INTERNATIONAL TAX POLICY: OECD, BEPS AND G20

Implications for Brazil?

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1

INTRODUCTION

by Romero J. S. Tavares
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IN NOVEMBER 2015, G20 leaders met in Turkey and approved 14 reports[1] prepared by the *Organisation for Economic Co-operation and Development (OECD)* as a partial result of the *Base Erosion and Profit Shifting Project (BEPS)*[2]. There are still extremely sensitive technical matters being negotiated and developed in a piece that will result in the reissuing of *OECD's Convention Model*[3], *Comments and Interpretation Guidelines, which will be extended until 2020.*

However, consensus has been reached in several important matters and several standards, which do not depend on international treaties, will be adopted through each country's domestic legislation. Several countries have began adopting the set of measures. During 2016, the terms and structure for the *Multilateral Instrument* addressed by the project's Action 15 will be negotiated, with the aim of altering the network with over 3,000 bilateral agreements in force currently, ratifying international tax law measures that result in the BEPS Project.

Now, Brazil's interests have to be defended: the National Treasury and the Domestic Industry. Above all, the National Treasury interest, as the tax reforms being implemented abroad, which result in the BEPS Project tend to increase the burden on Brazil's exports and foreign investments. In case Brazil does not increase its network of *Double Taxation Avoidance Agreements (DTAAs)* and does not undertake a wide reaching reform of its domestic legislation, this burden will not find a matching action and will turn into a revenue loss for the National Treasury. This study provides some suggestions for changes in the Brazilian legislation that would impede or reduce these negative consequences.

One must not forget that the confrontation of national tax policies through the reform of the international tax system is above all, a commercial clash, where investment, productivity and employment are in competition[4]. The negotiation and design of this global tax reform, which has been taking place for decades at the level of the OECD and United Nations Organization (UN)[5], was reinforced after the world economic crisis of 2008-2009, as a result of political circumstance favourable to changes. Indeed, since 2014 it has developed significantly under the charge of the G20 through the BEPS Project.

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1 See OCDE, ***Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project***, *(Paris, 2015).*

2 For a description of the BEPS Project, refer to Tavares, Romero J.S., ***Política Tributária Internacional: OCDE, BEPS e Brasil*** – ***Como deve se posicionar o setor industrial brasileiro?,*** Revista Brasileira de Comércio Exterior (RBCE), n. 121 (2014), pp. 52-61.

3 ***OECD Model Convention with respect to Taxes on Income and on Capital,*** *OECD (1963, reedited until 2014)*

4 Tavares, Op. cit. n.1, p. 53.

5 It is worth mentioning that the United Nations Organization (UN) plays an important role in this context. The UN developed the **UN Model Double Taxation Convention Between Developed and Developing Countries,** UN, 1981, reedited until 2011), as a contrary position to the OECD model, with a view to safeguarding the interests of developing countries that receive foreign direct investment, or places where infrastructure services would be rendered, or where extractive activities would be conducted by foreign companies ("destination countries" or "source countries"). Confronting the UN and OECD models tends to be a starting negotiation point for agreements between developed and developing countries, and has influenced the design of Brazilian agreements. More recently, through activities by the United Nations Financing for Development Office and the Committee of Experts on International Cooperation in Tax Matters, the UN achieved new relevance by editing the **Practical Manual on Transfer Pricing for Developing Countries.** The manual uses the same OECD principles on the issue (as the UN and OECD models do not diverge on this point). However, examples of different interpretation by countries like China and India, and the Brazilian practice, which keeps it distant from the OECD and UN recommended principles are described. Refer to **Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations** (OCDE 2010) *e UN Department of Social and Economic Affairs*, **United Nations Practical Manual on Transfer Pricing for Developing Countries** (ONU 2013).

The BEPS Project does much more than curb abuse and artificiality, or aggressive tax avoidance practices. It does more than impose minimum standards of conduct against countries that foster such abuse and artificiality. Rearranging the tax bases is the Project's declared objective and without a doubt, one of the several relevant economic issues at stake. However, this is a clash where each country tries to balance its wider national economic interests through bilateral and multilateral international relations. The contest between the United States of America and the European Union, and between both and China flared up even more in 2015 in the context of the BEPS Project discussion, not limiting itself to the tax base. International competitiveness, capital attraction and job generation in high value added activities (like research and development, information technology and marketing) is at stake.

The present study addresses BEPS Project's partial results, based on reports approved in November 2015, taking into consideration this wider international relations and domestic economic development context the project finds itself in. It sums up some of the main technical analysis aspects presented by the author for the National Industry Confederation (CNI) and Business and Industry Advisory Committee to the OECD (BIAC) during the BEPS Project. It also approaches issues related to the implementation of reforms originating in the BEPS Project in Brazil, providing suggestions for policies aimed at defending the industry's and the National Treasury's interests.

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TAX POLICY AFTER BEPS: ANTI-ABUSE AND PRO-DEVELOPMENT

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2.1 International Fiscal War and New Convergence

THROUGH PARLIAMENTARY COMMITTEES OF INQUIRY IN 2012, Through parliamentary committees of inquiry in 2012, American senators and British MPs made public information and documents, confidential until then, about activities of American multinational companies and the low effective taxation of over US$ 2.5 trillion in accrued profit by such enterprises. They were covered up by apparently legitimate fiscal structures that aggravate the deferral of American residual taxation on said profit. American senators and congressmen were aiming at a legislative reform that would enable for US taxation to be re-established on these companies' profits, without hindering their international competitiveness, matter which is still in that country's agenda.

The UK Parliament conducted a similar investigation in relation to the fiscal structures in question, making public the effects suffered by European countries, resulting from the same complex tax structure and apparently abusive conduct by American companies, which were claimed to be immoral despite its legitimacy. This is what truly triggered the BEPS Project, which had the support of the USA, Europe and all G20 countries[6].

However, some countries (including Europe) attempted to use the BEPS Project to discuss more fundamental reforms to the international tax system, which in addition to prohibiting abuses and enhancing standards, would result in a reduction in American fiscal jurisdiction, in relation to their multinational companies. Countries like China and India notoriously defend a re-division of the power to tax multinational companies, advocating for more extreme reforms than the ones defended by OECD member countries, which wanted more significant jurisdictional reforms as part of the BEPS Project.

Nevertheless, the G20 political consensus that motivated the OECD mandate to conduct the BEPS Project did not include such an extreme re-division of the taxation power, only the prohibition of abuses and improvements to the existing tax system. The United States lead coalitions with other OECD members at the level of the BEPS Project, thus, avoiding the project's scope to be widened. Therefore, work developed by the BEPS Project has not resulted in a radical redistribution of the power to tax multinationals, but in enhancing the system with a view to curbing abuse and artificiality, aiming to end the *opaque international fiscal war.*

Unsatisfied, the European Union and China are still striving to implement unilateral measures (including threatening to impose retroactive enforcement), with the aim of taxing residual profits of American companies, while the US threaten to retaliate. At the same time, USA, the United Kingdom, China and several European and Asian countries (i.e.; Japan) are adopting overt measures to attract foreign capital and benefit multinationals that conduct legitimate operations (including by significantly reducing companies' income tax rates), in a new and converging transparent international standard for tax competition[7].

6 *See*, Tavares, R.J.S., Bogenschneider, B., and Pankiv, M., ***The Intersection of EU State Aid and U.S. Tax Deferral: A Spectacle of Fireworks, Smoke and Mirrors*** (2016).

7 *See* Tavares, R.J.S. e Bogenschneider, B.N., ***The New de minimus Anti-Abuse Rule in the Parent Subsidiary Directive: Validating EU Tax Competition and Corporate Tax Avoidance?*** 43 Intertax 484 (2015); and Tavares, R.J.S. and Owens, J., ***Global Tax Policy Post-BEPS and the Perils of the Silk Road***, in ***Asian Voices: BEPS and Beyond***, IBFD (2016).

In parallel to the BEPS Project and making the most of the same political opportunity, huge progress was made at the (*Global Forum on Transparency and Exchange of Information for Tax Purposes*), culminating in 96 countries signing the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters,* which governs the *Automatic Exchange of Information* (AEOI), a notable feat. Another expressive result was the 31 countries immediately signing the *Multilateral Competent Authority Agreement (MCAA)*[8], in January 2016, which governs the automatic exchange of Country-by-Country Reports, (CbCR), as per terms of Action 13 of the BEPS Project[9]. This new age of transparency in multinationals and international cooperation between tax authorities will not allow countries that used to engage in damaging competition practices (that substantiated the international fiscal war), to hide such practices, nor use abusive and artificial structures resulting from them.

In the post-BEPS age, countries try to redefine their position in Global Value Chains (GVCs)[10] through a new international tax standard system in a coherent manner, with the aim of climbing up these chains to capture more wealth. This clash will affect the competitiveness of multinational companies and consequently, different countries' capital markets. It will also influence the location of technological advances, geographic distribution of productivity gains and human capital development[11] and thus, determine each nations' growth and prosperity.

Adopting new stricter standards than the ones previously in place, consistently and coherently will allow each country to curb abuse in the same extent as its competitors – which allows for a level playing field. This anti-abuse standard neutrality measure between countries that are big producing and consumer markets is critical to make competitiveness among them viable, as they need to protect their tax base without sacrificing their economic efficiency and social well-being. Being selective and not adopting the whole set of anti-abuse measures would not solve the BEPS problem. On the other hand, being inconsistent and keeping stricter unilateral anti-abuse measures than the international standard, would lead to equally serious economic distortions by reducing insertion in GVCs and burdening foreign investment. Indeed, it is this competitive setting and the prospect of international balance that should guide Brazil's international tax policy.

It is undeniable that the liberal business environment developed in Europe and Asia, based on the tax standard system advocated for by the OECD, was extremely favourable to capital mobility and international trade, enabling the proliferation and development of GVCs, furthering economic interdependence between countries, disseminating knowledge, integrating markets and fostering productivity. For example, taking part in these value chains has been essential for China's enrichment, as well as for the integration of Europe and it is critical for the economic success of American multinationals and capital markets. However, there is consensus in relation to acknowledging that OECD's international standards system and guidelines has become outdated, suffering with abuses, including through the artificial restructuring of GVCs and tax avoidance practices, which flared up in the digital economy age. Modernising the system to curb such abuse and artificiality was part of the BEPS Project scope.

Historically, Brazil resisted the adoption of standards and guidelines advocated by OECD. Mainly because it saw itself as a developing country, a mere importer of capital in a world where international trade was restricted. In the last two decades, after the reduction of foreign trade barriers propagated by the World Trade Organization (WTO), Brazil kept its divergent posture in relation to income tax matters because it noticed the frailty of the standard model recommended by OECD and the opacity of several countries that were engaging in the deplorable international fiscal war – opacity that comes to an end with the dawn of an unprecedented transparency age, resulting from the BEPS Project.

