2018

PROPOSALS FROM INDUSTRY

FOR THE 2018 ELECTIONS

CORPORATE TAX: BRAZIL NEEDS TO ADAPT TO THE NEW GLOBAL STANDARDS

TAXATION

15

CNI

National Confederation of Industry
Brazil

CNI. THE STRENGTH OF THE BRAZILIAN INDUSTRY

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IN CONFORMITY WITH THE 2018-2022

STRATEGY MAP

FOR INDUSTRY

CNI

2018

PROPOSALS FROM INDUSTRY

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SUMMARY

FOREWORD

At its average Gross Domestic Product (GDP) growth rate of the last 10 years, only 1.6%, Brazil will need more than half a century to reach the GDP per capita of developed countries.

To succeed in our challenge of at least doubling GDP growth in the next few years, we must not repeat policy errors that sap potential growth – and this includes a coherent economic and institutional reform agenda.

Government changes are special moments when we need to reflect on national goals and strategies. These moments also represent opportunities to push the country out of its comfort zone and to raise our growth ambitions.

A specific peculiarity of the 2018 elections enhances the meaning of this ambition. The end of the terms of office of the next president and legislators will coincide with the 200th anniversary of our independence.

We must use this milestone to stimulate actions focusing on removing major growth hurdles and on building a competitive, innovative, global and sustainable industry.

The *2018-2022 Strategy Map for Industry* the National Confederation of Industry (CNI) published earlier this year proposes an agenda to enhance Brazil's industrial competitiveness and to raise our life standards to developed country level.

Based on the priorities mentioned in the Map, CNI has commissioned 43 studies that discuss key competitiveness factors and hurdles and suggest solutions for major Brazilian problems.

The tax system has a critical impact on competitiveness. Brazilian companies have to navigate a complex, bureaucratic and distortion-riddled tax framework that harms investment and exports, drives costs up, causes legal uncertainty and thus drags investment and growth down.

This work offers suggestions for Brazil to align its corporate tax rules with new global practices. Our goal is to make these rules compatible with those used in more competitive nations so as to foster Brazil's integration with global value chains.

This will lower production costs, improve the business environment, increase Brazil's integration with the global economy, attract investments and enhance industrial competitiveness, thus making our country wealthier.

Robson Braga de Andrade
President of the National Confederation of Industry – CNI

EXECUTIVE SUMMARY

Brazil needs to improve its corporate tax rules in order to attract more investment, to increase its integration with Global Value Chains (GVCs) and to grow faster. The new international tax order initiated with the BEPS Project (Base Erosion and Profit Shifting) and Brazil's bid to join the OECD promote a favorable environment for the change the country needs to accomplish. But this new order also poses risks to Brazil's economic growth and tax base if we fail to adjust our tax rules.

Each country is trying to reposition itself in GVCs through the multilateral negotiation of a new international tax system and by designing its own reforms so as to ascend within these chains, capturing more value. This dispute will affect the competitiveness of multinational corporations and influence the territorial distribution of technological innovation.

By adopting new rules, more stringent than those that preceded the BEPS Project and in alignment with the rest of the world, each country will curb tax abuse to the same extent of its competitors, creating a level playing field. This element of neutrality between different countries' anti-avoidance rules is essential for them to compete because they need to protect their tax bases without sacrificing their economic efficiency and social well-being.

The improvement of Brazilian corporate income tax rules cannot be selective (implementing only those changes that benefit tax authorities without considering their economic impacts) and more strict than the international standard, because this will neither solve the BEPS problem nor increase integration with GVCs but will saddle foreign investment with additional burdens.

Brazil no longer has the option to remain misaligned with international standards and OECD Guidelines. Convergence is not only convenient and necessary but imperative in view of Brazil's OECD accession bid. And the new international order represents a viable alternative for Brazil.

The path for Brazil to avoid losses (and to make gains) involves expanding its Double Taxation Agreements (DTA) network and converging towards best international practices in cooperation with the OECD and in sync with the tax policies of other major emerging economies (such as China and India). This option will protect Brazil's Treasury and investment abroad and will open new GVC integration pathways, increasing foreign investment in Brazil.

Recommendations

1. **Expand and improve our bilateral treaty (DTA) network in order to avoid double taxation**, reaching a number of treaties commensurate with the size of Brazil's economy and comparable to the networks maintained by Mexico and by other BRICS and G-20 countries.
2. **Converge Transfer Pricing in Brazil towards international standards** while keeping the positive aspects of current Brazilian rules. All Brazilian methods and fixed margins will remain in place with sporadic improvements but will become optional (safe harbors).
3. **Lower nominal corporate tax rates (IRPJ and CSLL) below the OECD average**, remove the 30% cap on tax loss set off and improve Interest on Stockholders' Equity (JCP) making it tax deductible (assumed expense based on stockholders' capital and reinvested retained earnings).
4. **Adopt the world's best anti-deferral practices (CFC)** as per BEPS Project Action 3. Brazil should enact effective regulations against abuse, artificiality and the stockpiling of unproductive capital abroad. These regulations must not thwart investment and reinvestment in foreign operations.
5. **Foster technological innovation** by allowing expense consolidation and tax incentive calculation within five-year windows (instead of in each single year), permitting the deduction of expenses with innovation activities outsourced in Brazil and not limiting the tax incentive deduction on taxable income (tax loss acceptable).
6. **Establish a new Tax Compliance Cooperation program (CCT)** for major taxpayers and transnational corporations.
7. **Create a mutually binding consultation system** (including in relation to transfer pricing – Advance Pricing Agreement or APA), **include Tax Arbitration in the Mutual Agreement Procedure** (MAP) established under DTA and widen access to these mechanisms to taxpayers that join CCT/Prorelit.

INTRODUCTION

In November 2015, leaders of G-20 countries – the 20 largest economies in the world – met in Turkey and approved the 14 Reports[1] **prepared by the Organisation for Economic Co-operation and Development (OECD) as a partial product of the Base Erosion and Profit Shifting Project (or BEPS Project)**[2]. At the time, some extremely sensitive matters remained under negotiation in an effort that will continue beyond 2020 and whose outcome will be the review of the OECD Model Convention[3], *Comments and Interpretation Guidelines.*

The BEPS Project created consensus on significant matters. Many rules that do not depend on international treaties have been adopted through each country's national laws.

In 2016 were negotiated the terms and the structure of the Multilateral Instrument referred to in BEPS Project Action 15, aiming at altering the more than 3,000 bilateral treaties (DTAs) now in effect in order to ratify, within the framework of international tax law, the measures proposed within the BEPS Project.

The significance of the BEPS Project and of associated international tax transparency initiatives and Brazil's active participation both in the Project and in the initiatives strengthen the country's May 2017 bid for full OECD membership. Brazil's accession is justified and called for in a new post-BEPS reality in which both Brazil and the OECD became more modern (NUNES FERREIRA, 2018).

This new reality contrasts will Brazil's and the OECD's earlier policies, under which the obstacles to some systemic reforms required for accession were deemed unsurmountable. The main obstacles are very probably to be found in taxation[4], especially in relation to transfer pricing and to service taxation, among other issues. The OECD opposed the maintenance of Brazilian rules while Brazil opposed the adoption of OECD Guidelines. In today's post-BEPS environment, both see the coexistence and harmonization of their systems as feasible.

The options must be examined considering that the implementation abroad of BEPS-related tax reforms tends to render Brazilian exports and foreign investments more expensive. The reference for any options must be to offer Brazil greater potential growth and the ability to protect and increase (via economic growth) the tax base available to the Brazilian Treasury. If Brazil fails to expand its DTA network

1. See (OECD, 2015a).
2. For a description of the BEPS Project, see (TAVARES, 2014).
3. OECD Model Convention with respect to Taxes on Income and on Capital, (OECD 1963, reviewed until 2014).
4. See (BRAZIL, 2018).

and to widely review its national laws, there will be no benefit to offset additional costs, causing the Brazilian Treasury to lose revenue.

On the one hand, Brazil's diminished competitiveness in a post-BPES world will impact GDP growth and drag tax revenues down. On the other hand, harmonization and convergence will tend to induce more domestic and foreign investment and, in consequence, more growth.

This document proposes changes to Brazilian tax law whose goal is to prevent or mitigate the adverse consequences of Brazil's misalignment with the tax laws of the world's major economies. These changes will raise growth by increasing the country's integration with global value chains.

The contest between national tax policies based on the international tax system tends to turn into a dispute for investment, productivity and jobs (TAVARES, 2014). This trend was reinforced by the 2017 US tax reform, which greatly enhanced US competitiveness by lowering the corporate income tax rate to below the world average, among other significant measures.

Global tax reform negotiation and design, for decades unfolding under the aegis of the OECD and of the United Nations (UN)[5], gained new momentum after the 2008-9 world crisis due to political circumstances that favored change and have advanced significantly since 2013 within the OECD-guided BEPS Project.

The BEPS Project encompasses much more than curbing abuse and artificiality or aggressive tax avoidance practices and imposing minimum standards of conduct on countries that foment such abuse and artificiality. Tax base recovery was the Project's explicit objective and no doubt is one among several significant economic themes in discussion.

But that contest will continue and intensify after the BEPS Project with each country trying to balance its wider national economic interests through international bilateral and multilateral relationships. The disputes between the United States and the European Union and between both and China escalated even more during BEPS Project discussions and after its completion and transcend tax base protection and tax morality. International

5. The United Nations (UN) plays an important role in this process. The UN developed a Model Double Taxation Convention (UN, 1981) in contrast to the OECD Model. The former's purpose is to protect the interests of developing countries that receive foreign direct investment or where infrastructure services are provided or where extractivist activities are conducted by foreign companies ("destination countries" or "source countries"). The differences between the UN and the OECD models usually are the starting point for agreement negotiations between developed and developing countries and have influenced the design of Brazilian agreements. Having gained renewed importance thanks to the activities of the United Nations Financing for Development Office and of the Committee of Experts on International Cooperation in Tax Matters, the UN published a **Practical Manual on Transfer Pricing for Developing Countries** using the same principles as the OECD (UN and OECD models do not disagree in this matter) but interpreting them differently in relation to countries such as China and India. The Manual finds Brazilian practices non-compliant with recommended UN and OECD principles. See (OECD, 2010) and (UN, 2013).

competitiveness, capital attraction and job generation in high added value activities (such as research and development, information technology and marketing) are ultimately at stake.

This document examines partial BEPS Project results based on the reports approved in November 2015 and now under implementation all over the world, within the Project's broader context of international relations and national economic development. This document then suggests some corporate income tax reforms Brazil needs to consider against the new international taxation backdrop, as shown in Table 1. Brazil's OECD accession bid has added importance to some of these suggestions.

