conclusion is inescapable, as the court below very clearly pointed out, that by this roundabout process petitioner received the same benefit ‘as though it had retained that amount from distribution and applied it to the payment of such indebtedness.’ Payment of indebtedness, and not distribution of dividends, was, from the beginning, the aim of the understanding with the stockholders and was the end accomplished by carrying that understanding into effect. A given result at the end of a straight path is not made a different result because reached by following a deviant path.

It should be noted, however, that in many circumstances, the form chosen by the taxpayer should prevail. Such is the case when form clearly reflects the substance of the transaction. Another example occurs when “the substance of a transaction is ambiguous or capable of being achieved through more than one transactional approach, form frequently becomes the dispositive factor in determining the tax treatment of the parties.” Moreover, there are many situations in which form is essential to control the tax consequences of certain transactions. As pointed out by some commentators:

For example, numerous accounting elections drastically affect tax liabilities without altering taxpayers’ relations

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80. See BITTKER, supra note 40, at 1-29.

81. Lewis R. Steinberg, *Form, Substance and Directionality in Subchapter C*, 52 *Tax Law* 457, 459 (1999) (analyzing several hypothetical examples in which form plays an essential role in controlling the tax implications of a specified transaction).
with the outside world. A taxpayer’s right to report income using the cash method rather than the accrual method, to elect accelerated depreciation rather than straight line depreciation, and to use a fiscal or calendar year is not in any way impaired by the fact that these are matters of form rather than substance. Similarly, a taxpayer with several blocks of the same company, purchased at different times at different prices, can sell either high-cost or low-cost shares merely by designating which shares are intended to be sold, even though the designation has non-tax ramifications.  

In summary, although the successful invocation of the substance-over-form doctrine depends upon the facts and circumstances of each case, many factors must be taken into consideration by courts when ignoring the form of a transaction for tax purposes. Such factors include, among others, existence of tax avoidance motivation (tax planning purpose), reflection of economic reality or business purpose, and presence arm’s length conduct.  

Having given a general overview of the development of the substance-over-form doctrine in the United States, the next step is to examine those transactions that have been challenged by the government on the ground of substance-over-form doctrine: related party transactions, transactions characterized as part gift and part sale, transactions recast as like-kind exchanges, and transactions involving “who” is entitled to take depreciation deductions.  

(i) Related Party Transactions  

The substance-over-form doctrine most often comes into play when transactions are entered into between related parties since, in many circumstances, the form of the transactions are manipulated to take advantage of tax benefits. Not surprisingly, transac-

82. See BITTKER & LOKKEN, supra note 77, at S4-3, 4-4.  
83. See Steinberg, supra note 81, at 476-77.  
84. Although this paper focuses on the application of the substance-over-form doctrine to related party transactions, transactions characterized as part gift and part sale, transactions re-characterized as like-kind exchanges, and situations in concerning entitlement to deductions, there are many other circumstances in which this doctrine may come into play, such as shareholders as conduits for the sale of corporate assets, and deductibility of interest, among others. For example, see Commissioner v. Court Holdings Co., 324 U.S. 331 (1945); John Kelley Co. v. Commissioner, 326 U.S. 521 (1946); United States v. Cumberland Public Service Co., 338 U.S. 451 (1958); Knetsch v. United States, 364 U.S. 361 (1960).
tions between related parties are often structured as a mere device to avoid taxes. As suggested by Boris I. Bittker and Lawrence Lokken "[t]he substance-over-form doctrine is invoked by the government with greatest success with respect to transactions between related persons, since in these circumstances form often has minimal, if any, nontax consequences and particular forms are often chosen solely to reduce taxes."  

In this regard, the United States Supreme Court has scrutinized transactions entered into between related parties, applying, when appropriate, the substance-over-form doctrine. For example, in the 1940 case of Higgins v. Smith, the taxpayer attempted to deduct a loss on the sale of securities to a corporation, Innisfail Corporation, wholly owned by the taxpayer. The Court denied the deduction of such loss on the ground that no sale in substance had occurred. The Supreme Court pointed out that:

There was sufficient evidence of the taxpayer's continued domination and control of the securities, through stock ownership in the Innisfail Corporation, to support this verdict, even though ownership in the securities had passed to the corporation in which the taxpayer was the sole stockholder. Indeed this domination and control is so obvious in a wholly owned corporation as to require a peremptory instruction that no loss in the statutory sense could occur upon a sale by a taxpayer to such an entity.