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8 *See* OECD Press Release, ***A boost to transparency in international tax matters: 31 countries sign tax co-operation agreement to enable automatic sharing of country by country information*** (January 27, 2016).

9 *See* OECD, ***Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project***, OECD Publishing, Paris (October, 2015).

10 *See* ***Joint Report by OECD, World Trade Organization (WTO) and the United Nations Conference on International Trade and Development (UNCTAD)***) for the Trade Summit of G20 Leaders in Saint Petersburg Russia, September 2013, ***Implications of Global Value Chains for Trade, Investment, Development and Jobs (2013); Joint Report by OECD, TWO and World Bank*** for Meeting of G20 Ministers in Sydney, Australia, 19 July 2014 ***Global Value Chains: Challenges, Opportunities, and Implications for Policy (2014); and OECD Report Interconnected Economies: Benefiting from Global Value Chains (2013).***

11 *See* ***Human Capital in Value Creation and Post-BEPS Tax Policy: An Outlook***, Bulletin of International Taxation, IBFD (2015), pp. 591-601.

Brazil continued to diverge from the OECD standard, also due to the complex guidelines in the area of transfer pricing and the burden resulting from managing this complexity, developing its own, uniquely Brazilian system (i.e.; transfer pricing, taxation and deductibility of royalties and services rendered abroad, etc.), which in great extent, repels abuses and artificialities addressed by the BEPS Project.

However, the Brazilian income taxation system for legal corporations (and for income earned by non-residents), discourages national and foreign productive investment, also excessively burdening international trade. For instance, Brazil imposes a non-tariff barrier in relation to the import of knowledge and intangible goods, even when incorporated to industrial inputs and components, as well as for the import of technical and administrative assistance services. This effectively hinders Brazil's full insertion in global value chains. In other words, in order to curb potential abuse by foreign companies when the international system was more vulnerable than it is today, the Brazilian system opted for burdening everyone, isolating the national industry as a whole, depressing economic growth and punishing the Brazilian worker.

The new international system emerging from the BEPS Project (like different countries' best practices to curb abuses and artificialities), presents itself as a viable alternative for Brazil. The new rules and practices will be used in a transparent environment in global value chains and multinational companies. They will also be of great service for cooperation between tax authorities throughout the world, particularly those that are part of a wide-ranging treaty network. ***Increasing the treaty network and converging with the new standards*** standards using international best practices, in cooperation with OECD and in tune with fiscal policy options applied by big emerging economies i***s the only way for Brazil not to incur any damages (but gains).*** In addition, it will protect the National Treasury and Brazilian investment abroad, allowing the country to be inserted into global value chains. On the other hand, if Brazil continues to keep a limited network of treaties, not taking up the OECD space accessible to it, still diverging from the world standard tax rules established and enhanced through the BEPS Project, the National Treasury and industry will incur substantial damages.

In other words, if Brazil is selective and partial in implementing reforms derived from the BEPS Project, without taking into consideration its economy's growth and competitiveness, remaining isolated from the rest of the world in aspects critical to the structure of its taxation rules and income tax related administrative practices, it will be exposed to great risks. The Brazilian National Treasury runs the risk of losing relevant tax revenues with the results of the BEPS Project, vis-à-vis the expected increment in tax abroad on Brazilian multinational companies (as well as big national exporters), without the prospect of imposing a corresponding rise in the Brazilian tax base on foreign capital. Brazil is running the risk of losing competitiveness in relation to its exports, which tend to increase in price abroad because of true commercial barriers disguised as taxes on income. In addition, it is running the risk of forcing migration abroad (i.e.; Europe, India) of high added value functions and activities conducted today in Brazil by transnational companies.

Brazil's limited network of International Double Taxation Avoidance Agreements [12] and the incipient network of *Investment Protection and Promotion Agreements (IPPAs)*[13] reduce the country's level of attractiveness to foreign direct investment. Administrative or rules related deficiency that reduce existing DTAAs' use making them sometimes inefficient, have the same damaging effect. These situations impose a risk-premium for investing in Brazil, an additional cost for foreign capital, reducing the total volume of investments in the country – or competition -, even when aimed at the Brazilian market(*market-seeking*) and the nation's natural resources (*resource-seeking*). They also tend to make foreign investments aimed at productive efficiency (*efficiency-seeking*), unviable, which optimise the industrial capacity already installed in Brazil and allow the sector to grow, characterised by inserting industrial establishments in GVCs. In a 'post-BEPS' world, these limitations and deficiencies will represent more than a burden for the private sector, but a significant cost for the National Treasury. If Brazil continues to have an inconsistent income tax system for legal corporations (and non-residents' earnings), as well as limited DTAA and IPPA networks, it will remain be-

12 *See* Confederação Nacional da Indústria, ***Relatório dos investimentos brasileiros no exterior 2013 - Recomendações de Políticas Públicas para o Brasil***, CNI (Brasília, 2013); e CNI/FET/EY, ***Análise da Rede Brasileira de Acordos de Dupla Tributação – Razões e Sugestões para seu Aprimoramento e Ampliação***, CNI (Brasília, 2015).

13 Brazil signed 14 bilateral investments agreements between 1994 and 1999 that were not ratified (with countries like Germany, Holland, United Kingdom and Switzerland), and another 22 IPPAs (in 2016 with Angola, Chile, Colombia, Malawi, Mexico e Mozambique, pending ratification), 13 of which are in force (particularly the ones involving the MERCORSUR)..

low its growth capacity and contrary to emerging economies like China, India and Mexico will not make the most of the industrial sector to promote social inclusion.

Brazil is an industrial country and not one that has only an extractive economy. Moreover, its intermediate industry will never be competitive if it is primarily destined for the domestic market and remains relatively isolated from GVCs, while the world becomes increasingly interdependent. Brazilian agribusiness is thriving, as well as the mining and metal sectors, and *commodities* scommodities related value chains that developed in the country. However, even in these chains, most of the higher value added activities take place abroad. **The Brazilian industrial sector is significantly under-dimensioned and under-presented in GVCs, which represents a huge growth opportunity for the country.**

Coherent policies that enable the Brazilian industrial sector to be fully inserted into GVCs, going beyond supplying for the domestic market, as well as the services sector (particularly information technology) will be critical for the country's growth. In fact, they can be seen as a path for reducing social inequality sustainably, through the full development of our human capital. **Defending Brazil's interests means not missing the opportunity of converging with the new multilateral standards with sovereignty and understanding that protecting the interests of the National Treasury and industry may indeed coincide.**

2.2 Global Value Chains, Foreign Investment and the BEPS Project

The opportunity to reposition Brazil strategically in the post-BEPS age does not limit itself to protecting the competitiveness of its exports and transnational companies, although these are important objectives approached by this study.

Direct foreign investment stock made by Brazilian companies abroad has increased significantly in the last two decades, from USD 44.5 billion in 1995 to USD 206 billion in 2012, reaching USD 315 billion in 2014. However, the growth of direct investment made by foreign companies in Brazil was even more spectacular in the same period. The referring stock in 1995 stood at USD 47.9 billion, rising to USD 696 billion in 2011 and reaching USD 755 billion in 2014[14].

Nevertheless, multinational companies keep USD 4.4 trillion[15] in cash reserves, which ends up being distributed in productive investments throughout the world. Hence, reassessing Brazil's international tax policy is not limited to reviewing the effects of such policy on Brazilian transnational companies and protecting these enterprises' competitiveness after BEPS, repelling threats from the National Treasury. An assessment has to be made of how Brazil may increase its investment environment in the post-BEPS age and protect its tax base coherently when dealing with foreign multinationals. Brazil's post-BEPS convergence with international tax standards in terms of income tax may result in the luring of a significant part of these USD 4.4 trillion efficiency-seeking type FDI, in order to make the most of the Brazilian industrial capacity and its full insertion in GVCs.

Brazil has been attracting foreign capital for over a century, particularly due to the domestic market and natural resources. Several countries that have reached high levels of social and economic development (like Singapore and South Korea), did so through strategies that privilege foreign investments, efficiency-seeking and converging with the standards recommended for Brazil. China and India grow exponentially as they combine their big consumer (and labour) characteristics, which Brazil also has, with strategies for attracting foreign investments and convergence in relation to rules – which Brazil still lacks -. This is what allows these countries to have a higher level of insertion in GVCs, as will be shown later.

China's foreign investment stock increased[16] afrom USD 101.2 billion in 1995, (111.2 percent higher than Brazil) to USD 712 billion in 2011 (22.1 percent higher than Brazil), reaching USD 1.1 trillion in 2014 (43.8 percent higher than Brazil), year when China started to be the main destination of FDI in the world, beating the United States. It is possible to see that in 2011, due to the emergence of its domestic market and attractive natural resources, Brazil reached levels close to China. However, Brazil's lower share in GVC investment flows links it to the commodities market and thus, makes it more vulnerable to domestic crises.

14 UNCTAD, ***World Investment Report (WIR) 2015, Reforming International Investment Governance***, ONU (2015), ***Country Fact Sheet: Brazil***.

15 UNCTAD WIR 2015, *Op. cit.* n. 10 *supra*, p. 19.

16 Id., ***Country Fact Sheet: China***.

Furthermore, China's investment stock abroad increased[17] from USD 17.8 billion in 1995 (60 percent less than Brazil's) to USD 424.8 billion in 2011 (106 percent higher than Brazil's), reaching USD 729.6 billion in 2014 (130.1 percent higher than Brazil's). Some aspects of China's international tax policy, like for example the rapid development of its DTAA network and the implementation of transfer pricing rules based on OECD guidelines (even with some relevant interpretation differences), favour Chinese expansion in both investment flows. The Chinese 25 percent income tax rate for legal corporations (which may effectively reach 15 percent in strategic sectors) and the lack of a rule for anticipated taxation of profits earned abroad, with exacerbated and punitive scope like in Brazilian rules, without a doubt contributed to China's investment expansion abroad.

India's case is similar, even if absolute values are lower and their foreign investment stock not growing significantly between 2012 and 2014. India's foreign investment stock went from USD 5.6 billion in 1995 (87.3 percent lower than Brazil's) to USD 206.4 billion in 2011 (70.4 percent lower than Brazil's), reaching USD 252.3 billion in 2014 (66.5 percent lower than Brazil's). India's FDI stock abroad was irrelevant in 1995 (USD 495 million), however, it reached USD 109.5 billion in 2011 (46.9 percent lower than Brazil's) and USD 129.6 billion in 2014 (59 percent lower than Brazil's). India, like China, increased its treaty networks and adopted OECD guidelines. Nevertheless, the country operated in a highly litigious environment and tax related uncertainty. Indeed, this is what it is attempting to make more efficient in the post-BEPS age, in order to attract more foreign capital, particularly in the automotive sector as part of its new 'Make in India' industrial policy. Despite lacking infrastructure, energy and natural resources India grew more than Brazil in foreign capital terms, partly due to its more efficiency-seeking FDI and higher insertion in GVCs. It is more than a matter of attracting through low cost of labour. India has been climbing positions in GVCs because of the performance of high value added strategic functions, like research and development. The country adopts transfer pricing positions that allow it to treat synergy gains from cost difference (particularly qualified labour) as profits from Indian source, concept that has been gaining force at the scope of the BEPS Project.