Table 1 – Summary of major critical corporate income tax issues in Brazil

CRITICAL ISSUE	PROBLEM CREATED	SOLUTION
Limited and inadequate bilateral treaty (DTA) network, overtaxation of remittances.	Double taxation and legal uncertainty make investing in Brazil less attractive. Obstacle to Brazil's integration with global value chains.	Widen and improve the Brazilian bilateral treaty (DTA) network. Adopt the concept of Permanent Establishment and eliminate barriers to technology and service imports.
Transfer Pricing (TP) rules severely misaligned with international standards.	Double taxation, especially of intangible assets, making it unattractive to invest and manufacture in Brazil, especially intermediate industrial products, and thwarting the country's integration with Global Value Chains (GVCs).	Converge TP rules towards internation-al practices, keeping the positive as-pects of current Brazilian rules. The Brazilian method (including fixed mar-gins) to become optional (safe har-bors) and OECD rules to be freely ac-cessible to Brazilian taxpayers.
Nominal corporate income tax (IRPJ and CSLL) rates above OECD average.	Business activities are more heavily taxed in Brazil, damaging the competitiveness of companies that operate in Brazil when compared to those that operate abroad.	Lower nominal corporate income tax (IRPJ and CSLL) rates from the current 34% to a level below the OECD average (24%).
Companies are deprived of capital, interest paid on stockholders' equity may be taxed abroad.	Reinvestment is thwarted and compa-nies may end up paying more income tax, diminishing Brazil's competitiveness in comparison to its competitors.	Improve Interest on Stockholders' Equity (JCP) making it a tax deductible expense instead of paid directly to stockholders.
Cap on tax loss set off against corporate income tax.	Greater business risk and disincentive to investment, increasing the corporate income tax burden and hampering Brazil's competitiveness.	Remove the rule limiting tax loss set off to 30% of each fiscal year's profits.
Overtaxation of income earned abroad.	Foreign investment is thwarted and the competitiveness of Brazilian multinational corporations is diminished in comparison to their competitors.	Tax active income at its destination and passive income at its origin, pre-venting abuse without hurting investment.

Table 1 – (Cont.)

CRITICAL ISSUE	PROBLEM CREATED	SOLUTION
Low incentive to technological innovation.	Greater business risk when researching and developing new technologies and knowledge. Obstacle to Brazil's integration with higher added value global chains.	Allow expense consolidation and tax incentive calculation within five-year windows, permitting the deduction of expenses with innovation activities outsourced in Brazil and not limiting the tax incentive deduction on taxable income.
Tax authority intransigence or inconsistency and legal uncertainty.	Brazil's corporate income taxation is inconsistent with that of trade partners and foreign investors, making Brazil less attractive to foreign capital and hampering Brazil's integration with GVCs.	Establish a new Tax Compliance Cooperation program (CCT) to reduce tax litigation. Create a mutually binding consultation system (including in rela-tion to TP), include Tax Arbitration in the Mutual Agreement Procedure (MAP) under DTA and widen access to these mechanisms to taxpayers that join CCT/Prorelit.

Source: CNI.

1 POST-BEPS TAX POLICY: ANTI-ABUSE AND PRO-DEVELOPMENT

1.1 International Tax Warfare and the New Convergence

In 2012 US senators and UK members of parliament brought to light in congressional and parliamentary investigation committees information and documents on the activities of US multinational corporations and on the low taxes they pay on the more than US$ 2.5 trillion in profits they keep parked abroad, veiled under seemingly legitimate tax structures that exacerbate the deferral of residual US taxation on these profits. US senators and congresspersons wanted to reform tax law so as to make these profits again taxable in the US without hurting corporate competitiveness.

Those tax structures having been made public, the UK Parliament conducted a similar investigation that showed the effects on European countries of the complex and apparently abusive tax structures built by US corporations, which were denounced as immoral in spite of their lawfulness. This triggered the BEPS Project with the support of the US, of European and of all G-20 countries[6].

Some countries (including from Europe) took advantage of the BEPS Project to debate the reform of more fundamental aspects of the international tax system, aiming not only at banning abuse and at improving regulations but also at abating US tax jurisdiction on multinational US corporations. But the reform ambitions of countries such as China and India, that want to redistribute the power to tax multinational corporations, are more extreme than those of OECD member states.

However, the political consensus in the G-20, that gave the OECD the mandate for the BEPS Project, did not include such extreme redistribution of taxing power but rather focused on banning abuse and on improving the existing tax system. Because the United States and other OECD countries have formed coalitions to block the broadening of the BEPS Project, it has not radically redistributed the power to tax multinational corporations but only upgraded the system in an effort to curb abuse and artificiality and to abate international tax warfare.

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6. See (TAVARES; BOGENSCHNEIDER; PANKIV, 2016).

Unhappy with this outcome, the European Union and China continue to implement unilateral measures (and to threaten to enforce retrospective claims) to tax the residual profits of US companies while the United States threatens retaliation and adopted a more aggressive stance in 2017. At the same time, the US, the UK, China and several European and Asian countries (such as Japan) openly implement measures to attract foreign capital and to favor multinational corporations that conduct legitimate operations (including significant corporate income tax rate cuts). All of that within a new and convergent standard of transparent international tax competition[7].

In parallel to the BEPS Project and benefiting from the same political circumstances, the Global Forum on Transparency and Exchange of Information for Tax Purposes has made wide strides so that the Multilateral Convention on Mutual Administrative Assistance in Tax Matters, that governs the Automatic Exchange of Information (or AEOI), now boasts 96 member states.

Another significant milestone was the immediate (in January 2016) adherence of 31 countries to the Multilateral Competent Authority Agreement (or MCAA)[8], that governs the automatic exchange of Country-by-Country Reports (or CbCR) as per BEPS Project Action 13[9]. This new era of multinational corporation transparency and of international tax authority cooperation will prevent countries that engaged in harmful competition (that fanned the flames of international tax warfare) from concealing these practices and the ensuing abusive and artificial structures.

In Post-BEPS times, countries will use the multilateral negotiation of a new system of international tax laws to try to capture more wealth by ascending in Global Value Chains (GVCs)[10]. This contest will affect the competitiveness of multinational corporations and, in consequence, the capital markets of different countries. The location of technological advances, the geographical distribution of productivity gains and the development of human capital will also be impacted[11]. In short, this contest will determine each nation's growth and prosperity levels.

By consistently and coherently adopting more stringent rules, each country will be able to curb abuse to the same extent of its competitors, creating a level playing field. This neutrality of the anti-abuse rules of major producer and consumer countries is essential for them to compete because they need to protect

7. See (TAVARES; BOGENSCHNEIDER, 2015), (TAVARES; OWENS, 2016).
8. See (OECD, 2016a).
9. See (OECD, 2015b).
10. See the Joint OECD, World Trade Organization (WTO) and United Nations Conference on Trade and Development (UNCTAD) Report for the September 2013 G-20 Leader Summit on Trade in Saint Petersburg, Russia; Implications of Global Value Chains for Trade, Investment, Development and Jobs (2013); Joint OECD, WTO and The World Bank Report for the G-20 Ministerial Summit in Sydney, Australia, on July 19, 2014; Global Value Chains: Challenges, Opportunities, and Implications for Policy (2014); and Interconnected Economies: Benefiting from Global Value Chains (2013).
11. See (TAVARES; OWENS, 2015, p. 591-601).

their tax bases without sacrificing their economic efficiency and social welfare. Cherry-picking what measures to adopt from the anti-abuse package will not solve the BEPS problem. But inconsistently and unilaterally adopting anti-abuse measures that are more exacting than the international standard will cause equally severe economic distortions, reducing GVC integration and putting additional burden on foreign investment. Brazil's international tax law must be guided by these competitive dynamics and prospective international equilibrium.

The liberal business environment that Europe and Asia established based on the tax law system OECD supports has clearly and greatly favored capital mobility and international trade. These factors led to the proliferation and development of GVCs that make countries more economically interdependent, disseminate knowledge, integrate markets and foster productivity.

Participation in these value chains was of paramount importance for China to grow richer, for European integration and for the success of US multinational corporations.

But the consensus is that the OECD international rulebook and Guidelines became obsolete and opened the door to abuse, including through artificial GVC reconfiguration and by tax avoidance practices that became more common with the rise of the digital economy. The scope of the BEPS Project was to modernize the system to curb these abuses and artificialities.

Brazil used to resist OECD corporate income tax standards and guidelines. A *priori*, because Brazil saw itself as a developing country, a capital importer in a world of restricted international trade. In the last two decades, while the world dismantled trade barriers under the aegis of the World Trade Organization (WTO), Brazil's perception of the weaknesses of the OECD rulebook and of the opacity of nations that engaged in international tax warfare led the country to maintain its divergent position.

Brazil contrasts with the OECD standard also in the complexity of its transfer pricing treatment and on the cost of navigating this complexity. The country developed its own unique system (transfer pricing, taxation and deductibility of royalties and services rendered abroad etc.) to a large extent to counter the abuse and artificialities referred to in the BEPS Project.

But the Brazilian corporate income tax system (and its taxation of income earned by non-residents) thwarts national and foreign manufacturing investment and puts excessive burden on international trade. For instance, Brazil imposes significant non-tariff barriers on the import of knowledge and of intangible assets, even when incorporated into industrial inputs and components, and on the import of technical and administrative assistance services.

This prevents Brazil from fully integrating with global value chains. In other words, so as to curb potential foreign company abuse when the international system was more vulnerable than it is today, Brazil chose to put a burden on everyone, isolating industry, depressing growth and punishing workers.

The new international system that emerged from the BEPS Project (as well as other countries' best practices to curb abuse and artificiality) is a viable alternative for Brazil. New rules and new practices will be applied in an environment of greater GVC and multinational corporation transparency and of better cooperation between tax authorities, especially for countries that boast a wide DTA network. Expansion of the treaty network and convergence towards the new standards, using best international practices, is the best way for Brazil to protect its economy, Treasury and investments abroad and to stimulate its integration with GVCs.

If Brazil continues to maintain a limited treaty network and to diverge from the world tax law standards perfected by the BEPS Project, both the country's economy and its Treasury will suffer substantially. And misaligned regulations will be a significant, if not unsurmountable, hurdle to Brazil's OECD accession.

The selective and partial implementation of reforms recommended by the BEPS Project and the continued misalignment of crucial aspects of corporate income tax law will expose Brazil to risks and to adverse effects on growth and competitiveness. The BEPS Project will likely cause the country to lose significant tax revenue in view of the expected heavier foreign taxation of Brazilian multinational corporations (and major exporters) without a corresponding increase in Brazil's foreign capital tax base.

Brazil also runs the risk of seeing its exports lose competitiveness if actual trade barriers cloaked as income taxes make them dearer. And high added value functions and activities that transnational corporations currently develop in Brazil may be transferred elsewhere (to Europe and India, for example).

Brazil's limited network of Double Taxation Agreements[12] **and incipient network of Investment Promotion and Protection Agreements (IPPAs)**[13] **make the country less attractive to direct foreign investment**. Administrative or regulatory deficiencies that dampen the usefulness of existing DTAs and sometimes make them ineffective have the same harmful effect.

12. See (CNI, 2013) and (CNI; FET; EY, 2015).
13. Brazil signed 14 Bilateral Investment Agreements between 1994 and 1999 that have not been ratified (including with Germany, the Netherlands, the United Kingdom and Switzerland) and 22 other IPPAs (in 2015 with Angola, Chile, Colombia, Malawi, Mexico and Mozambique, all pending ratification) of which 13 are in effect (mainly those involving Mercosur).