Another Supreme Court case clearly reflecting the interference of the substance-over-form doctrine to indirect sales between related parties is McWilliams v. Commissioner. In this case, the husband and wife taxpayers entered into transactions with the sole aim at establishing tax losses. One spouse used the stock exchange to sell shares to an unrelated purchaser, while at the same time, the other spouse used the stock exchange to purchase the same amount of shares from an unrelated seller. Filing separate tax returns, the taxpayers claimed deduction of the losses incurred on the sale of stocks, but the government disallowed the deduction. The Supreme Court understood that the sale of stock to third parties was bona fide. Nonetheless the Court held that in substance each transaction was an indirect sale between family members and denied deductibility of the tax losses. The Court

85. See Bittker & Lokken, supra note 77, at S4-7.
87. Id. at 475-76.
also noted that “[s]ecurities transactions have been the most common vehicle for the creation of intra-family losses.”

It should be borne in mind that in many situations certain transactions are not what they are purported to be. As a consequence, these transactions are recast not only by the government but also, more importantly, by courts.

(ii) Transactions Re-characterized as Like-Kind Exchanges

In *Redwing Carriers, Inc. v. Tomlinson*, the taxpayer sold used trucks to G.M.C. for cash and simultaneously bought new trucks from G.M.C. for cash. The transactions were totally interdependent, meaning the first transaction would not have occurred without the second. Instead of reducing the price paid for the new trucks through a commercial discount, G.M.C. paid an excessive amount for the old trucks. The taxpayer structured the transactions with the sole purpose of creating tax advantages by recognizing capital gain on the sale of the used trucks and taking a larger depreciation deduction on the purchase of the new trucks. The court held that this kind of transaction structured by the taxpayer could not be treated as a sale for tax purposes. Instead, the transaction should be recast as a like-kind exchange. Relying on the substance-over-form doctrine, the court held that “[e]qually well established is the corollary that an integrated transaction may not be separated into its components for the purposes of taxation by either the Internal Revenue Service of the taxpayer.”

The court also suggested that tax avoidance is a right of the taxpayer, but tax avoidance not reflecting business purposes should not prevail. According to the court:

Taxation is transactional and not cuneiform. Our tax laws are not so supple that scraps of paper, regardless of their calligraphy, can transmute trade-ins into sales. Although Redwing’s transfers may have been paper sales, they were actual exchanges. A taxpayer may engineer his transac-

89. Id. at 699.
90. Redwing Carriers, Inc. v. Tomlinson, 399 F.2d 652 (5th Cir. 1968).
91. Id. at 654. Instead of treating both transactions separately for tax purposes, the court treated them as like-kind exchanges, relying on Section 1031(a) of the Internal Revenue Code, which states as follows: “[n]o gain or loss shall be recognized if property held for productive use in trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment.” Id. at n.1.
92. Id. at 658.
tions to minimize taxes, but he cannot make a transaction appear to be what it is not. Documents record transactions, but they do not always become the sole criteria for transactional analysis.  

(iii) Transactions Re-characterized as Part Gift and Part Sale

Courts have also addressed the tax implications involving conditional gifts, applying, in many situations, the substance-over-form doctrine to treat conditional gifts as part gift and part sale. In *Diedrich v. Commissioner*, the parents, the taxpayers, made a gift of stock with a basis of fifty thousand dollars ($50,000) and fair market value of three hundred thousand dollars ($300,000) to their children on condition that the children assumed the parent's obligation to pay sixty thousand dollars ($60,000) of federal gift tax. The tax authorities recast this transaction treating it as part gift and part sale. Relying on the substance-over-form doctrine, the United States Supreme Court decided in favor of the government. According to the Court, the assumption of the parent's liability by the children led to an economic benefit to the parents similar to the receipt of cash. Furthermore, the Court noted:

Consistent with the economic reality, the Commissioner has treated these conditional gifts as a discharge of indebtedness through a part gift and part sale of the gift property transferred. The transfer is treated as if the donor sells the property to the donee for less than the fair market value. The "sale" price is the amount necessary to discharge the gift tax indebtedness; the balance of the value of the transferred property is treated as a gift. The gain thus derived by the donor is the amount of the gift tax liability less the donor's adjusted basis in the entire property. Accordingly, income is realized to the extent that the gift tax exceeds the donor's adjusted basis in the property. This treatment is consistent with § 1001 of the Internal Revenue Code, which provides that the gain from the disposition of property is the excess of the amount realized over the transferor's adjusted basis in the property.  

93. *Id.* at 659.
95. *Id.* at 198-99.
(iv) Who is entitled to take depreciation deductions?

Courts already have addressed the application of the substance-over-form doctrine with respect to depreciation deduction for corporate tax purposes. Even though someone holds legal title of certain real property, he only will be allowed to take depreciation deductions for the real property if he is considered the owner in substance of the building.

In *Helvering v. Lazarus*, the taxpayer, Mr. Lazarus, transferred the legal title of three buildings, which he had used as a department store, to a trustee. The trustee immediately leased back the properties to Mr. Lazarus for ninety-nine years with an option to renew the leases and repurchase the properties. The taxpayer claimed depreciation deductions, but the tax authorities denied such deductions, arguing basically that the right to a depreciation deduction follows legal title. The United States Supreme Court held in favor of the taxpayer on the ground that the taxpayer, who had used the buildings for their entire useful life, was the real owner of the properties for tax purposes.

*Frank Lyon Co. v. United States* is another Supreme Court case in which the substance-over-form doctrine was examined by the Court for the purpose of depreciation deductions. This case involved Frank Lyon Company (the taxpayer), Worthen Bank & Trust Company (a state bank), and New York Life Insurance Company (the lender). The state bank spent $10 million dollars for the construction of its new headquarters building, but the Federal Reserve System, to whose supervision the bank was subject, did not permit such an expenditure to construct new premises on the ground that $10 million dollars was in excess of the bank's capital stock, disallowing, therefore, the bank to continue owning the building. However, for the bank to continue using the building, but without legally owning it, the Federal Reserve System allowed the following transaction entered among the parties: The taxpayer purchased the building from the bank, paying $500,000 dollars as down payment, and financed the remaining through a 25-year mortgage loan from the lender. Subsequently, the taxpayer leased the building back to the seller for twenty-five years, giving the seller an option to repurchase the building at specific times and prices during the eleventh through twenty-fifth years of the lease. It is worth noting that the lease arrangement entered

into between the parties was a net lease, meaning that the lessee was responsible for all expenses of the building, such as insurance, taxes, maintenance, etc. Moreover, the monthly rent payable by the bank to the taxpayer was similar to the mortgage payment owed by the taxpayer to the lender.

The issue under consideration was the fact that the taxpayer, who was the holder of the legal title of the building, took depreciation deductions for the building, but the tax authorities, relying on Helvering, denied such deductions on the ground that in substance, the taxpayer was not the owner of the building. Focusing on the fact that the taxpayer was liable on the mortgage, as well as the fact that the Federal Reserve System did not permit the bank to borrow directly from the lender, the United States Supreme Court decided in favor of the taxpayer, allowing the depreciation deductions for the building.

It should be noted, however, that the rationale of this case was completely different from the rationale of Helvering. While in Helvering the court held that the lessor was not the real owner of the real property for tax purposes, the court held in Frank Lyon that the lessor, under the same circumstances, was the real owner of the real property for tax purposes. The Frank Lyon Court drew a distinction between these two cases, relying on the fact that while Helvering involved a two-party transaction in which "[t]he Court looked closely at the substance of the agreement between those two parties and rightly concluded that depreciation was deductible by the taxpayer despite the nomenclature of the instrument of conveyance and the leaseback," Frank Lyon involved a three-party transaction where a two-party transaction was not permissible because of the restrictions imposed by the Federal Reserve System upon the bank. Furthermore, the taxpayer in Frank Lyon was primarily liable for the mortgage, retaining substantial economic risks associated with the buildings. Therefore, the taxpayer was entitled to take depreciation deductions.