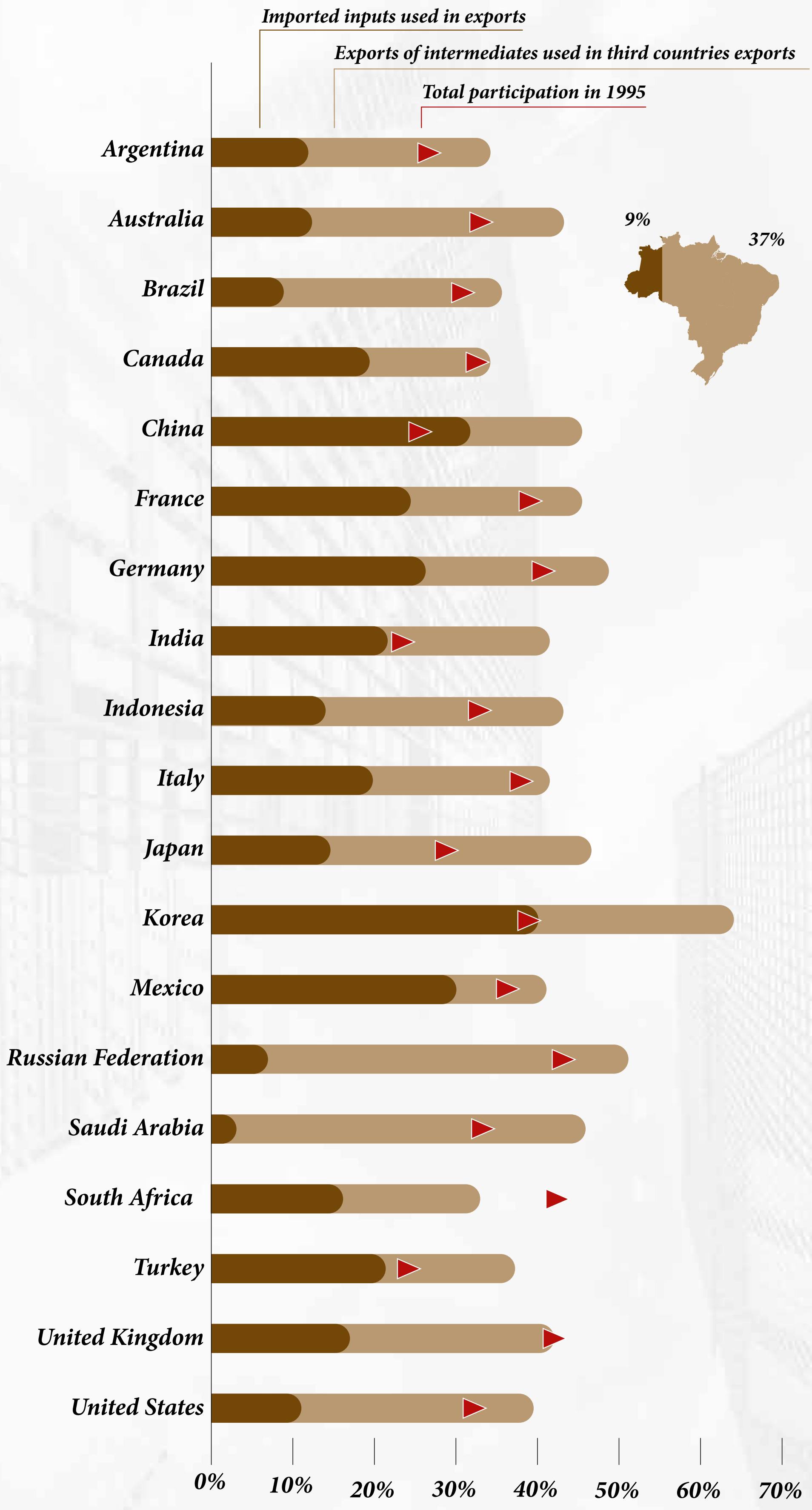
Between 30 and 60 percent of exports of G20 countries are inputs used in global value chains. Indeed, 80 percent of these chains are coordinated by multinational and local companies (particularly the industrial sector), contributing with between 40 and 50 percent of the value added of these GVCs. The income produced by these commercial flows (within GVCs) doubled between 1995 and 2009 (600 percent for China, 500 percent for India and 300 percent for Brazil)[18]. The highest gains were seen in China, India, Japan and South Korea[19]. However, the chart below shows that Brazil's involvement with GVCs is the result almost solely of the export of its commodities, while its participation in GVCs has remained almost the same since 1995.

17 Ibid.

18 *See* OCDE/OMC/UNCTAD, Op. cit. n. 7, p.5.

19 *See* OCDE/UNCTAD/Banco Mundial, Op. cit. n. 7, p.13.

Figure 1: GVC participation, 1995 and 2009



The index is calculated as a percentage of gross exports and has two components: the import content of exports and the exports of intermediate inputs (goods and services) used in third countries exports.

Source: OECD (2013a)

In other words, Brazil's participation in GVCs stayed practically the same from 1995 to 2009 and because of the low imported content of its exports (like seen in Argentina, Australia, Russia and Saudi Arabia), it continues to be predominantly engaged in the supply of commodities (from agribusiness, or the mining and metal sector), used as inputs and re-exported in the link of the following chain. The 300 percent increase in earnings by Brazil in these GVCs is directly correlated to the spike in the price of commodities in the same period. This observation is consistent with the fact that investments by Brazilian companies abroad[20] tend to be market-seeking (particularly in the food and agribusiness sectors, but also in services like engineering and in smaller scale, other industrial sectors) and resource-seeking (mainly mining and metals), just like foreign investments in Brazil.

A higher share in intermediate industrialisation with imported inputs would represent a quantitative and qualitative leap for Brazil's engagement in GVCs – however, this rise will only be possible if Brazilian tax rules converge more with international standards, which could be an opportunity provided after BEPS. Out of 19[21]G20 countries, the small increase in participation incurred by Brazil between 1995 and 2009 (despite the commodities boom) was lower than nothing less than 15 countries. In fact, among lower growing nations, the United Kingdom presented a significant higher level of insertion, including intermediate industrialisation. In addition to South Korea and Japan, India and China showed the highest growth in relation to GVC share in the period. Indeed, all these countries have significantly more imported content in their exports than Brazil, in other words, they rose in GVC share and experienced expressive growth as a result of fostering intermediate industrialisation.

In GVC operations a huge fragmentation of industrialisation, technical and administrative activities is seen, in absolute interdependence and usually directed remotely. In addition to consistent transfer pricing rules, with particular emphasis on assessment of intangibles, the lack of barriers for the import of technical and administrative services[22] related to the core business of companies, which are fragmented throughout GVCs, are critical to make efficiency gains in the chains viable. Administrative procedures that eliminate double taxation and avoid litigation also enable the functioning of GVCs, like Advance Pricing Agreements or APAs, and Mutual Agreement Procedures or MAPs. These practices reduce the country risk, attributed to the intragroup capital cost and administrative expenses in order to comply with fiscal obligations, unburdening industrial projects.

Coherent rules and the lack of barriers for the service trade encourage the full insertion of different countries in these chains. The Brazilian system operates in a diametrically opposing situation to the one recommended. Because of its inconsistent transfer pricing rules (particularly in relation to intangibles), barriers imposed to the import of services, limited DTAA network and consequently, not using the best international administration practices (like bilateral or multilateral APAs, or MAPS), Brazil keeps itself distant from global value chains.

It is worth looking at the extension23 (and maturity) of other countries' DTAA networks, which serves as indicators of the compatibility level of its tax related rules in relation to international standards.

20 *See* CNI, *Op. cit.* n. 9 *supra*, p. 9.

21 The European Union is also a member of G20.

22 For example, centralising and sharing the costs of support-activities of these companies, which results in the international charging of technical and non-technical, administrative and similar services, is essential for the efficiency of these chains.

23 *See CNI/FET/EY, Op. cit. n. 9 supra.*

Figure 2: Extended networks agreements to avoid double taxation

Source: Data collected by EY in July 2015.

Analysing the maturity of the DTAA network is even more revealing as a foreign investment flow indicator, compatible with the rise in 'intermediate' participation in GVCs. Between 1985 and 1995, China started putting together its network and signed 43 DTAAs that include all major countries that invest there. In addition, between 1996 and 2015 it signed 57 new DATTs to protect Chinese investments abroad. Before 1985, India had just 5 DTAAs, but between 1985 and 1995, it signed another 25. Furthermore, between 1996 and 2006, it signed another 66 DTAAs, having today agreements in force in its main investor countries, as well in nations where they invest themselves.

In other words, in the same period when they expanded their DTAA networks and converged with international standards (particularly transfer pricing), China and India managed to increase their participation in GVCs exponentially, thus, attracting additional foreign direct investments in relation to their markets. Therefore, their GVC related income increased between 500 and 600 percent, despite not standing out in the export of commodities (on the contrary, China imported substantial volumes of Brazilian commodities with rising prices, sponsoring Brazil's earnings in the period). Brazil already had 12 DTAAs in place in 1980, reaching 20 in 1990. However, since then, its network has increased to 31 agreements only. In fact, Germany has filed a claim against the DTAAs because of inconsistency in Brazilian rules and important clauses in the treaty[24].

NIt is worth mentioning that there are countries that present themselves as foreign investment channels, with a wide reaching DTAA and IPPA networks, in addition to offering good infrastructure, being close to relevant consumer markets, low sovereignty risk and available qualified labour. Among those that serve Brazilian investments abroad, Austria stands out (with nothing less that 91 DTAAs and 62 Bilateral Investment Treaties or BITs in force, in addition to another 64 IPPAs) and Holland (with 95 DTAAs, 91 BITs and another 53 IPPAs in force)[25]. Despite Project BEPS fighting against abuse and artificiality (which sometimes used countries like theses), today UNCTAD acknowledges the relevant extra-fiscal role played by countries that place themselves as *reinvestment platforms, receivers of headquarter-activities and/or GVC management, seeing them as facilitators of foreign investment*[26].