These circumstances impose a risk premium on investment in Brazil, an additional cost for foreign capital, reducing the total investment volume in the country even when focused on the domestic market (market-seeking) and on natural resources (resource-seeking). They also tend to drive away investment focused on production efficiency (efficiency-seeking) that would optimize Brazil's existing industrial capacity and stimulate manufacture through its integration with GVCs.

In a Post-BEPS world, these limitations and deficiencies will not only thwart GDP growth but also cause significant losses to the Brazilian Treasury. An inconsistent corporate income tax (and non-resident income taxation) system and a limited DTA and IPPA network will continue to drag down growth and will prevent Brazilian industry, in contrast to emerging economies such as China, India and Mexico, from contributing as much as it could towards the country's economic and social development.

Brazil is an industrial country and not only an extractivist economy. And our intermediate manufactures will never be fully competitive if they focus primarily on the domestic market and maintain their relative isolation from GVCs while the world becomes ever more interdependent. Brazil's agribusiness, mining and metals industries are thriving and commodity-related value chains have developed here but even in these chains a significant portion of high added value activities occur abroad. Brazil's industry is significantly undersized and underrepresented in GVCs, creating an immense opportunity for Brazil to grow.

Consistent policies that cause industry and services (especially information technology) to fully integrate with GVCs are key for Brazil to grow and offer a chance to reduce social inequality in a sustainable way through the full development of our human capital. Brazil must not lose the opportunity to converge towards new multilateral standards without compromising its sovereignty and this became imperative with Brazil's OECD accession bid. We have to bear in mind that the interests of the Treasury and of the economy can coincide.

1.2 Global Value Chains, Foreign Investment and the BEPS Project

Brazil's strategic repositioning opportunity in the Post-BEPS world is not limited to enhancing the competitiveness of its exports and transnational corporations, although these are important goals.

The direct foreign investment stock of Brazilian companies abroad grew markedly in the last two decades, climbing from US$ 44.5 billion in 1995 to US$ 204.2 billion in 2013 and reaching US$ 172.4 billion in 2016. But the direct investment stock of foreign companies that operate in Brazil grew even more over the same time, jumping from US$ 47.9 billion in 1995 to US$ 644.8 billion in 2013 and reaching US$ 625.9 billion in 2016 (UNCTAD, 2015a).

Multinational corporations maintain US$ 4.4 trillion in cash reserves, which will be totally or partially allocated in manufacturing investments all over the world (UNCTAD, 2015a, p. 19). The revamping of Brazil's international tax policy thus must not be limited to its effects on Brazilian transnational corporations, on promoting their post-BEPS competitiveness and on deflecting threats to the Treasury.

Brazil must also focus on improving its post-BEPS investment environment and on consistently protecting its tax base also in relation to foreign multinational corporations. Brazil's post-BEPS convergence towards international income tax standards may attract a significant share of those US$ 4.4 trillion in efficiency-seeking foreign direct investment (FDI), helping optimize our industrial base and fully integrated it with GVCs.

Brazil has been receiving foreign capital for more than a century, especially because of its domestic market and natural resources. Several countries that attained high economic and social development levels, such as Singapore and South Korea, used strategies that privileged efficiency-seeking foreign investment and implemented the regulation convergence recommended for Brazil. China and India grew exponentially because they combined large consumer markets and labor forces with foreign investment attraction and regulatory convergence strategies that caused these countries to integrate with GVCs much more than Brazil. Brazil has similar consumer market and labor force characteristics but needs to improve tax rules to attract more investment.

The foreign investment stock in China went from US$ 101.1 billion in 1995 (111.1% more than in Brazil) to US$ 956.8 billion in 2013 (48.4% more than in Brazil) and reached US$ 1.35 trillion in 2016 (115.7% more than in Brazil), surpassing the United States as the largest FDI destination in the world (UNCTAD, 2015b). The emergence of Brazil's domestic consumer market and the attractiveness of its natural resources brought it closer to China in 2013 but Brazil's smaller participation in GVC investment flows leaves it shackled to commodities markets and more vulnerable to domestic crises.

Moreover, the stock of China's foreign investment abroad soared from US$ 17.8 billion in 1995 (60% less than Brazil's) to US$ 660.5 billion in 2013 (223.5% more than Brazil's) and reached US$ 1.28 trillion in 2016 (643% more than Brazil's) (UNCTAD, 2015b).

Some aspects of China's international tax policy, such as the fast expansion of its DTA network and the implementation of transfer pricing rules based on OECD Guidelines (even if with considerable differences in interpretation), favor China's progress in both investment flows. China's 25% corporate income tax rate (that can actually fall to 15% in strategic industries) and no pre-payment of tax on income earned abroad (which Brazil taxes broadly) also favor the expansion of Chinese investment abroad.

India offers a similar case even if absolute amounts are lower and if the stock of Indian investment abroad did not grow significantly from 2013 to 2016. Foreign investment stock in India went from US$ 5.6 billion in 1995 (88.2% less than in Brazil) to US$ 226.5 billion in 2013 (64.9% less than in Brazil) and reached US$ 318.5 billion in 2016 (49.1% less than in Brazil). India's FDI stock abroad was insignificant in 1995 (US$ 495 million) and shot up to US$ 119.8 billion in 2013 (41.3% less than Brazil's) and to US$ 144.4 billion in 2016 (16.4% less than Brazil's).

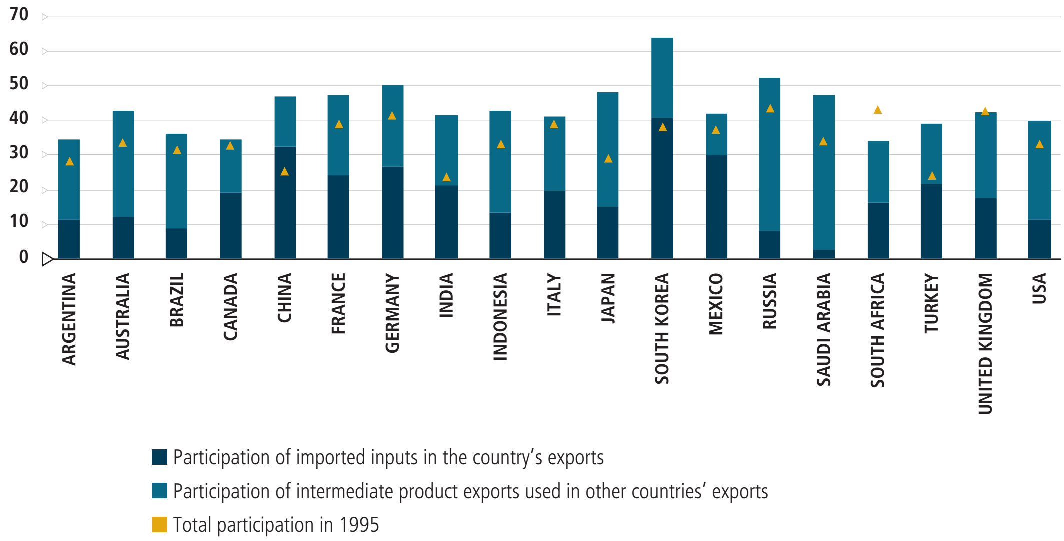
India, as China, expanded its DTA network and adopted OECD transfer pricing Guidelines. And India intends to reform its very litigious and uncertain tax law environment in order to attract more foreign capital in the post-BEPS world, especially for the auto industry, within its new "Make in India" industrial policy. In spite of its poor infrastructure and insufficient power and natural resources, India outperformed Brazil in foreign capital attraction partially because it captured more efficiency-seeking FDI and is more integrated with GVCs. India's attractiveness goes beyond the abundance of cheap labor. The country has gained space within GVCs by offering strategic high added value functions such as research and development. India's transfer pricing rules treat cost difference due to synergy gains (especially from skilled labor) as income from Indian sources, a concept that gained traction within the BEPS Project.

Between 30% and 60% of G-20 country exports are GVC inputs. Aggregate value generation within these trade flows is highly GVC-oriented. Some 80% of GVCs are coordinated by a single company (especially in manufacture) answering for 40%-50% of aggregate value within its chain.

Attracting a significant portion of the GVCs coordinated by these companies became ever more important as the income created by intra-chain trade flows doubled between 1995 and 2009 (flows to China grew by 600%; to India, by 500%; and to Brazil, by 300%)[14]. China, India, Japan and South Korea gained the most[15].

14. See OECD/WTO/UNCTAD, Op. cit. n. 7, p.5.
15. See OECD/UNCTAD/World Bank, Op. cit. n. 7, p.13.

Graph 1 – Participation in Global Value Chains (%) – 2009



Source: OECD.

Graph 1 shows that Brazil participates in GVCs essentially through its commodity exports and that its participation rose only slightly between 1995 and 2009. The low imported content of Brazilian exports means that the country participates in GVCs mainly by supplying commodities (from the agribusiness, mining and metals industries) that are used as inputs and re-exported in the following step of the chain.

The 300% growth in the income Brazil derives from these GVCs was directly caused by the rise in commodity prices over the same time. This is consistent with the fact that Brazilian investment abroad[16] tends to be market-seeking (especially in the food and agribusiness industries but also in engineering services and, in smaller scales, in other manufacturing activities) and resource-seeking (mainly in mining and metals), the same occurring with foreign investment in Brazil.

Deeper penetration in intermediate industrialization using imported inputs will represent a quantitative and qualitative leap to Brazil's GVC engagement. This will be feasible only if Brazilian tax law converges towards international standards and opens a post-BEPS opportunity. Brazil's slight participation growth between 1995 and 2009 (in spite of the commodity boom) lagged behind 15 of the 19 other G-20 countries [17]. Of those that performed worse than Brazil, the United Kingdom had already achieved a much higher participation level, including in intermediate industrialization. Of those that performed better, South Korea, Japan, India and China use much more imported inputs in their exports than Brazil does. In other words, they gained ground within GVCs and grew significantly by stimulating intermediate manufacture.

16. See (CNI, 2013).
17. The European Union also is a G-20 member.

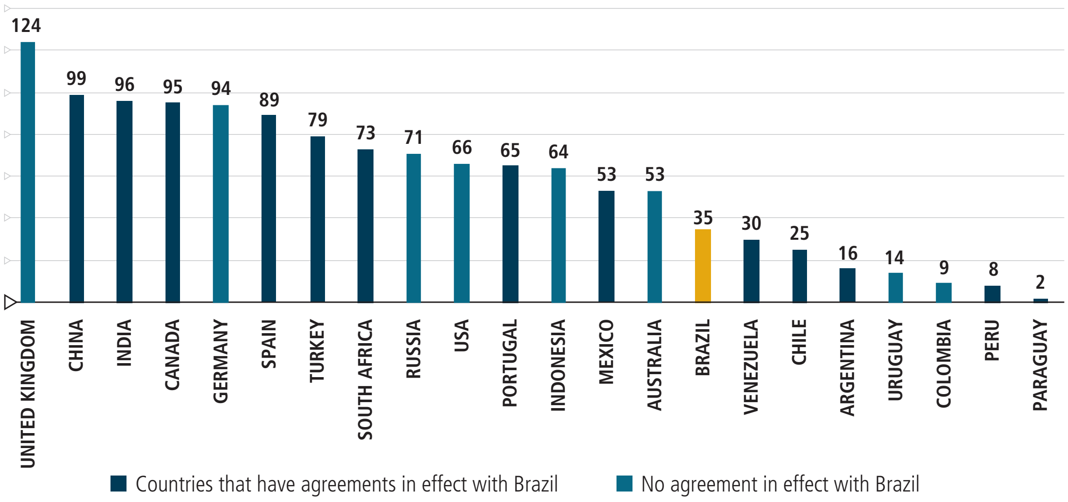
GVC industrial, administrative and technical assistance activities are very fragmented and GVC operations are totally integrated and often remotely controlled. The absorption of GVC efficiency gains requires not only consistent transfer pricing regulations, especially on intangible assets, but also the removal of barriers to technical and administrative service imports[18] related to the company's main activity.