Upon describing the transactions above, as well as the outcome of the cases, it is important to note the role of the substance-over-form doctrine with respect to depreciation deductions. More importantly, sometimes courts are reluctant to accept the idea that the holder of the legal title of a piece of property is necessarily entitled to claim depreciation deductions.

98. Id. at 574-75.
99. Id. at 575.
100. See Swift Dodge v. Commissioner, 692 F.2d 651, 654 (9th Cir. 1982) (holding
B. The substance-over-form doctrine in Brazil: The statutory law

On January 10, 2001, the Brazilian Congress enacted Complementary Law No. 104, including a sole paragraph to Article 116 of the Brazilian Tax Code, which reads: "the administrative authority may disregard legal acts or business activities performed with the objective of dissimulating the occurrence of a taxable event, or the nature of the elements that constitutes the tax obligation, following the procedures to be prescribed by ordinary laws."\(^{101}\)

The enactment of Complementary Law No. 104 has led to several debates among tax practitioners, commentators, courts, and even members of the Secretaria da Receita Federal. The center of such debates is the adoption of the substance-over-form doctrine in the Brazilian tax system, in which tax authorities may disregard transactions structured by taxpayers in such a manner of reducing their tax liability, lacking, moreover, any evidence of business or economic purposes.

Many commentators have pointed out that there are three ways to interpret the scope of application of this new tax statute. First, Complementary Law No. 104 has not created any new institute into the Brazilian tax system, since it is exclusively applied to behaviors involving tax evasion. Because the law uses the verb "to dissimulate", which means to defraud, to simulate, or to hide, it will only be applied to circumstances that denote fraud or simulation. However, both fraudulent and simulated behaviors already were punishable by the Brazilian legal system before the enactment of this tax statute.\(^{102}\) Second, Complementary Law No. 104 has imposed limits on tax planning, permitting tax authorities to disregard the form of certain transactions when they are structured to avoid taxes. Under this proposition, commentators have argued that Complementary Law No. 104 is unconstitutional because the right of the taxpayer to arrange his affairs to incur the least tax liability is assured by the principle of legality set


forth in the Brazilian constitutional system. Third, Complementary Law No. 104 has definitely incorporated the substance-over-form doctrine into the Brazilian tax system and such incorporation is totally permissible. In other words, the Brazilian substance-over-form doctrine is constitutional.

Pursuant to Complementary Law No. 104, tax authorities only may disregard legal acts or business activities, or apply the substance-over-form doctrine after the enactment of an ordinary law. More importantly, the former Brazilian president, Fernando Henrique Cardoso, tried to give practical effect to Complementary Law No. 104, passing Provisional Measure No. 66, which, among other things, limited the liberty of the taxpayers to reduce their tax liability. However, the Brazilian Congress refused to convert the provisions concerning limitations on tax planning of Provisional Measure No. 66 into an ordinary law. This act of the Brazilian Congress clearly suggests that Provisional Measure No. 66 is totally unconstitutional, and, as a corollary of that, Complementary Law No. 104 also is incompatible with the Brazilian tax system.

It should be noted that before the enactment of Complementary Law No. 104, the disregard of legal acts or business activities by the tax authorities must follow certain procedures to be prescribed by ordinary laws.


105. According to Complementary Law No. 104/2001 the disregard of legal acts or business activities by the tax authorities must follow certain procedures to be prescribed by ordinary laws.

106. Medida Provisória [Provisional Measure] No. 66, de 29 de agosto de 2002, D.O.U. de 30.08.2002, arts. 13-19. It is worth noting that, according to Article 62 of the Brazilian Constitution, the Brazilian President, in certain limited circumstances, has the power of adopting provisional measures that have the force of ordinary laws provided that such provisional measures are converted into ordinary laws by Congress within a period of sixty days extended to another period of sixty days.