The coherence between each country's tax system and strategies related to foreign direct investment (FDI) flows continue to be sought out and unilaterally redefined. Taking part in this *multilateral game* that interacts *unilateral tax reforms*, looking for coherence between each country's tax and trade policies, taking into consideration the cooperative movements of other players (Nash)[27], is the only posture that allows each country to gain (or lose) competitiveness and wealth. It is up to Brazil to recognise this reality.

China takes over as the G20 chair in 2016 and its tax authority has published a Mandarin version of all BEPS Project reports published by OECD, after editing new sound transfer pricing rules, making the most the new standards brought about by the project[28]. In addition, it has announced that it will edit the full package (and not selective) of Anti-BEPS measures, even if adapted to Chinese interests, particularly in relation to transfer pricing rules (without losing sight of its growth and infrastructure investment strategy).

The European Union has edited a new Directive[29] with a view to promulgating *all BEPS Project 'minimum standards'* , which will be set up through domestic legislation edited by each member country. Several other countries have started to implement reforms, restructuring their international tax practices. As a result of their focus on the industrial sector and engagement in GVCs, India has got closer to its western investors (United States and Germany) and is implementing cooperation between tax authorities with a view to resolving disputes via friendly procedures. Actually, through bilateral or multilateral Advance Pricing Agreements, it wants to facilitate the administration of OECD Transfer Pricing Guideline, thus, reducing conflicts by jointly overseeing global value chains[30]. It is now time for Brazil to position itself.

24 *See CNI/FET/EY, Op. cit. n. 9.*

25 UNCTAD, ***Investment Policy Hub***, http://investmentpolicyhub.unctad.org/IIA/IiasByCountry#iiaInnerMenu.

26 UNCTAD WIR 2015, ***The importance of offshore investment hubs and transit FDI***, pp. 188 et seq.

27 For a summary of John Nash's work and bibliography on game theory and equilibrium and its applicability in economics, sociology and international politics, see Nobel Seminar (1994), ***The Work of John Nash in Game Theory***, available online at http://www.nobelprize.org/nobel_prizes/economic-sciences/laureates/1994/nash-lecture.pdf ; e T.L. Turocy, B. von Stengel, ***Game Theory***, CDAM Research Report LSE-CDAM-2001-09 (2001).

28 *See* Tavares e Owens, *Op. cit.* n. 7.

29 *See* European Commission, ***Proposal for a COUNCIL DIRECTIVE laying down rules against tax avoidance practices that directly affect the functioning of the internal market*** COM/2016/026 final - 2016/011 (CNS).

30 *See* Tavares e Owens, *Op. cit.* n. 7.

International Tax Policy: OECD, BEPS and G20 – Implications for Brazil?

3

BEPS PROJECT PARTIAL RESULTS

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BEPS PROJECT PARTIAL RESULTS, In sum, the BEPS Project had the goal of[31]: (1) consistently curbing the use of companies and structures in artificial 'roles', deviated from their economic activities and harmful tax regimes that protect them (i.e., "*Cash Boxes*" e "*IP Boxes*"); 2) reducing conceptual legal inconsistencies that result in financial operations and legal corporations being treated incoherently (i.e. 'hybrid' structures or instruments); (3) demanding the consistent enhancement of tax rules for passive income, including presumption, emphasising the need for economic substance in operational activities (i.e. improving the efficacy of 'CFC' rules); and (4), consistently enhancing transfer pricing rules and guidelines to further refine the Comparison Principle (profit prices) in the Arm's Length Principle or 'ALP', particularly in relation to intangible assets. The goal is to reach the highest alignment in relation to profit recognition with jurisdictions where value creation functions and activities are developed (i.e. developing and using intangible assets, instead of the mere funding of research activities and legal patent rights).

On the other hand, it is worth mentioning again that the BEPS Project has not been directed at the debate surrounding income tax rates practiced in different countries and has not defined regimes that use relatively low rates as harmful. In addition, it continues to recommend definitive tax regime for active incomes in the destination-country, as a practice that mostly leads to economic development, accepting the method of deferred residual taxation at the origin (American method), in huge contrast with the anti-deferral rule in Brazil. Despite the wide reaching debate on alternative methods, the BEPS Project had not rejected the Arm's Length Principle and has served to enhance OECD's Transfer Pricing Guidelines, conferring more clarity to the economic and functional analysis that guides the recommended methods, as well as sounder legal instruments, necessary for its administration.

Based on these goals, the BEPS Project has resulted particularly, in the systematisation of new ***Minimum Standards***, new anti-abuse rules that all G20 countries (including Brazil) have agreed to implement as soon as possible. These are the results of Action 5 on 'Harmful International Tax Practices' perpetrated by countries engaged in the international fiscal war (Countering Harmful Tax Practices More Effectively taking into account Transparency and Substance); Action 6 on the 'Improper Use' (or Abuse) of DTAAs (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances); Action 7 Preventing the Artificial Avoidance of Permanent Establishment Status; Action 13 on new standards for Transfer Pricing Documentation and Country-by-Country Reporting; and Action 14 on the resolution of international disputes (Making Dispute Resolution Mechanisms More Effective). In addition to these, the automatic exchange of tax information (AEOI) became new minimum standards, which emerged from the Global Forum, including Action 13 (CbCR)[32].

This ***minimum standard*** package will materialise itself in legal international tax rules (hard law), changing DTAAs through Action 15's ***Multilateral Instrument*** (Developing a Multilateral Instrument to Modify Bilateral Tax Treaties). Among the *minimum standards* only the one that emerges from Action 5 will not be the object of DTAAs, but of

31 *See* Tavares, *Op. cit.* n. 2.

32 *See* OCDE, *Op. cit.* n. 8.

domestic legislation of each country's international tax law (like the possible adoption of a general anti-abuse rule in treaty matters, as an optional part of Action 6). Promulgating a package of legal rules that implement all of these minimum standards represents a great move forward for the international tax system, responding to many of the main concerns addressed by the BEPS Project three pillars (coherence, substance and transparency).

Other greatly important matters, complementary to the *minimum standards,* took shape as ***Recommendations,*** qwhich will materialise in new ***Comments*** to the OECD Convention Model (soft law). Tax authorities in OECD member-countries are expected to commit to interpreting treaties in the terms of the organisation's new Comments, in case they do not add any *Observations to the Comments (equivalent to Reservations)*in relation to the publishing of the new Model and obviously, in case their bilateral treaties are consistent with the OECD Model (and in case they do not make any reservations to Action 15's Multilateral Instrument).

Although with less forcefulness, the same could be argued in the case of countries that are not OECD members and took part of the BEPS Project on equal footing. OECD Comments made in relation to the Model's Article 9 refers to Transfer Pricing ***Guidelines*** as instruments to interpret and apply the Arm's Length Principle. In relation to Article 9 of the Convention, the obligation of registering the observations to the comments is more controversial, as guidelines do not interact directly with the comments. Anyway, the guidelines are very influential and are usually reproduced (sometimes adapted) as per terms of each country's tax law in transfer pricing matters, being commonly used as interpretation instruments by those adjudicators involved in resolving litigation. Therefore, although the content of the report on transfer pricing (Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10), may materialise itself in soft law, it will have great legal efficacy.

Action 2 Reports on 'Hybrid Organisations or Instruments' (Neutralising the Effects of Hybrid Mismatch Arrangements) also materialised into ***Recommendations*** as well as Action 4 Reports on 'Abuses on Interest Deductions and other Financial Payments' (Limiting Base Erosion Involving Interest Deductions and Other Financial Payments). Such reforms are optional and will be implemented through each country's domestic legislation. However, in Actions 2 and 4, it is possible to see that the reach of measures may go beyond combating abuse and artificiality, inadvertently affecting productive investment (national and foreign) negatively. Coherence between the objective and purpose of these anti-abuse rules has to be strived for, as well as consistent transfer pricing rules and national policies that encourage investments.

Lastly, some Actions of the BEPS Project will materialise only as ***Best Practice Reports.*** It is the case of Action 3 on passive income tax rules, including presumption (Designing Effective Controlled Foreign Company Rules). As expected, the Brazilian rule that also taxes in advance profits reinvested in operations abroad was not seen as a best practice. Brazil would have a lot to gain by adopting the most rigorous international practices, replacing the current rule, the only in the world of its kind, as well as the burden it represents for the country's transnational companies[33].

TAction 12, Mandatory Disclosure Rules, was also concluded with ***best practices*** being presented, as discussed further in this paper. Such practices are often placed in contexts where there is more cooperation in relation to tax authority and taxpayers, more sophisticated and different regulatory environments than what is seen in Brazil (e.g. cooperative compliance, horizontal monitoring, compliance assurance process), as will be discussed later.

The implementation of measures derived from the BEPS Project has already been seen in several countries. Indeed, in some cases these reforms introduce anti-abuse rules and in others, adapt already existing anti-abuse rules, usually aiming at the equilibrium between domestic and foreign rules, taking into consideration broader unilateral economic goals than tax targets[34].

In addition to signing the Multilateral Convention that governs Action 13, in 2014 several countries announced they would implement CbCR or correlated measures (including the United States, United Kingdom, South Africa, Australia, Singapore, South Korea, Slovakia, France, Malaysia and Mexico)[35]. Unilateral measures adopted or announced re-

33 *See* Tavares, Op. cit. n. 2.

34 *See* J. Owens, ***BEPS: Looking Back; Looking Forward***, Journal of the State Administration of Taxation (SAT) of the People's Republic of China (2016); J. Owens, J., ***The Role of Tax Administrators in the Current Political Climate***, Bulletin of International Taxation, IBFD (2013); *e* Tavares e Owens, *Op. cit.* n. 7.

35 *Id.*

late to for example, Action 1 in the United Kingdom and Australia, in addition to Spain, India, Israel and Japan; Action 2 in the European Union, Australia, Austria, Spain, USA, France, Japan, Mexico and United Kingdom; Action 5 in all of the European Union and USA; Action 6 in the European Union, as well as Germany, China, Denmark, Spain, Italy, Japan and Russia; Actions 8, 9 and 10 in China and USA, in addition to Chile and Denmark[36].

3.1. How to adopt the Minimum Standards Accepted by G20 in Brazil?

The technical problems of the international tax system were already well known by tax authorities, being the object of constant studies and reforms at the OECD level, and its member countries (particularly the United States) for over a decade[37]. The persistent international tax war was exactly what stood in the way of the resolution of these problems, fed by the American strategy of excessively incentivising their multinational companies with exacerbated deferral of profits earned abroad and accrued in tax havens.

In relation to the law used in the treaties (Action 6), it is notable and innovative to have arrived at a consensus on the need for a minimum standard of substance and purpose, despite there being significant divergence about alternative presented standards. G20 countries agree that, in addition to changing the treaties' preamble (explaining that they should not provide for artificialities and abuses), a specific anti-abuse clause has to be included in the agreements through a ***Limitation on Benefits*** or LOB ***and/or*** a general anti-abuse rule through a ***Principal Purpose Test*** or PPT[38].