GVCs further require administrative procedures that do not cause double taxation and litigation, such as binding transfer pricing consultations (Advance Pricing Agreements or APAs) and amicable DTA procedures (MAPs). These practices lower the risk premium attributed to intragroup capital costs and tax compliance expenses, reducing the cost of industrial projects.

Consistent transfer pricing rules and the absence of service trade barriers stimulate a country's integration with these chains. The Brazilian system operates at the opposite end of the spectrum in relation to recommended standards. Brazil is absent from the best phases of global value chains because of its inconsistent transfer pricing rules (especially on intangible assets), of its trade barriers to service imports, of its limited DTA network, and, as a corollary to all that, because the country does not use the best international administrative practices (such as bilateral or multilateral APAs and MAPs).

The extension (and maturity)[19] of other countries' DTA networks works as an indicator of the level of convergence between their tax regulations and international standards.

Graph 2 – Extension of avoid double taxation agreement networks



Source: Study made by EY in July 2015.

18. For instance, centralizing support activities and sharing their costs are essential for GVC efficiency and this demands the international invoicing of technical and non-technical services.
19. See (CNI; FET; EY, 2015).

There is a clear correlation between achieving a significant intermediate participation in GVCs (with high import content in exports), as shown in Graph 1, and maintaining a large number of DTAs, as shown in Graph 2. An extensive treaty network signifies the closer convergence between national and international income tax rules. Of G-20 countries, South Korea, China and Mexico are highly ranked in both aspects but Germany, France, India and Turkey also confirm this correlation.

The maturity of a DTA network is an even more revealing indicator of investment flows compatible with heightened intermediate GVC participation. Between 1985 and 1995, China began developing its network and completed 43 DTAs covering all major investor countries in China. Another 57 DTAs were completed between 1996 and 2015 to protect also Chinese investments abroad. Prior to 1985 India had only 5 DTAs. Twenty-five were completed between 1985 and 1996 and another 66 were signed between 1996 and 2015. India now boasts agreements with all its major investor and investment countries.

In other words, while expanding their DTA networks and converging towards international standards (especially on transfer pricing), China and India exponentially increased their GVC participation and attracted more foreign direct investment than their domestic markets alone would have drawn in. Their GVC-related income grew between 500% and 600% regardless of their lack of significant commodity exports (on the contrary, China imported substantial volumes of Brazilian commodities at growing prices, providing income to Brazil over that time period). Brazil had 12 DTAs in 1980 and reached 20 in 1990 but managed to increase its network only to 35 (Germany terminated the relevant DTA exactly due to the inconsistency between Brazilian rules and important treaty clauses)[20].

Some countries become "foreign investment conduits", offering a wide array of DTAs and IPPAs in addition to good infrastructure, proximity to significant consumer markets, low sovereign risk and plentiful skilled labor. Here are some examples picked from countries that are conduits for Brazilian investment abroad: Austria (with 91 DTAs, 62 Bilateral Investment Treaties – BIT and 64 other IPPAs) and the Netherlands (with 95 DTAs, 91 BITs and 53 other IPPAs) (UNCTAD, 2018). Despite the abuses and artificialities the BEPS Project was designed to curb (sometimes implemented using countries such as these), the United Nations Conference on Trade and Development (UNCTAD) acknowledges the important non-tax role played by countries that position themselves as platforms for reinvestment and for GVC head office and/or management activities, seeing them as foreign investment facilitators (UNCTAD, 2015c, p. 188-189).

Brazil needs to acknowledge a new reality. Each country must unilaterally seek and redefine the convergence between its tax system and its strategies on both FDI

20. See (CNI; FET; EY, 2015).

flows. But any one country will gain (or not lose) competitiveness and wealth only by participating in the multilateral game, in interaction with unilateral tax reforms, and by conducting coherent tax and trade policies that take heed of the post-BEPS cooperative movements of other players (Nash)[21].

China assumed the G-20 Chairmanship in 2016 and the Chinese tax authority published a Mandarin version of all BEPS Reports released by the OECD after adopting new and robust transfer pricing rules already based on Project standards[22]. Moreover, China announced its full (and not selective) adoption of the anti-BEPS package, although adapted to China's interests especially in relation to transfer pricing (without abandoning its growth and infrastructure investment strategy).

The European Union passed a new Directive[23] to adopt all BEPS Project "minimum standards", to be implemented through each member country's statutes. Several other countries have begun reforming their international taxation practices. India, focusing on industry and on GVC engagement, moved closer to Western investors (United States and Germany). India also stepped up its tax cooperation efforts aiming at amicable dispute resolution, whether by means of joint oversight of global value chains[24] or of bilateral or multilateral Advance Pricing Agreements, in order to smooth the adoption of OECD Transfer Pricing Guidelines and reduce disputes. Now is the time for Brazil to reposition itself.

21. See (KUHN et al., 1996) and (TUROCY; VON STENGEL, 2001) for a summary of John Nash's work and for references on game theory and on finite game equilibrium and on its application on economics, sociology and international politics.
22. See (TAVARES and OWENS).
23. See (EUROPEAN COMMISSION, 2016).
24. See (TAVARES and OWENS).

2 PARTIAL BEPS PROJECT RESULTS

In summary, the goals of the BEPS Project were[25]:

- to consistently curb the use of artificial "paper" companies with no economic activities and of the harmful tax regimes that disguise them (for instance, Cash Boxes[26] and IP Boxes[27]);
- to reduce conceptual legal inconsistencies that cause inconsistencies in the treatment of financial transactions or legal entities (for instance, "hybrid" structures or instruments);
- to consistently improve the taxation of passive income, including assumed ones, emphasizing the requirement that operating activities have some economic substance (i.e., increment the effectiveness of CFC rules); and
- to consistently improve transfer pricing rules and guidelines so as to fine-tune the Principle of Comparison (of Prices or Profits) on a Commutative Basis (Arm's Length Principle or ALP), especially in relation to intangible assets.

Based on these goals, the BEPS Project sought to align profit recognition to the jurisdictions where value creation functions and activities are developed (for instance, looking at intangible asset development and use, instead of only at research funding and legal ownership of patents).

The BEPS Project did not focus on different countries' income tax rates nor did it categorize as harmful those regimes that use relatively low rates. The Project continues to recommend that active income be finally taxed at the destination country, this being the practice more conducive to economic development, and to accept deferred residual taxation at the origin (US method). And, the ample debate on alternative methods notwithstanding, the BEPS Project did not reject the Arm's Length Principle and did improve the OECD's Transfer Pricing Guidelines, clarifying the economic and functional analysis that guides the recommended methods and buttressing the legal instruments required for its management.

The main result of the BEPS Project was the new Minimum Standards, a set of new anti-abuse rules that all G-20 countries (including Brazil) agreed to implement

25. See (TAVARES, 2014).
26. Legal entities that earn financial and operating profits through the artificial transaction intermediation.
27. Legal entities that earn royalty revenues without performing the corresponding research and development activities.

as soon as possible. They stem from Action 5, on the "Harmful International Tax Practices" carried out by countries engaged in international tax warfare (Countering Harmful Tax Practices More Effectively taking into account Transparency and Substance); from Action 6, on the "Improper Use or (Abuse) of DTAs" (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances); from Action 7, on the "Prevention of Tax Avoidance through the Artificial Non-Characterization of Permanent Establishments (Preventing the Artificial Avoidance of Permanent Establishment Status); from Action 13, on new standards for "Transfer Pricing Documentation and Country-by-Country Reporting"; and from Action 14, on the "Resolution of International Disputes" (Making Dispute Resolution Mechanisms More Effective). New minimum standards also include the automatic exchange of tax information (AEOI), including Action 13 (Country-by-Country Reporting) that emerged from the Global Forum[28].

This minimum standard package will come to fruition through new international tax regulations (hard law) that alter DTAs through the Action 15 Multilateral Instrument (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties). The minimum standard emerging from Action 5 is the only one stemming not from DTAs but from each country's national laws and from international tax law (the same occurs with the potential adoption of the general anti-abusive treaty rule included in the optional part of Action 6). The enactment of legislation to implement all these minimum standards represents a great leap forward for the international tax system and addresses several major concerns of the three BEPS Project pillars (Coherence, Substance and Transparency).

Other themes of great importance, supplemental to the minimum standards, were formatted as Recommendations that will become new Comments to the OECD Model Convention (soft law). The tax authorities of OECD member-states are expected to interpret treaties according to the new OECD Comments. This will be the case for countries that submit no remarks to the Comments (functionally equivalent to reservations) when the new Model is published and whose bilateral treaties obviously are consistent with the OECD Model (and if they submit no reservations, with the Action 15 Multilateral Instrument).

With somewhat less emphasis, the same may be said in relation to non-OECD countries that participated in the BEPS Project at equal conditions. OECD's Comments to art. 9 in the Model refer to Transfer Pricing Guidelines as instruments to interpret and enforce the Arm's Length Principle. In relation to art. 9 in the Convention, this obligation to submit remarks on the Comments is more controverted because the Guidelines are not part of the Comments.

The Guidelines wield great influence and are usually reproduced (sometimes adapted) in each country's transfer pricing regulations and are frequently used

28. See (OECD, 2015b).

as interpretation instruments by dispute adjudicators. It follows that the report's transfer pricing sections (Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10) will have great legal effectiveness despite their soft law character.

Action 2 Reports on "Hybrid Instruments or Entities" (Neutralising the Effects of Hybrid Mismatch Arrangements) and Action 4 Reports on "Abuses on Interest Deductions and Other Financial Payments" (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments) also generated Recommendations. These reforms are optional and will be implemented through each country's national laws. Actions 2 and 4, however, show that measures can transcend the struggle against abuse and artificiality and unintentionally cause adverse impacts on manufacture investment (national and foreign). The purpose of these anti-abuse rules must be balanced with transfer pricing rules and national investment inducement policies.

Finally, some BEPS Project Actions gave birth only to Best Practice Reports. That is the case of Action 3, on "Rules for Taxation of Passive Income, including Assumed Ones" (Designing Effective Controlled Foreign Company Rules). The relevant Brazilian rule, requiring pre-payment of tax on active income reinvested in operations abroad, was not deemed Best Practice. Brazil will gain much by adopting the international practices in substitution of its current rule, unique in the world for its type and for the burden it places on Brazilian transnational corporations (TAVARES, 2014).

Action 12, on "Mandatory Disclosure of Uncertain Tax Positions" (Mandatory Disclosure Rules), also closes with a Best Practices Report. Said practices frequently require more cooperation between tax authorities and taxpayers and a regulatory environment more sophisticated than the Brazilian one (for instance, cooperative compliance, horizontal monitoring, compliance assurance process).