107. Although Provisional Measure was in fact converted into an ordinary law (Lei No. 10.637, de 30 de dezembro de 2002, D.O.U. de 31.12.2002), the provisions dealing with the application of the substance-over-form doctrine were rejected by Congress.

108. It is worth noting that as soon as Congress passed Complementary Law No. 104 the National Confederation of Commerce brought a suit before the Brazilian Supreme Court (ADIN No. 2446) seeking the declaration of unconstitutionality of Complementary Law No. 104. However, such a lawsuit is still pending of a court decision.
tary Law No. 104/2001, Brazilian tax authorities had attempted to ignore the form of certain transactions for tax purposes. Nevertheless, such an effort did not prevail. For example, the Administrative Court of Appeals has ruled that the Brazilian tax system does not permit the recast of a transaction structured in such a manner to reduce the income tax liability provided that the taxpayer has acted in accordance with the principle of legality. Accordingly, if the taxpayer performs an activity that is not a taxable event, he cannot be compelled to pay income tax as a consequence of such activity.

C. A hypothetical example that contrasts both substance-over-form doctrines

A single example is sufficient to demonstrate that the American common law system allows the broad application of the substance-over-form doctrine, while the Brazilian civil law system, particularly due to the structure of the constitutional tax system, does not permit the invocation of such a doctrine for tax avoidance purposes. With respect to the American tax system, as suggested by some commentators:

The substance-over-form doctrine can be successfully invoked in order to treat a purported lease of business equipment with an option in the lessee to purchase the property as a sale on credit if the option price is nominal in amount or the term of the lease is coextensive with the property's anticipated economic life. This same fact pattern has already been confronted by Brazilian courts. In many circumstances the Brazilian government has tried to recast a leasing arrangement as an installment sale, denying the deduction of the monthly payments made by the lessee for corporate tax purposes. It usually occurs when the pre-arranged fixed amount to be paid by the lessee at the end of the leasing agreement is nominal. However, the Superior Court of Justice, Brazil's second highest court, has refused to accept the government's position on the ground that the existing statutory law does not establish a minimum requirement for the amount of the pre-arranged fixed payment. Therefore, the parties are free to nego-

110. BITTKER & LOKKEN, supra note 77, at S4-9.
VI. CONCLUSION

Although both Brazil and the United States have developed a mechanism against tax avoidance, or the substance-over-form doctrine, such development clearly was influenced by the characteristics of the legal tradition of each country. Therefore, there is a substantial difference concerning the circumstances in which the substance-over-form doctrines developed by both countries may come into play.

Due to the differences of both legal traditions, the circumstances in which the taxpayer has the right of arranging his affairs to pay less tax is much more accepted in the Brazilian legal system than in the U.S. legal system. In addition, while the U.S. tax authorities may successfully invoke the substance-over-form doctrine to disregard the form of a transaction structured by the taxpayer with the sole purpose of tax avoidance, the Brazilian tax authorities may only invoke this doctrine when the taxpayer evades taxes by means of fraudulent or simulated behavior.

In the United States, the substance-over-form doctrine is essentially a judicial doctrine since it has developed by case law, capable of being successfully applied to any kind of transaction lacking economic purpose or entered into with the sole aim at avoiding taxes. The substance-over-form doctrine in Brazil is a legislative doctrine, created by Congress with the promulgation of Complementary Law No. 104. Nonetheless, the Brazilian substance-over-form doctrine has no practical effect since the ordinary law required by Complementary Law No. 104 has not been passed. Assuming that the ordinary law required by Complementary Law No. 104 is promulgated by Congress, it most likely will be challenged in courts since a mechanism for restricting tax avoidance, like the mechanism currently in force in the United States, is incompatible with the civil law tradition of the Brazilian tax system. The Brazilian civil law tradition, strongly relying on the principle of legality, permits any taxpayer to take all necessary steps permitted by law to reduce his tax liability provided that the tax event has not occurred yet.