The LOB clause comes from American treaties and is detailed and complex, providing exceptions to safeguard cases where there is economic substance. In addition, is enhanced in the post-BEPS context[39], it may be extremely efficient. It is the preferred alternative by the USA, who are working at the moment in enhancing the terms of this clause and reducing the reach of its exceptions (where they may still be room for abuse).

The LOB clause makes it difficult (or impedes) legal corporations to interpose themselves in treaty shopping, but it may not be compatible with European Union Law and its development and liberal economic policies, which favour investment in and the integration of the European market[40]. For example, the United Kingdom rejects the LOB clause, favouring the PPT general rule. However, some non-European countries intend on adopting both in their treaties (e.g. Japan, China and India).

Nevertheless, applying (and litigation) on the general anti-abuse rule tends to weaken this type of rule's efficacy, as it reduces the resulting legal uncertainty. In matter of treaties, this may result in a new era of formalism; result contrary to the tax policy goal aimed at. Applying a specific anti-abuse rule tends to result in its enhancement as time goes by, preserving the efficacy of the anti-abuse policy aimed at.

Therefore, the recommendation is for Brazil to adopt the Action 6 minimum standard package (new preamble, LOB and PPT) and based on this new standard, substantially increase its DTAA network. This posture will preserve Brazil's foreign direct investments and does not tend to compromise foreign investment in Brazil. It will also serve to discourage taxpayers to use avoidance practices used in the treaties. However, it is recommended that the Brazilian tax authority prioritise the use of the LOB clause in the overseeing of risky situations, thus, avoiding litigation on the PPT clause or the new trea-

36 *Ibid.*

37 The work on Harmful Tax Competition recalls the 1998 OECD Report and activities from the Forum, which was established to review national practices and curb abuses by countries. The discussion on incentives for research and development, where the use of benefits focused on risk (input) activities is advocated for, and where the use of incentives focused on the mere registration of patents and intellectual property (output incentives) has been developed since the 1990s, greatly evolving before the BEPS Project. Discussing advantages and disadvantages of the ALP in relation to the Global Formulary Apportionment has lasted for almost a century, having had its emphasis renewed back in 1995. Indeed, since 2001 this has influenced in the development of different rules that have sophisticated the ALP in relation to the allocation of profits and permanent establishments (Authorized OECD Approach of the PE Reports from 2008 and 2010), resulting in new terms for Article 7 of the OECD Model Convention. The restructuring of business with the migration of intangibles, including through Cost Contribution Agreements has been widely discussed since 2005 in the USA and OECD, resulting in the editing of Chapter IX of OECD Guidelines in 2010; and the definition among other aspects, of transfer pricing related to intangible goods has been in discussion at OECD since 2011. Even the work on Digital Economy had its origins in 2001 studies on e-commerce. What the BEPS Project did to a great extent, was recycle and reedit these same OECD and/or USA studies and papers.

38 *See* R.J.S. Tavares, ***The "Active Trade or Business" Exception of the Limitation on Benefits Clause*** *in* ***Base Erosion and Profit Shifting: The Proposals to Revise the OECD Model Convention*** (M. Lang et al. eds., Linde Verlag 2016); and M. Lang, ***BEPS Action 6: Introducing an Antiabuse Rule in Tax Treaties***, Tax Notes Intl. p. 655 (2014).

39 *Id.*

40 *See* Tavares and Bogenschneider, Op. Cit. n. 7

ties' preamble, so as to not reduce the behavioural effect and legal efficacy of the general rules, and enhancing the specific rule's efficacy.

The minimum standards resulting from Action 7, which reform the concept of Permanent Establishment or PE, tend to be particularly harmful for Brazil. This is because on one hand, Brazil does not use this concept to tax foreign capital and transactions using non-residents. For example, Brazil does not exercise fiscal jurisdiction in income tax matters on several commercial activities covered by special custom regimes that could possibly be characterised as PEs. In addition, it taxes by withholding at the source, remittances abroad that could be considered as income produced in Brazil under the PE concept and thus, would not be taxable in Brazil (generally the case of the taxation of services exported abroad). Therefore, changes resulting from the BEPS Project will not assist the National Treasury.

On the other hand, big Brazilian exporters guide themselves based on the Permanent Establishment concept to organise ***preparatory and auxiliary activities*** abroad, including those related to storing stock under special custom regimes in foreign territory and promoting sales by ***commercial agents or representatives*** or rendering services abroad (for example engineering), activities that foster the export of Brazilian goods and services to foreign markets. They are guided by this concept of treaty law in order to avoid characterising an income producing source abroad (PE works as presumption of business activity with profit taxed abroad) and thus, may fully register in Brazil revenues and profits resulting from these exports.

With changes resulting from Action 7 in the treaties, probably several foreign jurisdictions will start to recognise the existence of PEs, which were not present in the current terms of Brazilian DTAAs, or based on the market-countries domestic legislation. In order to avoid double taxation, such exports are forced to change their procedures and for instance, structure branches abroad that allow them to acknowledge revenues and profits, today accounted for in Brazil. Consequently, they will start to pay income tax abroad regularly. This redistributed the fiscal jurisdiction between Brazil and abroad, with the Brazilian fiscal jurisdiction becoming residual. These foreign taxes, vis-à-vis the current Brazilian universal base taxation system (TBU) will turn into credits and will represent an effective burden for the National Treasury.

Brazilian transnational companies also structure their operations abroad in order to allow for a maximum presence in foreign markets, without characterising permanent establishments. Often, they control GVCs, as they are controlled abroad, located in certain countries (e.g. Austria, Holland, Belgium, Switzerland) and coordinate operations in several other market-countries, also avoiding PEs from being recognised in them.

The countries where these GVCs coordination and management centres are located usually keep effective income tax rates lower than many market-countries. Therefore, fiscal jurisdiction redistribution for market-countries tends to increase the total value of taxes paid by Brazilian transnational companies abroad. Market-countries will certainly claim improper use of treaties in the scenarios where they restrict characterisation of PEs, combining the results of Actions 6 and 7 (particularly based on the preamble or PPT clause). In many cases, the treaties will be adapted to Action 7 minimum standard and PEs will be recognised by both countries, resulting in the same increase in the tax burden abroad, as mentioned above. Therefore, like in the case of big exporters, faced with the Brazilian TBU system, this rise in tax burden abroad will become additional credit in Brazil, in other words, a burden for the National Treasury.

In addition, the amount of profit attributed to PEs in several countries, does not correspond to OECD Transfer Pricing Guidelines. In many cases, they may also not correspond to OECD criterion for *Attribution of Profits to Permanent Establishments* (resulting from Authorized OECD Approach or AOA), addressed by OECD 2009 and 2010 Report[41], and that influenced the new wording in Article 7, included in the 2010 OECD Model Convention, still used by few countries. Many foreign rules use arbitration concepts of taxable profit based on indicators (for example, revenue, assets) that may present incoherent results.

As a result of the probable proliferation of PEs in the post-BEPS age, it would be ideal if the Action 15 Multilateral Instrument could include the AOA to standardise the

41 OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2008), International Organizations' Documentation IBFD, and OECD, *Report on the Attribution of Profits to Permanent Establishments* (OECD 2010), International Organizations' Documentation IBFD.

highest number as possible of bilateral treaties, with criterion for allocation of profits for PEs, but this probably will not happen. Attributing profit from the head office to the branch of PE continues to be a unilateral procedure or at best bilateral, if there is a treaty in force.

In order to defend Brazilian fiscal jurisdiction in relation to big exporters, avoid the improper proliferation of PEs and over attribution of profits to these branches, it would be interesting for Brazil to increase its DTAA network, effectively using the Mutual Agreement Procedure (MAP), addressed by Action 14 on International Dispute Resolution.

MAP's new *minimum standards* (in the sense that countries would increase access to MAP and endeavour to reach an agreement, thus, avoiding double taxation in a reasonable timeframe) fell short. Because of uncertainties emerging from the BEPS Project, increasing access to MAP as a minimum standard would be necessary, as well as making resolution between states compulsory, in a pre-established deadline.

Even so, the terms in Action 14 represent a step forward and will be up to each country whether they use this instrument to protect their interests and treasury. Indeed, it may be vital for Brazil to adopt arbitration procedures as part of MAP. This procedure is already in OECD's Model Convention and is widely used in Europe and the USA. As part of the BEPS Project, a coalition of countries was set up with the aim of developing this dispute resolution instrument between nations (several among them, looked on this procedure with caution in the past and now, intend to adopt it, notably Japan), implementing a new arbitration model as part of MAP through the Multilateral Instrument. It is recommended that Brazil be part of this group and conciliates its domestic legislation (e.g. fiscal administrative process) so as to ensure broad access to MAP, with the possibility of using international arbitration.

Because of the result of Action 13, this risk is confirmed in the case of Brazilian transnational companies. Brazil should share with other countries a **Global Master File** where all Brazilian transnational operations in the world are described, with highly confidential and sensitive information on these companies' value chains and strategic differentials. This Global Master File would be obtained by the Brazilian tax authority as part of information provided annually by taxpayers (e.g. Tax Filings or ECF) and will serve as a common base for an economic analysis (functional and risk) of Brazilian transnational operations. In addition, it will guide transfer pricing studies according to OECD Guidelines (and according to standards recommended by the UN) to be conducted in each country. These national studies are documented separately in each country through a ***Local File*** which provides details on relevant operations in that country.

For transnational company groups, with consolidated revenues of over 750 million Euros (category where practically all Brazilian transnationals may be found), Brazil shall also collect ***Country-by-Country Reports or CbCR***. This report will list on a country-by-country basis, revenues (identifying those resulting from third party transactions in relation to related parties), profits and losses before income tax, taxes paid, subscribed capital and accrued profits, number of employees and intangible assets (except cash and equivalent). In case Brazil signs the *Multilateral Competent Authority Agreement,* resulting from Action 13 [42], the Brazilian tax authority will commit to not only *collecting automaticamente*, these reports, but also to sending them *automatically* each year, to all the other signatory countries through the system that will be established by that convention.

Brazil has yet to sign this Convention, however, it has been a signatory of another since 2011, the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters,* which also governs the Automatic Exchange of Information (AEOI), in addition to the spontaneous exchange, joint inspections and other international cooperation procedures between tax authorities, which Brazil has promised to ratify. Hence, if Brazil complies with what it has promised as a member of the Global Forum and with what it has said it would do at the level of G20 and OECD as part of BEPS, including the accessory obligation of sending this information to the Brazilian tax authority, the country will also send (automatically or by a request from a foreign tax authority engaged in inspection) the Global Master File and CbCRs of Brazilian transnational companies to up to 95 countries.