Several countries have already implemented measures stemming from the BEPS Project. These reforms either introduce anti-abuse rules or adapt pre-existing ones, typically aiming at balancing national and international rules and focusing on unilateral economic goals that go beyond tax matters.

In addition to joining the Multilateral Convention that arose from Action 13, since 2014 several countries have announced the implementation of Country-by-Country Reporting or associated measures (including the US and the United Kingdom, South Africa, Australia, Singapore, South Korea, Slovakia, France, Malaysia and Mexico). The unilateral measures already adopted or announced refer to, for instance, Action 1 in the United Kingdom, Australia, Spain, India, Israel and Japan; Action 2 in the European Union, Australia, Austria, Spain, US, France, Japan, Mexico and the United Kingdom; Action 5 in the whole European Union and in the US; Action 6 in the European Union, Germany, China, Denmark, Spain, Italy, Japan and Russia; Actions 8, 9 and 10 in China, US, Chile and Denmark (OWENS, 2016); (OWENS, 2013); (TAVARES; OWENS).

2.1 How Should Brazil Adopt G-20 Minimum Standards?

The technical problems of the international tax system have long been known to tax authorities and have been studied and reformed under the auspices of the OECD and its member-states, especially the United States, for more than a decade[29]. What prevented the resolution of these problems was exactly the persistence of international tax warfare, fed by the blatant favor the US gives its multinational corporations in allowing them to excessively defer tax on income earned abroad and parked in tax havens.

In relation to "Treaty Law" (Action 6), the innovation was the consensus on a minimum treaty substance and purpose standard, although significant disagreement on alternative standards remains. G-20 countries agree that treaty preambles need to be altered (clarifying that treaties must not be used to conceal abuse and artificiality) and that treaties need to include a specific anti-abuse rule using the template Limitation on Benefits (or LOB) Clause and/or a general anti-abuse rule including the Principal Purpose Test (or PPT)[30].

Based on US treaties and favored by the US, the LOB Clause is detailed and complex, includes exceptions to protect cases with economic substance and, if reviewed for the post-BEPS context, may be extremely effective. The US is currently working to perfect its language and to curtail the scope of its exceptions (which still leave room for abuse).

The LOB Clause makes it difficult (if not impossible) to interpose a chain of legal entities for tax avoidance purposes (treaty shopping) but may be incompatible with European Union Law and economic policy, which favor investment within, and the integration of, the European market (TAVARES; BOGENSCHNEIDER, 2015). The United Kingdom, for example, rejects the LOB Clause, preferring the general anti-abuse rule (PPT). Some

29. Work on Harmful Tax Competition goes back to the 1998 OECD Report and to the Forum created to review national practices and to curb abuse by certain countries. The debate on research and development incentives, favoring benefits focused on risk activities (input) and condemning those focused on simple patent filing and ownership rights (output incentives), has been going on since the 1990s and advanced significantly prior to the BEPS Project. The discussion of ALP pros and cons in comparison to Global Formulary Apportionment has been running for almost a century and gained new momentum after 1995. Beginning in 2001 it influenced the development of other rules that made ALP a more sophisticated tool to attribute income to permanent establishments (Authorized OECD Approach in the 2008 and 2010 PE Reports), resulting in the new language in art. 7 in the OECD Model Convention. The restructuring of businesses with the migration of intangibles (including through Cost Contribution Agreements) has been widely discussed since 2005 in the US and in the OECD, resulting in the 2010 publication of chapter IX in the OECD Guidelines. And the OECD has been discussing intangible asset transfer pricing, among other transfer pricing aspects, since 2011. Even work on the Digital Economy can be traced back to 2001 analyses of e-commerce. The BEPS Project to a large extent recycled and reedited US and/or OECD studies and analyses.

30. See (TAVARES, 2016); (LANG, 2014).

non-European countries, however, intend to include both in their treaties (e.g. Japan, China, India).

But general anti-abuse rule enforcement and litigation cause legal uncertainty that tends to sap its effectiveness. This may lead to excessively formal treaties that clash with the intended tax policy goal. Use of the specific anti-abuse rule, on the other hand, leads to its improvement over time and to preserve the effectiveness of the intended anti-abuse policy.

Brazil is recommended to adopt the Action 6 Minimum Standard Package (new preamble, LOB and PPT) and to use this new standard to substantially expand its DTA network. This will dissuade taxpayers from using treaty-allowed tax avoidance strategies and will protect Brazilian direct investment abroad and is not expected to harm foreign investment in Brazil. But Brazilian tax authorities are advised to prioritize the LOB Clause in risk situations and to avoid litigation on the PPT Clause and on the new treaty preamble. This will enhance the effectiveness of the specific rule without dampening the behavioral effect and the legal effectiveness of general rules.

Action 7 Minimum Standards, that reform the concept of Permanent Establishment (or PE), tend to be particularly harmful for Brazil. This because Brazil does not use this concept to tax foreign capital or transactions with non-residents. Brazil does not claim tax jurisdiction for income tax purposes on several trade activities cloaked under special customs regimes that might be deemed PEs. Moreover, Brazil requires tax to be withheld on remittances abroad that might not be deemed income earned in Brazil under the PE concept, thus not being taxable in Brazil (this usually is the case with services exported from abroad). BEPS Project-related changes would thus contribute nothing to the Brazilian Treasury.

Major Brazilian exporters use the Permanent Establishment concept to organize preparatory and support activities abroad in furtherance of Brazilian exports of goods and services, such as inventory warehousing under special customs regimes and sales promotion by commercial agents or representatives, or to perform services abroad (e.g., engineering services). This type of arrangement leaves no room for tax authorities to argue that income was earned abroad (the PE works as an assumed business activity whose income is taxable abroad), allowing the taxpayer to fully book in Brazil its export revenues and profits.

Action 7 alterations to treaty language will likely cause several foreign jurisdictions to deem existing PEs that did not exist under current DTAs with Brazil or under the national laws of the relevant market-countries. To avoid double taxation, exporters will be forced to change their procedures, for example, organizing foreign affiliates that give them grounds to recognize abroad revenues and profits now booked in Brazil, causing these exporters to regularly pay income tax abroad. This will redistribute tax jurisdiction between Brazil and other countries, making Brazilian jurisdiction residual. Under Brazil's current universal tax base (UTB) system, taxes paid abroad will become credits causing an actual loss to the Brazilian Treasury.

Brazilian transnational corporations also structure their foreign operations so as to give them maximum presence in other markets without creating any permanent establishments. They frequently coordinate GVCs within which affiliates located in certain countries (e.g., Austria, the Netherlands, Belgium and Switzerland) lead operations in several other market-countries, again avoiding the creation of PEs in the latter.

The actual tax rates of countries where these GVC coordination and management centers are located are usually lower than those of many market-countries. The tax jurisdiction redistribution towards market-countries tends to raise the taxes Brazilian transnational corporations pay abroad. Market-countries will certainly claim improper use of treaties if the latter restrict them from deeming PEs to exist, combining the results of Actions 6 and 7 (especially based on the preamble or on the PPT Clause). In many cases, treaties will satisfy minimum Action 7 standards and PEs will be recognized by both countries, causing the same increase in the tax burden abroad mentioned earlier. As with major Brazilian exporters, Brazil's UTB system will again turn the additional tax paid abroad into credits that can be used in Brazil to the local Treasury's detriment.

Furthermore, the income attributable to PEs in several countries does not correspond to the OECD Transfer Pricing Guidelines and in many cases may also not correspond to the OECD criteria for Profit Attribution to Permanent Establishments (Authorized OECD Approach or AOA) referred to in the 2008 and 2010 OECD Reports and that influenced the new art. 7 language in the OECD Model Convention, whose use remains limited to a few countries. Many foreign rules use methods to calculate assumed taxable income based on indicators (e.g., revenue and assets) that may yield inconsistent results.

In view of the expected post-BEPS PE proliferation, the Multilateral Instrument in Action 15 should ideally include AOA to standardize the PE income allocation criterion in as many bilateral treaties as possible. But this will in all likelihood not happen. Attributing income from the parent company to an affiliate or PE remains a unilateral or, at best, bilateral procedure if a treaty exists.

Brazil must widen its DTA network and effectively use the Mutual Agreement Procedure (MAP) referred to in Action 14, on International Dispute Resolution, **to defend its tax jurisdiction in relation to major exporters, to avoid improper PE proliferation and excessive income allocation to these affiliates**.

New minimum MAP standards requiring countries to increment MAP access and to use their best efforts to agree as soon as possible on how to prevent double taxation fall short of what is needed. The uncertainty surrounding the BEPS Project requires not only greater access to MAP as a Minimum Standard but also making it mandatory for countries to reach agreements within certain deadlines.

Even then, Action 14 represents progress and each country will use this instrument to a lesser or greater extent to defend its interests and its Treasury. Brazil will perhaps have no option but to adopt arbitration proceedings within MAP. Arbitration is already included in the OECD Model Convention and is widely used in Europe and in the US.

The BEPS Project includes a coalition of countries to develop this inter-country dispute resolution mechanism (including some, Japan in special, that showed great concern in the past but now intend to adopt this mechanism) and to implement a new MAP arbitration model through the Multilateral Instrument. Brazil is advised to join this group and to adapt its national law (e.g. Administrative Tax Proceeding) in order to give ample access to MAP and to allow international arbitration.

The result of Action 13 heightens the risk of international conflict on income attribution in relation to the permanent establishments of Brazilian transnational corporations in other countries. Brazil should share with other nations a Global Master File describing the operations of Brazilian transnational corporations all over the world and containing highly confidential and sensitive information on the value chain of each such corporation and on their strategic differentials. Said Global Master File will be prepared by Brazilian tax authorities using the information taxpayers submit annually (for instance, the Accounting and Tax Report or ECF) and will provide a common basis for the economic analysis (functional and risk-related) of Brazil's transnational operations. It will also guide the transfer pricing studies according to OECD Guidelines (and to UN-recommended standards) each country is supposed to prepare. These national studies will be documented in an individual Local File containing details on significant operations in the relevant country.

Brazil is also required to gather in Country-by-Country Reports (or CbCR) information on transnational business groups with consolidated revenues in excess of 750 million euros (encompassing essentially all Brazilian transnational corporations). This report will list, on a country-by-country basis, the revenues (stemming from third-party versus related-party transactions), profits or losses before income tax, taxes paid, capital subscribed and retained earnings, number of employees and tangible assets (cash and cash equivalents excepted). If Brazil joins the Multilateral Convention Between Competent Authorities arising from Action

13[31], Brazilian tax authorities will be required not only to gather this information but to automatically and annually send it to all other signatory countries using the system established in that Convention.

Brazil has not yet signed the Convention but has since 2011 been a member of the other one, the Multilateral Convention on Mutual Assistance in Tax Matters, which also governs the automatic exchange of information (AEOI) and the spontaneous exchange of information, joint inspections and other international cooperation procedures between tax authorities that Brazil agreed to ratify. When Brazil, in fulfilment of the pledge made as a Global Forum member and of the promises made to the G-20 and to the OECD within the BEPS Project, includes in Brazilian law the secondary obligation to submit this information to Brazilian tax authorities, the country will also provide (automatically or at the request of a foreign tax authority engaged in an inspection) up to 95 nations with the Global Master File and the CbCRs for Brazilian transnational corporations.