42 *See* n. 8.

This represents a significant advance for tax authorities in their transfer pricing risk monitoring. Despite representing a relevant additional 'compliance' burden for transnational companies, as well as risk of fiscal confidentiality breach (potentially with strategic commercial implications).

However, the Brazilian tax authority should not request this information from a foreign national or use information provided by Brazilian companies as part of their transfer pricing inspections (except when and limited to, the new Brazilian method used in the oil and gas sector, under the sharing regime[43]). Maybe this is done as an abuse or sham, so as not to consider legal corporations or artificial transactions (be it in transfer pricing matters, be it in relation to remittances abroad or profits earned abroad). These are the exception hypotheses that do not reach most transnational taxpayers and do not capture the biggest potential of tax revenues resulting from the use of transfer pricing methods recommended by OECD and the UN.

STherefore, if different transfer pricing rules continue to be used, with a limited DTAA network, not using the *Permanent Establishment* concept aiming at a coherent increase of taxation on foreign capital, minimum standards in Actions 6, 7 and 13 will not bring any gains, but certainly relevant losses to the National Treasury.

Hence, it is clearly interesting for the industry, as well as the National Treasury, to engage in international cooperation and converge in relation to the minimum standards in BEPS Project Actions 6, 7, 13 and 14. In order to defend its interests, Brazil should:

(a) Increase its DTAA network adopting the anti-abuse minimum standards emerging from Action 6;

(b) Emphasise a sound version of the LOB clause in its treaties and overseeing actions;

(c) Start using the Permanent Establishment concept, utilising the minimum standards of Action 7 assertively and fully exercising its tax jurisdiction on foreign investment in Brazil, in a coherent and consistent manner with other G20 members (drawing away from the excessive use of tax retention at the source, particularly eliminating the taxation of technical and administrative services that do not represent abuse or artificiality);

(d) Start using Mutual Agreement Procedures (MAP) when dealing with other tax authorities, complying with minimum standards in Action 14 in order to avoid the improper proliferation of permanent establishments of Brazilian companies abroad and allocation of profits to such presumptions of establishments, including the use of international arbitration as part of MAP;

And only adopt all minimum standards described above,

(e) Adopt Action 13's minimum standard, editing accessory obligation that will allow it to collect the Global Master File and CbCR of Brazilian transitional companies, as well as sharing information with foreign tax authorities. As a matching action, Brazil may use the same types of information to better oversee foreign capital and ensure the appropriate characterisation of PEs in Brazil of foreign exporters and multinationals.

Another minimum standard resulting from the BEPS Project does not apply directly to Brazil, but may serve as a lesson and motivate a review of the national technology innovation policy. In order to facilitate international technology transfer and foster productivity, as well as the development of GVCs, OECD recommends that income tax not be withheld at the royalty-paying source at the level of DTAAs.

This pro-development policy serves as a big incentive for the proliferation of DTAAs. However, its tax logic presupposes that the country *taxing royalties* related income would do so using 'fair' rates (in a way or another), and would truly be the capital exporting country. In other words, it would the country keeping the relevant infrastructure and favourable environment to substantial research and development activities, place where

43 Costs and investments necessary for the production sharing contracts established by Law 12,351/10 (Article 6 and following) will be deductable and refundable to contracts, if compatible with market values (arm's length contract), in a system similar to the profit sharing method under OECD's arm's length principle. *See* F. Gaspar and M. R. Oliveira , ***The State Of The Arm's Length Standard In Brazil – Some Ex citing Developments,*** Informa (2016).

the intangible, which makes operations in the source-country viable, would have been created (high risk and value added business activity) and *royalties* paid for. Therefore, this policy presupposes the non-artificial interposition of a tax haven (or equivalent) to discourage the intangible property without conducting development activities. Indeed, this was the exact abuse that took place in the years prior to the BEPS Project.

The BEPS Project condemned the practices of countries that kept regimes like 'Patent Boxes' (or IP Boxes), through which the legal rights of intangible assets (e.g. patents and brand property) were explored in jurisdictions where relevant economic functions were not performed (in addition to the availability of intragroup capital to acquire the asset or fund its 'risky' development).

The fiscal incentives of such countries materialise in the non-taxation of royalties related earnings (or taxation favouring effective rates of 5 percent for example), to the extent that the deductibility of royalties is ensured by its fair value based on Article 9 of the treaties (as interpreted by OECD and the UN). Value that would be paid using the arm's length principle to a third party who would have developed the intangible. The cash accrued by such intermediary countries is often used for loans and financing between the groups' companies, including the country that develops the intangible, generating additional relevant financial expenditure.

This type of structure often compromises not just the country that pays the *royalty* because of the improper reduction in retentions at the source via treaty shopping), but mainly the countries where the high value added research and development activities are performed, which require financing through licensing revenues. No wonder this type of incentive was already considered inefficient and harmful not only by OECD, but also by several capital exporting countries like Germany for years. Indeed, keeping it represented one of the main problems of the international tax war.

In order to avoid this type of abuse and artificiality, resulting in 'double non-taxation' of income, Action 5 supplies a new minimum standard to be implemented by domestic legislation in countries that keep special regimes like Patent Boxes (among others). The new standard aims for coherence in identifying 'substantial' activities and functions, which create value, in relation to where the profits are recognised, suggesting the adoption of a substance or 'nexus' (or 'modified nexus', following Europe's experience where this problem has intensified).

Through this new rule, favoured taxation regimes may only be used in the extent and proportion of qualified expenditures in value generating activities and functions, which create intangibles. Several countries (including all 14 from Europe have kept this type of special regime), have committed to gradually discontinuing harmful rules and have announced new regimes with the same benefits. However, conditioned to the new proportionality rule, in other words, incentivising the transfer of expenditure of qualified labour and attracting not only royalty revenues, but research and development activities, which today are disseminated throughout the world.

The new legitimately used regime, with the G20 seal of approval in the post-BEPS age is Knowledge Box (e.g. United Kingdom, Holland) or Innovation Box (e.g. being debated in the USA). Brazil looks to be immune to this problem by massively taxing royalties (effectively at 25 percent) and limiting its deductibility based on criteria from 1958. However, as a result it ends up not importing high value added services and intangibles that could increase national industry's productivity and its insertion in global value chains.

Nevertheless, Brazil is running a new post-BEPS risk. Its technology innovation incentive policy used to be advanced and intelligent, focused on the human factor (i.e. emphasis on the payroll and number of researchers) and could have been broadened significantly to attract even more research, development and innovation activities to the country. However, this good Brazilian practice was temporarily suspended in 2015. In case it is not resumed and vis-à-vis the proliferation of the special regimes described above, foreign as well as Brazilian transnational companies have to start considering, due to relevant competitive pressure, the possibility of reducing innovation global impacting activities, which are today conducted in Brazil, transferring them to Europe, Asia or the United States. Said companies would keep in the national territory, secondary activities aimed exclusively at the Brazilian market. Alternatively, in cases when this transfers is not possible (case of some Brazilian companies), they would lose competitiveness. This would be another level, through which Brazil would distance itself from the world, productivity gains and global value chains.

It would be important in order to defend Brazil's interest, for the following policies to be adopted in relation to Action 5's minimum standard:

(f) Restore and widen technology innovation incentives, allowing for the expenditure and calculation of said incentive to be consolidated in a period of up to five years (and not only for each separate year), not limiting the deduction based on taxable income (with the possibility of registering tax loss) – by definition, this system would be strictly compatible with Action 5's 'modified nexus' minimum standard -;

(g) Favour the increase of the DTAA network by not imposing income tax on royalties as per terms of Article 12 of the OECD Model Convention, even if keeping the Contribution for Intervention in the Economic Domain (CIDE), which is incurred on royalties only as a specific anti-abuse rule (similar to 'Diverted Profits Tax' in the United Kingdom and Australia, related to BEPS Project Action 1). The CIDE tax rate would be increased from 10 to 15 percent, but enforceable only in cases when the tax incidence on profits originating from royalty related revenues would be effectively lower than 15 percent, or over the limits imposed by the new Action 5 minimum standard. This would be easily verified through information exchange procedures, particularly CbCRs abroad resulting from Action 13.

3.1. How should OECD recommendations for G20 be used in Brazil?

In addition to pursuing the international consensus in favour of the end of aggressive tax policies in countries that exclusively long for predatory competition, represented by special regimes that hide Cash Boxes and Patent Boxes in tax havens, two technical reforms would be critical to the international tax-legal system. These reforms have the aim of curbing the use and the proliferation of this type of regime and artificial structures that simulate the setting up of intragroup GVCs:

a. Transfer pricing rules reform through the evolution of OECD Guidelines and countries' internal law (particularly in the chapter on intangible assets and restructuring). This will allow for intragroup legal instruments not to be considered, which increase the capital burden and property rights of high mobility assets (patents) to the detriment of operational functions; and

b. CFC rules reform in several countries with the aim of closing the 'loopholes' that allow for residual profit and passive income to be accrued abroad, notably in tax havens. These one-off deficiencies, not inherent to the rules (particularly in the American system) are very much known by governments and their permanence is motivated by countries wishing to protect their multinationals' competitiveness.

None of the technical reforms described above have materialised into new ***minimum standards.*** As there was no technical and political consensus at the OECD to debate global formulary apportionment in transfer pricing, reforms to national CFC rules were also not discussed at the same sphere, which would standardise and make them compulsory for all OECD and G20 members. Global formulary apportionment would tend to result in higher tax base allocation for capital importing countries, to the detriment of capital exporting nations. Standardising and enhancing CFC rules could have resulted in the reestablishment of an effective residual taxation in capital exporting countries, ***but at different rates*** which would substantially reduce the competitiveness of American companies vis-à-vis their European and Asian counterparts.

However, OECD Guidelines on transfer pricing are evolving significantly through the BEPS Project ***Recommendations.*** The new results of the application of the post-BEPS Guidelines may even be similar to or close to global formulary apportionments and may be seen as making the ALP flexible. Nevertheless, they are understood as a system evolution and sophistication, in terms of the critical reforms pointed out by item 'a' above. This evolution curbs abuses and artificialities significantly. It may have even more impact with the result of the debate on Actions 9 and 10, particularly in relation to the analysis of the ***Intra-***

group Capital Allocation Function and the application of ***the Profit Split Method*** (*Profit Split*), discussions that will produce results in 2016 and should continue beyond 2017.

In sum, the terms in OECD *Guidelines* emphasise the creation of value through the performance of functions and activities, limiting allocable returns to intragroup capital availability[44]. The UN should reedit its *Practical Manual on Transfer Pricing*[45] consistent with the new post-BEPS Guidelines.