This will be a significant boon for tax authorities' efforts to monitor transfer pricing risks despite the not insignificant additional compliance burden for transnational corporations and the danger of breach of tax secrecy (with potential strategic trade consequences).

Brazilian tax authorities, however, will not be allowed to request from other countries or to use the information provided by Brazilian corporations in its inspections or transfer pricing calculations (with the limited exception of Brazil's new method for oil production in the sharing regime)[32]. The authorities will perhaps do so to disregard artificial legal entities or sham transactions if they suspect some abuse occurred (in transfer pricing, remittances abroad or income earned abroad). These are exceptional circumstances that will neither include the majority of transnational taxpayers nor capture the largest tax revenue potential of transfer pricing methods recommended by the OECD and the UN.

If Brazil maintains its unique transfer pricing rules and limited DTA network and does not adopt the Permanent Establishment as a means to consistently raise foreign capital taxation, Actions 6, 7 and 13 minimum standards will bring no gain and will certainly cause the Brazilian Treasury to lose significant revenues.

Convergence and international cooperation in relation to BEPS Project Actions 6, 7, 13 and 14 minimum standards will benefit both the Brazilian economy and Treasury. In defense of its interest, Brazil should:

- **expand its DTA network** and adopt BEPS Project Action 6 minimum standards;

31. See (TAVARES; BOGENSCHNEIDER; PANKIV, 2016).
32. Costs and investments necessary to perform production sharing agreements entered into under Law 12.351/10 (art. 6 et seq.) will be deductible and refunded to contractors if consistent with market figures (on a commutative basis), in a system similar to the profit sharing method under the OECD's arm's length principle (GASPAR; OLIVEIRA, 2016).

- **include a robust LOB Clause** in its treaties and inspections;
- **adopt the Permanent Establishment concept based on BEPS Project Action 7 minimum standards** and fully enforce, consistently with other G-20 members, its tax jurisdiction on foreign investment in Brazil (abandoning the excessive use of tax withheld at source, especially by no longer taxing technical and administrative assistance services that are not abusive or artificial);
- **use Mutual Agreement Procedures (MAP) in relation to other national tax authorities**, international arbitration included and observing Action 14 minimum standards, to avoid the improper proliferation of permanent establishments of Brazilian transnational corporations abroad and the improper allocation of income to these assumed establishments; and only if all minimum standards above are adopted;
- **adopt the BEPS Project Action 13 minimum standard, create a secondary tax obligation in support of the collection of Global Master File and of CbCR information in relation to Brazilian transnational corporations and share this information with other national tax authorities**. In return, Brazil will be able to use the same sort of information to better inspect foreign capital and to properly assume that foreign exporters and multinational corporations maintain PEs in Brazil to access our domestic market.

Another minimum standard that arose from the BEPS Project, although not directly applicable to Brazil, may provide a lesson and inspire the country to review its technological innovation incentives. The OECD recommends that no tax be withheld at source in relation to royalties paid under DTAs so as to ease international technology transfers and to foster productivity and GVC development.

This policy works as an incentive for DTA proliferation but its tax logic assumes that the country that earns royalty income will tax it at "fair" rates and will be the actual capital-exporting country. In other words, it will be the country offering significant infrastructure and a favorable environment for substantial research and development activities, wherein was created the intangible asset (high risk and high added value business activity) that made the operations in the source country feasible and that is remunerated by the relevant royalty. This policy thus assumes the inexistence of any intermediary tax haven (or similar jurisdiction) that holds the ownership of the intangible asset without performing any development activity. This is exactly the sort of abuse that occurred in pre-BEPS Project times.

The BEPS Project condemned countries that maintain Patent Box (or IP Box) type regimes under which the legal ownership of intangible assets (for instance, trademarks and patents) is remunerated in jurisdictions where no significant economic activity is developed (other than the provision of intragroup capital to purchase the asset or to fund its development "at risk").

The tax incentive these countries offer comes to fruition in the non-taxation of royalties (or favored taxation at actual rates of, say, 5%) while royalties may be deducted at their fair value under art. 9 in the relevant treaties (as interpreted by the OECD and by the UN). This amount is paid on a commutative basis to a third party conducting the development of the intangible asset. The cash accumulated in these intermediary countries is often used in intragroup loans, including to the country that develops the intangible asset, generating significant additional financial expenses.

This type of structure frequently harms not only the country that pays the royalty (by improperly reducing taxation at source via treaty shopping) but mainly those countries where high added value research and development activities do occur and require funding, including via licensing revenues. For good reason not only the OECD but also capital-exporting countries such as Germany have for long considered this type of incentive harmful and its maintenance is a major international tax warfare problem.

To counter this type of abuse and artificiality resulting in the "double non-taxation" of income, Action 5 brought a new minimum standard to be implemented in the statute book of nations that maintain special regimes such as the Patent Box (among others). The new standard focuses on the consistent correlation between "substantial" value generating activities and functions and the location where profits are recognized and suggests the adoption of a substance or "nexus" test (or "modified nexus" following the Europe's experience, where this problem became more acute).

According to this new rule, favored taxation regimes may be used to the extent of and in proportion to qualified expenses with value generating activities and functions used to create the intangible assets. Several countries, including the 14 European ones, that maintain this sort of special regime agreed to phase out their harmful regulations and announced new regimes with the same benefits but subject to new proportionality rules, i.e., stimulating the transfer of skilled labor expenses and attracting not only royalty revenues but research and development activities.

The new regime, legitimately used with G-20 approval in post-BEPS times, is designated Knowledge Box (used in the United Kingdom and in the Netherlands) or Innovation Box (in debate in the US). Brazil is immune to this problem because it taxes royalties harshly (25% actual rate) and limits their deduction based on the 1958 rule. But this restricts the import of high added value intangible assets and services that might enhance the productivity of Brazilian manufacture and its integration with GVCs.

Brazil runs a new post-BEPS risk. Its technological innovation incentive policy is advanced and intelligent, focusing on the human element (i.e., emphasis on payroll and on the number of researchers) and may even be expanded to bring in more research, development and innovation activities. But significant competitive pressures caused by the aforementioned proliferation of special regimes may lead foreign and Brazilian transnational corporations to transfer to Europe, Asia or the United States innovation activities with global impact currently carried out in Brazil. To counter this new international scenario, Brazil needs to improve its research, development and innovation attraction policies.

Adoption of the following activities related to Action 5 minimum standards will strengthen Brazil's hand:

- **boost technological innovation incentives, allowing expense consolidation and tax incentive calculation within five-year windows (instead of in each single year) and** not limiting the tax incentive deduction on taxable income (tax loss acceptable). This system will, by definition, be entirely compatible with the "modified nexus" Action 5 minimum standard; and
- **favor the expansion of its DTA network by removing royalty taxation under art. 12 in the OECD Model Convention**, maintaining the excise tax (CIDE) on royalties as a specific anti-abuse tool (similar to the United Kingdom's and Australia's Diverted Profits Tax relation to BEPS Project Action 1). In this scenario, the 10% CIDE on remittances will be enforced only if royalty income is actually taxed at 15% or if it exceeds the limits imposed under the new Action 5 minimum standard. This can be easily monitored through information exchange procedures, specifically foreign CbCRs received under BEPS Project Action 13.

2.2 How Should Brazil Use OECD Recommendations for the G-20?

The BEPS Project achieved some international consensus on the elimination of the aggressive tax policies of countries engaging in unfair competition represented by tax haven Cash Boxes and Patent Boxes veiled under special regimes. But two key technical elements of the international legal-tax systems need to be reformed in order to curb the use and proliferation of these regimes and of artificial structures that house sham intragroup GVCs:

- reform of transfer pricing rules through the review of OECD Guidelines and of national laws (especially the chapter on intangible assets and restructuring) allowing tax authorities to disregard intragroup instruments that exaggerate the weight of capital and of ownership rights on high mobility assets (patents) to the detriment of operational functions; and

- reform of CFC rules in several nations, closing the loopholes that allow residual profits and active income to be stockpiled abroad, especially in tax havens. These specific deficiencies, non-intrinsic to the rules (in the US system in special), are very well known to governments and they remain in place as part of each country's defense of its multinational corporations.

No minimum standard addresses these reforms. Just as OECD member-states could not reach some technical and political consensus on global formulary apportionment for transfer pricing, neither did they manage to agree to reform national CFC rules making standard regulations mandatory for all OECD and G-20 member-states. Global formulary apportionment will probably shift tax base from capital-exporting countries to capital importers. The standardization and improvement of CFC rules, on the other hand, may reestablish the actual residual taxation of capital-exporting countries but at different rates, sapping the competitiveness of US companies in relation to European and Asian ones.

The OECD transfer pricing Guidelines evolves through the BEPS Project Recommendations. Post-BEPS Guideline results will perhaps approximate global formulary apportionments and be deemed a flexibilization of ALP. But they can be better seen as a step in the evolution and sophistication of the system as indicated in essential reform "a" above. This evolution will significantly curb abuse and artificiality and its impact may be magnified by the outcome of the debate on Actions 9 and 10, especially in relation to analysis of the Intragroup Capital Allocation Function and to application of the Profit Split Method.

In short, the new OECD Guidelines emphasize value creation through the development of certain activities and functions and limit the returns that may be allocated to intragroup capital[33]. The UN will review its Practical Manual on Transfer Pricing (UN, 2013) to align it to new post-BEPS Guidelines.

China, India, the United States, Canada and Japan, for instance, use interpretations that differ from OECD Guidelines. In other words, they apply the guidelines without jeopardizing their sovereignty, interpreting ALP as they deem fair and necessary to protect their national treasuries and to curb abuse.

Location-Specifc Advantages (or LSAs) are a concept of special importance for China and India. LSA was superficially discussed in OECD Guidelines and was incorporated into the BEPS Project chapter on comparisons between transactions or companies.

33. See (TAVARES; OWENS).

From China's point of view, the LSA concept may even allow access to the Chinese domestic market to be recognized as an intangible asset (market premium) and "goodwill" based, say, on the differences between advertising and marketing activities, client and contract portfolios and on other factors. Even if this intangible "market" asset is not recognized, the LSA concept may make it unfeasible to compare foreign and Chinese transactions (or companies) and thus require use of the Profit Split Method, which tends to favor China. India adopts a similar stance, focusing on the value added by its skilled labor force within GVCs.

All these countries (US, Canada, India and China), however, are willing to settle differences in transfer pricing interpretation through unilateral, bilateral or even multilateral mutually binding consultations or APAs (in response to taxpayers' requests) (jointly with other countries' tax authorities, as recommended by the OECD and the UN). They are also prepared to resolve interpretation conflicts with other countries through DTA amicable proceedings (MAPs). All these countries, India and China in special, provide examples of the path Brazil can follow to converge towards OECD Guidelines and the UN Manual.

The new scenario makes it possible for Brazil to align with the international transfer pricing system. The new and more robust scenario emerging from Actions 8, 9 and 10 and from the good practices of other G-20 countries that will cooperate with Brazil and the significant sophistication (both in personnel and in materials) of Brazil's Federal Revenue Service since the inception of local methods[34], make it possible for – and advantageous to – Brazil to align with the international transfer pricing system. Let us not forget that implementation of OECD Guidelines is a requirement for OECD accession.