China, India, the United States, Canada and Japan for example, adopt different interpretations in relation to OECD Guidelines. In other words, they apply the guidelines without hindering their sovereignty, doing what they deem fair and necessary in relation to how they interpret the ALP, in order to protect their treasuries and avoid abuse.

One of the particularly relevant concept for China and India is related to Location-Specific Advantages or LSAs, issue little approached previously by the OECD Guidelines and the BEPS Project, which incorporates the guidelines to the chapter that addresses the *comparability study on transactions or companies*.

From China's point of view, the concept of LSAs may actually implicate in acknowledging the unique and intangible asset, represented by access to the Chinese domestic market (market premium) and *trade fund*, based for instance, on the differentiation of advertising and marketing activities, client and contract portfolio, among other factors. Even in the lack of a distinctive, valuable and market unique intangible, the LSA concept may invalidate the comparability of foreign transactions (or companies) with Chinese enterprises, thus, resulting in a higher use of the Profit Split Method, which tends to favour China. India adopts a similar posture, focusing on the value added of its qualified labour that takes part in Global Value Chains.

Nevertheless, all these countries (USA, Canada, India and China) are open to resolving interpretation differences in the transfer pricing area through mutually binding consultations or unilateral, bilateral or even multilateral APAs (in response to the request by taxpayers). This would be done jointly with other countries' tax authorities, as recommended by OECD and the UN. They are also open to resolving interpretation conflicts with other countries through friendly DTAA's Mutual Agreement Procedures (MAPs). All these countries and particularly India and China, may serve as examples of what could become Brazil's *sovereign convergence* regarding OECD Guidelines and the UN Manual.

Faced with the new sounder system resulting from Actions 8, 9 and 10, as well as good practices employed by other G20 countries that cooperate with Brazil, as well as the transparency resulting from Action 13 and considering the better capacity-building of Brazil's Secretariat of the Federal Revenue (which has significantly evolved in relation to human and material resources since the creation of the Brazilian methods)[46], converging with the international system in transfer pricing matters starts being ***viable*** and interesting for Brazil.The experience acquired by Brazil with methods using fixed profit margins established by law, very administratively efficient and not harmful in some cases, would be very much useful: *All fixed margin methods wold remain in force, but would start being* **optional** *(safe harbours)*, solution justified by administrative efficiency. However, all other methods recommended by OECD and the UN, as per terms in OECD Guidelines and the UN Manual, would be incorporated to the national legislation. Through joint international oversight and cooperation, and effectively using information from Master Files, Local Files and CbCRs, Brazil's Secretariat of the Federal revenue will be able to manage this new *hybrid system* which brings together the Brazilian experience with the best international standards.

The United States had to agree with the final terms provided in the Action 1 report on Digital Economy, which effectively ***links*** the non-creation of special rules for taxing differently companies in the high technology sector (defended by the USA), to the full implementation of the minimum standards in the BEPS Project other Actions, also complying with transfer pricing *recommendations.* This was the matching action for the non-introduction of *minimum standards or recommendations CFC rules (which were also not wanted by several European countries because of competitiveness reasons).*

44 *See* Tavares and Owens, *Op. cit. n.*

45 *See* ONU, *Op. cit.* n. 5.

46 The Brazilian system in force in 2016 refers back to 1958 in the case of the import of industrial property, which incurs the payment of de *royalties* (*see* Ordinance MF 236/58, Law 4,131/62, Law 4,506/64), and 1996 (Law 9,430/96 as altered between 1999 and 2015) for other international transactions.

If technology exporting countries like the USA do not adopt the new sounder standards and recommendations, the position of countries that decide to adopt special measures will be justified, aiming to taxing transactions where they detect BEPS related risk. American companies, characterised by virtual operation models, would predominantly be the 'target' (e.g. Google/Alphabet, Amazon, Facebook, etc.). It is worth remembering that high technology companies were already very much in the sights of authorities in all G20 members (not only for fiscal reasons, but also due to competition related issues).

The report drafted under the coordination of the American delegation was right in its conclusions, in the sense that part of the digital economy should not be isolated (ring fence), making a certain sector the object of 'special' international taxation rules[47]. Such isolation, 'if not impossible, would be unviable' as per terms of the OECD Report, as to a higher or lower degree, all the economy operates and generates value through digital technology, not just in the case of companies with higher visibility in the high technology sector. In other words, all the economy is digital and taxing a sector separately (or the whole economy) in a stricter way, because of a non-qualified BEPS risk would be distortive, non-isonomic and harmful to development.

However, such special measures were not completely discarded and would be justifiable in cases were abuses and artificialities persist, which is presupposed that will happen in case the new BEPS Project *standards and recommendations* are not observed. There was no consensus in relation to what would be the most recommended measures *(less distortive and efficient) in these cases, but the hypotheses taken into consideration were:*

(a) Withholding income tax at the source on remittances abroad, which represent risk to BEPS (e.g. remittances of royalties to tax havens), or;

(b) The creation of a new concept of *digital permanent establishment* to tax in the source country, presumed income of operations conducted over the internet, or;

(c) The creation of a special tax (like the United Kingdom's Diverted Profits Tax) aimed at abusive or artificial operations not solved by the BEPS Project.

The report also points out that in direct digital transactions (online) with consumers (e.g. virtual content downloads, works protected by copyrights, software, etc.), countries should consider establishing a tax on consumption (Value-Added Tax or VAT) *at the destination and not at the origin*. This conclusion is consistent with the European Union's policy on this matter (charging VAT at the destination and not at the origin has become a rule in Europe since 2015), which serves to restrain tax war in the continent.

Brazil adopts the special measures in Action 1 as a rule, which should be of exceptional nature because of their potential for distortion. It burdens everyone with isonomy, but creates great economic inefficiency. By taxing all *royalties, copyrights* and services by withholding between 15 and 25 percent at the source[48]. as well as charging 10 percent of CIDE on all technology imports, Brazil burdens domestic market aimed value chains, reducing or increasing natural resources exploration costs. Industry's costs are increased, which may depress wages or national input purchases, as well as inflating prices for Brazilian consumers and/or reducing return on investment (making some unviable) – all these effects reduce Brazil's economic efficiency and development -.

This feature of the Brazilian system, combined with inconsistent transfer pricing rules in relation to other G20 members, makes it impossible for Brazil to be fully inserted in GVCs via intermediate industrialisation. As seen earlier, this type of industrial activity may attract efficiency-seeking foreign direct investment and could lever productivity gains and investments throughout the national industry. Importing technology and using services abroad is a feature of such efficiency-seeking GVCs.

AInconsistent taxation of said chains, diverging from international standards, with no DTAA coverage, generates huge inefficiencies and may effectively result in double taxation. For example, this could result in double economic or legal taxation, in case the technology or service providing country does not recognise the income source as Brazilian (which could occur even in the hypothesis of technology integrated to the value of components imported for re-exportation, or royalties higher than the 1958 limits that

47 *See* Tavares, *Op. cit. n. 2*.

48 In addition to PIS/Cofins and ISS or ICMS.

may not be deducted), or in case foreign taxes incurred on the income of these activities are lower than the Brazilian tax withheld at the source.

Many of these possible problems could be resolved through a bigger DTAA network and by using MAPs to conciliate differences between the countries. All these double taxation hypotheses materialise themselves through Brazil's insertion in GVCs for intermediate industrialisation, thus, making such insertion unviable, reducing the national industry's efficiency and investments in Brazil.

Other recommendations made by the BEPS Project affect the cost of foreign investment in Brazil directly and may also bring adverse effects to Brazilian investments abroad. With the aim of avoiding artificiality involving *Hybrid Entities or Operations* (Action 2), the BEPS Project attempts to eliminate the avoidance effects of structured financial operations that explore differences between civil or commercial law, as well as tax law in different countries. It also attempts to curb the abuse of Interest Deductions (Action 4), limiting them to undercapitalisation rules.

The structured financial operations addressed by Action 2 occur in regimes or countries where for example, bonds generate obligations recognised as interest deducted in the paying country and as exempt dividends in the receiving country (or subject to reduced taxation in artificial structures and opaque regimes), or where an obligation generates several deductions[49]. Action 2 recommendations seek coherence through a linking rule, which primarily allows for selectively banning such deductions in the country paying the 'interest'; or, in case the country does not treat this 'interest' as non-deductable, the rule allows for selective taxation in the country receiving the 'dividends', deducted as interest from the payer. Several countries will follow this recommendation (for example, adopted by the European Union and Japan).

This attempt put forward by OECD to curb artificiality and abuses may inadvertently, harm an innocent feature of Brazilian law, Interest on Own Capital (JCP) [50]. an intelligent, transparent non-distortive policy used in Brazil for 20 years. As they are disguised as *payments owed to partners* and are similar to dividends when declared, JCP distances itself from its technical origin and may be interpreted as *Allowance for Corporate Equity or ACE* despite this being the economic essence of the Brazilian JCP[51]. Equally, as tax is withheld at the JCP source at the same rate as that incurred by interest, which does not occur in the case of dividends, the distance increases.

PPL or ACE is a brilliant academic solution developed in 1984[52] to reduce debt's favourable tax position, solution already seen in Brazilian inflationary accounting (deductible inflationary losses)[53]. The European Union itself [54] considers the benefits of its use in order to avoid taxation rules to have distortive effects on investment related decisions, as well as eliminating incentives for unnecessary debts, which erode the tax base. It should operate not through a payment to partners (which implies in decapitalising the company), which implies in yield for partners and incentivises disinvestments, but in the ***tax elimination of interest assumption on share capital and accrued income that remain reinvested.***

Obviously, ACE will result in the reduction of taxes incurred by legal corporations (even if this tax waiver is lower than the company's resulting debt). However, ACE does not interfere in the eventual taxation of dividends, which may or not be later declared and paid to shareholders, and should not take the form of direct payment to partners. If the Brazilian JCP had adopted this different format, remunerating the company's net equity, instead of its partners, there would be doubts in relation to its ACE nature. In addition, there would be no risk of JCP being characterised as a hybrid instrument, susceptible to the effects of the BEPS Project Action 2.

49 *See* Tavares, Op. cit. n. 2.

50 Law 9,249/95, art. 9.

51 *See* Mooij, R.A. and Devereux, M.P., Mooij, R.A. e Devereux, M.P., ***Alternative Systems of Business Tax in Europe: An Applied Analysis of ACE and CBIT Reforms***, Taxud Taxation Papers, European Union (2009), p. 9. Mooji e Devereaux identificam os sistemas do Brasil e da Bélgica como representativos de ACEs, e menciona outros países que implementaram conceitos semelhantes, tais como Croácia, Itália e Áustria. A proposta é objeto de debates constantes na Alemanha

52 *See* Boadway, R. and Bruce, N. ***A General Proposition on the Design of a Neutral Business Tax,*** Journal of Public Economics 24 (1984), pp. 231-39.