Brazil can use the experience acquired with methods using statutorily fixed profit margins, of great administrative efficiency and, in some cases, not harmful to the economy. The Brazilian Federal Revenue Service and several taxpayer's confirm that Brazilian methods in some circumstances are administratively convenient and efficient, which justifies, from Brazil's point of view, making some current rules optional in coexistence with new ones and with OECD Guidelines.

Therefore, in this scenario:

Because of their administrative efficiency, all fixed margin methods will remain in place but as optional (safe harbor: assumed margins in optional methods). All other methods recommended in the OECD Guidelines and in the UN Manual will be incorporated into national law. The Brazilian Federal Revenue Service will manage this new hybrid system, blending Brazilian experience and best international practices,

34. The Brazilian system in place in 2016 goes back to 1958 in relation to industrial property imports paid through royalties (see Ministry of Finance Order 236/58, Law 4,131/62 and Law 4.506/64), and to 1996 (Law 9,430/96, as amended in 1999 and 2015) in relation to other international transactions.

through international cooperation and joint inspection efforts and using information from Master Files, Local Files and CbCRs.

The OECD used to vehemently oppose safe harbors. But ever more countries, especially those whose tax authorities are severely short of personnel and materials (mainly in Africa and Asia), have indicated that they would find it convenient to operate fixed margin systems and optional methods similar to Brazil's exactly because of their administrative efficiency. The OECD has then adopted a more flexible stance in the Platform For Collaboration on Tax it operates jointly with the IMF, the UN and the World Bank (OECD, 2016b), accepting systems wherein the OECD Transfer Pricing Guidelines coexist with safe harbor-type optional alternative methods.

The United States had to agree with the final version of the Action 1 Report on the Digital Economy, abandoning special taxes on high technology companies (as the US wished) in "reciprocity" for full implementation of minimum standards in all BEPS Project Actions and of transfer pricing recommendations. This was the quid pro quo for not introducing minimum standards or recommendations in CFC rules (opposed by several European countries for competitiveness reasons).

If technology-exporting nations such as the US fail to adopt the new and more robust minimum standards and recommendations, other countries will have reason to use special measures to counter the perceived BEPS risk. The "target" will be companies (mainly US) that use virtual operating models (Google/Alphabet, Amazon, Facebook etc.). G-20 tax authorities already saw high technology companies as "preferred targets" not only for tax but also for competitive reasons.

The report prepared under the coordination of the US delegation correctly found that the digital economy should not be ring fenced and made subject to "special" international tax rules (TAVARES, 2014). According to the OECD Report, this ring fencing is "if not impossible, unfeasible" because the whole economy, and not only high visibility high technology companies, to a greater or lesser extent uses digital technologies to run. BEPS risks must be adequately understood and qualified so that selective measures will curtail only harmful and unfair practices. The economy as a whole is digital and BEPS risks can be found in several segments but not in the conduct of the majority of taxpayers. To tax more heavily a single industry (or the whole economy indiscriminately) in response to a non-qualified BEPS risk will cause severe distortions, breach the principle of equality and hamper development.

But these special measures were not entirely abandoned and will be acceptable if abuse and artificiality persist, which will supposedly occur if new minimum standards and BEPS Project recommendations are not observed. No consensus was reached on which measures are advisable (less distortive and more efficient) in these circumstances. The options considered were:

- income tax withheld at source on remittances abroad involving BEPS risk (for instance, royalties paid to tax havens);
- creation of the new concept of digital establishment to tax at the source country the income assumed to have been earned from internet transactions; and
- creation of a special tax (such as the UK's Diverted Profits Tax) levied on abusive or artificial transactions not covered by the BEPS Project.

The report further suggests that Value-Added Tax (or VAT) on digital (online) transactions directly with consumers (such as downloading virtual content, copyright protected materials etc.) be levied at the destination and not at the origin. This is consistent with European Union policy (Europe collects VAT at the destination and not at the origin since 2015) and will dampen tax warfare in Europe.

Brazil uses as general rule the Action 1 special measures that should be exceptional because of their distortive potential. Its blanket use spreads the burden to everyone and creates significant economic inefficiency. By withholding 15% to 25% tax at source[35] on all royalty, copyright and service payments and by levying 10% CIDE on all technology imports, Brazil encumbers value chains focusing on the domestic market, thwarting its growth or increasing the cost of natural resource production. This will be another significant hurdle to Brazil's OECD accession. The current system raises manufacturing costs and can depress wages or the use of domestic inputs, inflate Brazilian consumer prices and/or lower return on investments (making some unfeasible). All these effects harm Brazil's economic efficiency and development.

This aspect of the Brazilian system, combined with the inconsistency between transfer pricing rules in Brazil and in other G-20 countries, precludes Brazil's full GVC integration via intermediate industrialization. As seen earlier, this type of industrial activity can attract to Brazil efficiency-seeking foreign direct investment that will boost overall industrial investment and productivity. Technology imports and the use of foreign services are typical characteristics of efficiency-focused GVCs.

The inconsistent taxation of these chains in disagreement with international standards and without DTA cover causes huge inefficiencies and may result in double taxation. Legal or economic double taxation will occur, for example, if the technology or service providing country does not treat the relevant income as generated in Brazil (which may occur with technology integrated into components imported for

35. Not to mention PIS/Cofins and ISS or ICMS.

re-export or if royalties in excess of the 1958 cap are not deductible) or if the foreign tax amount levied on the relevant income is lower than the tax amount withheld at source in Brazil.

Many of these potential problems can be resolved by a wider DTA network and by using MAP and Arbitration to settle disagreements between countries. The fact that the aforesaid double taxation will materialize if Brazil joins the intermediate industrialization phase of GVCs prevents the country from doing so, harming the efficiency of Brazilian industry and driving investment away.

Other BEPS Project recommendations will directly impact the cost of foreign investment in Brazil and may adversely affect Brazilian investment abroad. In order to curb the use of artificial structures involving Hybrid Transactions or Entities (Action 2), the BEPS Project seeks to curtail the tax avoidance effect of structured financial transactions benefiting from differences in the civil, commercial or tax law of different countries. The Project also strives to restrain abusive Interest Deductions (Action 4), limiting them beyond subcapitalization rules.

The structured financial transactions to which Action 2 refers occur in regimes or countries where, say, credit instruments create obligations recognized as deductible interest in the paying country and as tax-free dividends in the receiving country (or subject to reduced taxation in artificial structures and opaque regimes) or where one obligation gives rise to multiple deductions (TAVARES, 2014). Action 2 recommendations focus on coherence, using a linking rule to selectively ban deduction in the "interest" paying country. If this "interest" is deductible in that country, the rule allows the receiving country to selectively tax the "dividend" deducted as interest in the paying country. Several nations will follow this recommendation (for instance, the European Union and Japan).

This OECD measure to curb artificialities and abuses may inadvertently jeopardize a harmless feature of Brazilian law, the Interest on Stockholders' Equity (JCP)[36], an intelligent, transparent and non-distortive policy created 20 years ago. The facts that JCP is paid directly to stockholders, is taxed at source at the same rate used for interest payments and is declared similarly to dividends while the latter are tax free, distances JCP from its technical origin and opens the door for JCP not to be seen as a type of Allowance for Corporate Equity (ACE), which actually is the economic essence of the Brazilian JCP[37].

36. Article 9 in Law 9,249/95.
37. Mooji and Deveraux consider that Brazil's and Belgium's systems include ACEs and see similar mechanisms in other countries such as Croatia, Italy and Austria. The idea is hotly debated in Germany (MOOJI; DEVERAUX, 2009, p. 9).

Allowances for Corporate Equity (ACE) are an academic solution developed in 1984[38], to reduce the favored taxation of debt. The Brazilian accounting system already included a similar mechanism (deduction of inflation losses)[39]. The European Union (MOOJI; DEVERAUX, 2009) sees its standard use in all member-countries as beneficial to prevent tax law from distorting investment decisions and to eliminate the incentive to unnecessary indebtedness, which erodes the tax base. The mechanism will create a tax deductible assumed interest on stockholder's capital and on reinvested retained earnings without any payment to stockholders, which deprive the company of cash, or income accrued to stockholders, which fosters disinvestment. The resulting tax effect will be an increased dividend payment capacity, causing no loss to stockholders.

The ACE will lower the tax burden on the invested entity but the ensuing tax loss will be smaller than that caused by debt and the allowance will likely have no tax effect on any dividends that may be later declared and paid to stockholders. Thus, in contrast to JCP, ACE will not be paid directly to stockholders. Had Brazil's JCP assumed this format, remunerating stockholders' equity and not stockholders, its ACE character would be beyond dispute, preventing JCP from being (mistakenly) deemed a hybrid instrument subject to BEPS Project Action 2.

Although it precedes the BEPS Project, the international trend to lower nominal corporate income tax rates must be analyzed in Brazil within the general investment attraction issue. Because it taxes corporate income at high nominal rates (34%), the Brazilian system puts the country at a disadvantage in the international competition for investments. The US tax reform makes it even more urgent for Brazil to lower its corporate income tax rate to, at the most, the OECD average figure, which is likely to be lower than 24% because of the US reform.

Brazil should also expand and review JCP, excluding it from corporate income instead of paying it directly to stockholders, and remove the rule limiting tax loss set off to 30% of each fiscal year's profits. This will stimulate investment in production and corporate capitalization in Brazilian currency, remunerated at basic (risk-free) interest rates, and discourage private indebtedness in hard currency. The latter generally happens at higher interest rates and tends to create deductible financial expenses (negative exchange rate variation) that do not represent income and are not taxed at source. The system herein proposed, to the extent that it lowers indebtedness, benefits Brazil's Treasury and industry[40].

38. See (BOADWAY; BRUCE, 1984, p. 231-39).
39. See (TAVARES; WOMACK; WILSON, 1997).
40. This favorable (to the Brazilian Treasury) characteristic might justify the expansion of JCP benefits, bringing it closer to a true ACE. If all minimum standards discussed earlier are adopted, deductions can be based on the average interest rate of Brazil's sovereign debt instead of on the existence of profits and may even increase tax losses, as do negative exchange rate variations. Even then, JCP will be benefit the Brazilian Treasury in comparison to debt.

These are our BEPS Project Action 2 recommendations:

- **review the deduction of interest stemming from financial instruments deemed debt under Brazilian law and categorized otherwise abroad** (for instance, Profit-Sharing Bonds or Convertible PSBs). At the same time, create a specific anti-abuse rule consistent with Action 2 (linking rule)[41], similar to the rule that raises tax withheld at source on remittances to tax havens. This new rule will allow Brazil to ban the deduction of financial expenses in relation to these hybrid instruments;
- **review JCP so that it is deemed an assumed deductible interest expense on stockholders' capital and on reinvested retained earnings (ACE)**, instead of being paid directly to stockholders; and
- **lower nominal corporate income tax rates and expand JCP deductibility, allowing the deduction of the interest rate corresponding to Brazil's sovereign risk** from instruments denominated in Brazilian currency (this deduction will still be lower than that for interest and negative exchange rate variation), removing the 50% of profits cap and the rule limiting tax loss set off to 30% of each fiscal year's profits.

In the Action 4 Report, the OECD recommends limiting the deductibility of interest paid to related parties that exceed usual subcapitalization rules (specific anti-abuse rules creating ceilings for the related-party indebtedness that may give rise to deductible interest)[42] and using transfer pricing methods[43]. We thus suggest that Brazil adopts a rule similar to that used in the United States and in Germany, capping interest deductibility at 30% of the company's cash flow, measured by its EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization).

The Report also suggests an analysis of the overall indebtedness of a transnational corporation with third parties. The indebtedness level with unrelated creditors will not only signal potential excessive artificial indebtedness but also put a lid on the deductibility of interest from instruments with related parties.

Transnational corporations run a wide range of risks because they operate in different business segments, markets, projects or countries, creating a very complex factorial combination. The consolidated indebtedness test will very often fail at indicating the adequate level of debt for each operation. To set forth in statute pre-determined debt or deductible interest limits may render unfeasible capital-intense projects such as large scale industrial plants or infrastructure works.

41. Using international cooperation instruments such as the exchange of information with foreign authorities under Action 2 to find any inconsistencies.
42. Articles 24 and 25 in Provisional Measure 472/09, converted into Law 12,249/10 and detailed by Regulatory Instruction 1,154/11.
43. Law 9,430/96, as amended by Laws 10,451/02; 11,196/05; 12,715/12 and 12,766/12; and as detailed by Regulatory Instructions 243/02; 1,312/12; 1,321/12 and 1,322/12 and by Order 222/08.

The OECD transfer pricing methods make it possible to analyze the capitalization structure of related companies and to use economic and risk studies to pass judgment on adequate indebtedness levels. But pre-determined statutory limits reduce complexity and may be useful for their administrative efficiency. Further improving guidelines, if necessary and focusing on curbing abuse and artificiality, remains the best solution to avoid distortions and discouraging strategic investment. Brazil is thus recommended to:

- **adopt the BEPS Project Action 4 recommendation creating a rule to cap interest deduction at 30% of EBITDA for intragroup indebtedness, focusing on administrative efficiency**. This should be accompanied by the conversion of current subcapitalization rules into safe harbors, i.e., optional streamlined rules allowing the use of economic studies in support of indebtedness or interest deduction, as per OECD transfer pricing Guidelines; and
- **maintain income tax on interest withheld at source at 15%. Create a new Brazilian DTA Model with income tax on long term indebtedness (for instance, average amortization exceeding five years) withheld at source at 5% and exempting infrastructure projects in order to stimulate investment in production activities in Brazil**. This position will encourage the expansion of Brazil's DTA network and the renegotiation of existing treaties in order to adjust them to the post-BEPS anti-abuse standard.

2.3 How Should Brazil Use the Best Practices Suggested for the G-20?

The list of recommendations for G-20 countries included in the Action 3 Best Practices Manual does not include Brazilian anti-deferral rules[44]. Brazil's treatment of its transnational corporations was discussed within the BEPS Project but was not considered advisable.

The Report proposes balancing tax (anti-abuse) and economic (no distortion in investments or in international competition) purposes. This is exactly what the Brazilian system is missing. The OECD and the UN continue to argue that the international tax system must not discourage direct foreign investment in production activities. And this type of investment occurs in its purest form when operational profits are reinvested in the absence of cash surpluses – exactly the case the Brazilian systems punishes the most.

Consistency is essential for the international system to be balanced. Capital-exporting countries must operate regimes that tax speculative, unproductive passive income stockpiled abroad, especially if parked in opaque countries and tax havens.

44. See (TAVARES, 2014b); (TAVARES; CASTELO BRANCO, 2014); (TAVARES, 2014c).

And these regimes should be as consistent as possible. Specific rules against abuse and deferral could draw inspiration from the US model, which advanced in several aspects and whose distortions of the last two decades can be cured[45]. The ideal design will combine the US and German systems, switching over from the territorial to the credit regime so that active income is taxed at the destination and passive income, at the origin.

When defending the competitiveness of their transnational companies, each capital-exporting country defends its own domestic market; its value chains, that support these companies and create investment and jobs, especially in the home country; its capital markets and pension funds, that invest in these companies; the competition environment in the home country, giving big national corporations a level playing field wherein to compete with foreign ones, enhancing consumer welfare in the home country.

By not overtaxing their transnational corporations, capital-exporting countries defend their interests. Anti-deferral rules should counter abuse without harming investment. Brazilian transnational investment abroad (whether market-, resource- or efficiency-seeking) tends to benefit Brazil and these corporations' competitive losses harm the country. That said, Brazil cannot forgo tax neutral anti-abuse and anti-deferral rules.

A major feature of the US tax reform was the switch from the traditional US model to the German one. The US abandoned the credit (or taxation at origin) system[46] and the income and dividends US multinational corporations earn abroad are now tax free (except when anti-abuse rules apply). This model has long been used in Germany and in most of Europe and in recent years was adopted in the United Kingdom and in Japan. Of the world's largest economies with significant multinational corporations, only Brazil and China continue to use the credit method.

In view of Brazil's OECD accession bid and of the ensuing regulatory convergence, it is important that Brazil adopt the best practices in relation to the taxation of income earned abroad and to CFC rules.

Brazil is then recommended to:

- **adopt the world's most stringent and restrictive anti-deferral best practices, as indicated in BEPS Project Action 3**. Brazil should enact an effective rule to curb abuse, artificiality and the stockpiling of unproductive capital abroad, perhaps choosing an improved version of the system, combining the best characteristics

45. "The US in fact exercises a 'veiled' territoriality more complex and aggressive than that of other OECD countries, without any effective limitation to the use by US companies of Harmful Tax Practices abroad" (TAVARES, 2014).
46. Taxation at the origin was maintained as an anti-abuse rule for atypical circumstances, to curb the excessive mobility of intangible assets, and as an aggressive competitive tool against Europe (Global Intangible Low-taxed Income – GILTI).

of the US and German models. But the rule must not discourage investment and reinvestment in foreign operations. The assumed availability rule must be switched for taxation at the destination.

Finally, Action 12 brings a compendium of best practices for Mandatory Disclosure of Uncertain Tax Positions (Mandatory Disclosure Rules), often incorporated into broader policies focusing on increasing cooperation and building trust between tax authorities and taxpayers. These practices are used to prevent and resolve disputes in more sophisticated regulatory environments, where tax-related settlements are common.

The OECD Report on Cooperative Compliance with Tax Requirements (OECD, 2013; OWENS, 2013) provides many examples of this type of environment (e.g. Horizontal Monitoring in the Netherlands, Enhanced Relationships in the United Kingdom and Compliance Assurance Process in the US). The US Internal Revenue Service (IRS), for instance, maintains a department that plays the role of independent ombudsman (Taxpayer Advocate Service), monitoring the quality of the IRS' services and governance. The department head has the status of secretary and reports directly to the Legislative Branch.

These environments are much more sophisticated than Brazil's. Even in these countries, the disclosure of uncertain positions tends usually are optional and/or advantageous to taxpayers, leading to tax settlements that are more rational and efficient for both parties in comparison to what occurred in Brazil under the several versions of the Refis program.

Uncertain positions affect both taxpayers and tax authorities. Either the tax claimed or the taxpayer's position is illegitimate. Both parties run risks and are subject to the uncertainty of legal interpretation, that may grow as facts and court proceedings unfold. And both parties have to bear significant litigation costs. The economic value of the dispute is uncertain for both parties and often lies among one party's claims and the cost of litigation is high for both. Settlement at the principal tax amount owed plus interest[47], but without any fines tends to cause no economic harm to the taxpayer or to tax authorities. This is the type of environment where can be found the best uncertain position disclosure practices mentioned in Action 12.

Cooperative compliance programs provide excellent results in the countries where they exist. And in sophisticated countries, tax-related settlements are a key element of these programs (e.g., in Japan). Disclosure of uncertain positions usually occurs in the context of cooperative compliance programs that will at least waive fines, if not

47. Compound, not linear, interest.

reduce principal tax amounts, in order to stimulate cooperation between taxpayers and tax authorities.

In Brazil, even spontaneous tax delinquency confessions are controversial. Although confession probably releases taxpayers from fines of up to 20%, according to Opinion PGFN/CAT 1,347/2001 of the Office of the General Counsel for the National Treasury (CONDE, 2014), this understanding is not widely accepted within the Brazilian Federal Revenue Service (RFB). The RFB deems abusive many uncertain positions that fall within the scope of BEPS Project Action 12 and routinely slaps 150% special fines on the relevant taxpayers. But the Ministry of Finance's Administrative Tax Appeal Council (Carf) sees these positions as legitimate. Often the 150% special fine is changed into a 75% "ex officio" fine (MUNHOZ, 2014) because transparent but complex transactions that may be subject to legitimate dispute are not deemed fraudulent or sham.

The circumstances of Brazilian administrative disputes notwithstanding, the RFB did try to implement a Declaration of Significant Information and Transactions within the Litigation Reduction Program (Prorelit) created by Provisional Measure 685/15, which would have been the first BEPS Project implementation measure in the country. The effort to implement BEPS Project results and to align Brazil with international standards is, to be sure, commendable. It is understandable that the RFB saw as beneficial to the taxpayer a 20% fine owed if the relevant transaction were rejected, because this would create a regime equivalent to spontaneous confession. But it is also understandable that the RFB continued to deem undeclared transactions (tantamount to deliberate omission) liable to the 150% special fine.

Caselaw on both types of fine rendered ineffective any benefit the measure could bring to taxpayers. Contrary to the RFB's intention, litigation would not have been reduced but rather increased by disputes about the obligation to declare transactions, the 150% fine and the legitimacy of the 20% fine enforced under the spontaneous confession regime.

In view of the foregoing, Brazil is recommended to broadly adopt the Cooperative Compliance with Tax Requirements best practices mentioned in Action 12, as follows:

- give major taxpayers the option to join a new Tax Compliance Cooperation program (CCT) subsuming Prorelit and offering certain benefits established in statute but barring these taxpayers from joining future litigation reduction programs that mitigate tax liabilities (e.g., non-eligibility for future Refis versions). Submission of Uncertain Position Forms pursuant to Action 12 and of non-exhaustive significant transaction schedules must be compulsory for CCT participants;

- permanently exempt CCT participants from penalties on transactions reported timely (for instance, in filings for the first calendar-year in which their effects are felt) but charge compound interest at the Selic rate if the tax assessment is deemed legitimate after the taxpayer has been given the opportunity to defend himself at Carf level;
- create a settlement system to reduce litigation based on the probability of taxpayer success in administrative proceedings; and
- create a mutually binding consultation system (including in relation to transfer pricing – APAs) for CCT participants and widen their access for DTA MAP consultation purposes.

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LIST OF INDUSTRY'S PROPOSALS FOR THE 2018 ELECTIONS

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41. Brazilian Foreign Trade: Trade Facilitation and Cutting the Red Tape
42. Customs Documents: foreign trade without constraints
43. Sectoral Industrial Policy: concepts, criteria and importance (*this document will be disseminated during a specific seminar dedicated to the topic*)

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