53 *See,* Tavares, R.J.S., Womack, J.T., and Wilson, D.E., N.***New Brazilian Equity Interest Rules: Efficient Financing for U.S.-Owned Subsidiaries,*** Tax Notes International (January 1997).

54 *See* Mooij and Devereux, Op. cit. n. 49 supra.

The Brazilian corporate tax system, which uses high nominal rates (34 percent), while exempting dividends and allowing the deduction of JCP linked to pay outs to partners, encourages the decapitalisation and disinvestment of companies. ***If on the contrary, corporate tax was reduced as a matching action to an increase in income tax withheld at the source of dividends,*** and if JPC deduction was done by eliminating companies' real income and not direct payments made to partners, the system would encourage productive investments and capitalisation of companies. Furthermore, by incentivising capitalisation in national currency, paid by risk-free interest, the system would discourage private debt in strong currency, which in addition to generating expenses at higher interest rates, tends to lead to deductible expenses due to negative exchange variation, which may not be characterised as income and are not subject to being withheld. Therefore, the system suggested here, as long as it leads to less debt, is favourable to the National Treasury[55].

Redesigning the balance between corporate tax and withholding tax on dividends may also increase Brazil's bargaining position to widen its DTAA network, as lower rates may apply in the agreements. This will encourage other countries to seek to sign these treaties with Brazil. Therefore, the recommendations in relation to Action 2 are:

(a) Review its interest deductibility rules in financial instruments, which have their legal nature of debt in Brazilian law, being able to qualify as equity instruments abroad (e.g. Profit Sharing Debentures or Convertible DPLs), creating a specific anti-abuse rule, in terms of Action 2 (linking rule)[56], similar to the top withholding tax on remittances to tax havens; ***the new rule will allow Brazil to ban the deduction of financial expenses in these hybrid instruments;***

(b) Reformulate JCP, so that it may ***eliminate tax of interest assumption on share capital and accrued income that remain reinvested,*** instead of payment made directly to partners.

(c) Reduce nominal corporate tax from 34 to 23 percent and increase JCP's deductibility, allowing for interest rates equivalent to Brazil's sovereign risk to be deducted in its national currency instruments (still lower than interest and negative exchange variation resulting from taxpayers' debt); and

(d) Establish withholding income tax on dividends at a 20 percent rate and present a new Brazilian ***DTAA Model*** with this rate reduced to 5 percent, motivating the renegotiation of existing treaties to adapt them to the post-BEPS anti-abuse standard and increase Brazil's DTAA network.

In Action 4 report, OECD recommends the use of a rule to limit deductibility of interest owed to related parties, in addition to its undercapitalisation rules (specific anti-abuse rules that govern the maximum level of debt that may result in the deduction of interest expenses among related parties) [57] and the use of transfer pricing methods [58]. The suggestion is for a rule similar to the one in force in the United States and Germany to be adopted, through which a maximum interest deductibility limit would be established, corresponding to 30 percent of the cash generated by the company and represented by the EBITDA index (Earnings Before Interest, Taxes, Depreciation and Amortisation). The report also suggests a comparison of global debt level of a transnational company vis-à-vis a third party, to the extent that debt level in relation to non-related creditors would serve to point out the risk of excessive artificial debt, but also effectively limit the deductibility of interest resulting from the instruments between the related parties.

The thing is that transnational companies operate under diversified risks. Such risks are diversified in several ways, for instance, through operations in specific business areas, in different markets, projects or countries, in an extremely complex factorial combination. Generally speaking, the consolidated debt test will not be able to point out the

55 Indeed, this favourable characteristic to the National Treasury could justify the increase of JCP benefits, approximating it to ACE, by for example, using the average interest rate owed on sovereign debt in Brazil, not binding the deduction to profits. In fact, this could increase tax losses, as occurs with negative exchange variation on loans – still JCPs would be more favourable to the National Treasury than debt -.

56 Brazil would use international cooperation instruments, like the exchange of information with foreign authorities to identify terms not complying with Action 2.

57 Arts. 24 and 25 of Provisional Measure 472/09 converted into Law 12,249/10, as regulated by Normative Instruction 1,154/11.

58 Law 9,430/96, with modifications made in Laws 10,451/02, 11,196/05, 12,715/12, and 12,766/12, and as regulated by Normative Instructions 243/02, 1,312/12, 1,321/12 and 1,322/12, and Ordinance 222/08.

appropriate level of debt for each operation. Imposing limitations pre-established by law, for the level of debt or value of deductible interest may make high intensive capital projects unviable, like big industrial plants and investments in infrastructure.

The transfer pricing methods advocated for by the OECD Guidelines allows for the capitalisation structure of related companies and the adjudication on the appropriate level of debt to be analysed, through risk assessment and economic study. Nonetheless, using limits pre-established by law reduces complexity and may be useful in terms of administrative efficiency, even if it increases guidelines even more if necessary, with a view to curbing abuses and artificialities, is still the best way to avoid distortive effects and discouragement to strategic investment. Therefore, the recommendations for Brazil are:

(e) Adopt Action 4's recommendation and establish rule that limits the deduction of interest to 30 percent of EBITDA for intragroup financing, aiming at administrative efficiency. This rule should come hand in hand with the conversion of current undercapitalisation rules in ***safe harbors***, in other words, optional simplified rules that allow for the level of debt or interest deduction to be supported by an economic study, as per OECD transfer pricing guidelines;

(f) Establish withholding income tax on interest at a rate of 20 percent and present the new Brazilian ***DTAA Model*** with the rate reduced to 5 percent for long term financing (e.g. average amortisation period of over 5 years), with interest exemption in the case of infrastructure projects, so as to incentivise productive investment in Brazil. As in the case of dividends, this positioning will incentivise the renegotiation of existing treaties, in order to adapt them to the post-BEPS anti-abuse standard, as well as increasing Brazil's DTAA network.

3.1.3. How to use the Best Practices suggested by G20 in Brazil?

A lot has been discussed in relation to Brazilian anti-deferral rules[59]. The present study will not repeat the analysis of the deficiencies in the Brazilian rule, nor will it go into details to compare the Brazilian system to international practices. Action ***Best Practices*** Report is already clear by not including the Brazilian practice, among those recommended to G20 countries. Basically, it does not recommend what Brazil does to its transnational companies. In addition, Brazil's rule was the object of discussion at the level of the BEPS Project. This conclusion should be enough to motivate changes to the Brazilian system.

The report emphasises the need for balance between the anti-abuse tax goal and the economic objective of not distorting investments, nor improperly interfering in the international competition environment. Exactly what the Brazilian system lacks. OECD and the UN continue to defend that the international tax system should not discourage productive and direct foreign investment. Moreover, this investment's purest form is what happens by the reinvestment of operational income when there is surplus cash – exactly what is punished the most by the Brazilian system -.

Without a doubt, coherence is critical for the balance of the international system. Capital exporting countries need to operate regimes that effectively tax speculative, passive and unproductive income accrued abroad, particularly when kept in opaque countries and tax havens. It is desirable that such regimes be as consistent as possible. These specific anti-abuse and anti-deferral rules could be inspired by the original American model design, which has evolved in several aspects, but was distorted and corrupted in the last two decade, with specific healable deficiencies[60]. The ideal design is the one that combines the American to the German system, conciliating the method for taxing active income in the destination, with the method for taxing passive income at the origin by switching over from a territorial to a credit system.

By defending the competitiveness of its transnational enterprises, each capital exporting country is defending their own domestic market. It defends its value chains that support such transnationals, resulting in above all, investment and employment in

59 *See* Tavares, *R.J.S.*, ***Brazil's 2013 corporate tax reform: Policy and controversy aspects,*** Transfer Pricing International Journal, BNA (2014); Tavares, R.J.S. and Castelo Branco, F., ***O Risco de Expatriar Empresas***, Revista PIB (2014), *and* ***Queremos Ser Grandes***, Folha de SP (2014); *also see* Tavares, *Op. cit.* n. 2.

60 *See* Tavares, *Op. cit.* n. 2 *supra*, "os EUA praticam efetivamente uma territorialidade 'velada', mais complexa e mais agressiva que a dos demais países OCDE, sem limitações eficazes ao uso por empresas norte-americanas de Práticas Tributárias Nocivas no exterior".

the host country. It defends its capital and pension fund markets that invest in these national companies. It defends the host country's competition environment, ensuring that the big national companies do not operate in disadvantage vis-à-vis foreign competitors, resulting in the well-being of consumers in the host country.

In order to avoid overloading their transnationals and defending national interest, capital exporting countries are guided by these positions. Anti-deferral rules should be anti-abuse rules, and not anti-investment rules. The investment of Brazilian transnationals abroad (be it looking for markets or foreign natural resources, or in the search of efficiencies) tends to benefit Brazil and when these companies lose competitiveness, it harms the country. However, Brazil should not do away with anti-abuse and anti-deferral rules guided by a tax neutrality criterion.

Therefore, Brazil should adopt the most rigorous and restrictive anti-deferral *best practices* identified by the BEPS Project Action 3. No more, no less. Brazil should establish an efficient rule to fight abuse, artificiality and unproductive capital accrued abroad. In fact, it may even establish an enhanced version of the system that combines the best features of the American rule with the best characteristics of the German's. It will certainly curb abuse and artificialities, as well as the unreasonable income accrued abroad. Nevertheless, it should establish a rule that does not discourage investment and reinvestment in foreign operations, bringing the punitive rule released in 2001 to an end. The age of international transparency and cooperation resulting from the BEPS Project enables the Brazilian system to evolve.

Finally, Action 12 brings a compilation of the best practices of the Mandatory Disclosure Rules. Certainly, such common practices are part of a broader policy, which emphasises cooperation and the building of trust in the tax authority-payer relation. Regulatory environments more sophisticated in the prevention and resolution of disputes, where for examples, administrative tax transaction practices are common.

The OECD report on cooperative tax compliance (Cooperative Compliance)[61] provides a good example of this environment, which has materialised in several countries (e.g. Horizontal Monitoring in Holland, Enhanced Relationships in the United Kingdom and Compliance Assurance Process or CAP in the USA). The American Internal Revenue Service or IRS for instance, keeps an independent ombudsman department (Taxpayer Advocate Service), whose leader has the status of deputy-secretary and reports directly to the legislative branch, assessing the quality of IRS' services and governance, also rendering relevant service to taxpayers.

These are more evolved and distinguished environments than the ones found in Brazil. Publicising uncertain positions, even in these countries, tends to be optional and/or result in real relevant advantages for taxpayers, including the possibility of more rational and efficient ***tax transactions*** by both parties in relation to what was seen in Brazil in REFIS' (tax recovery programme) different editions.

In the rule of law, uncertain positions are uncertain for both parties, the taxpayer and the tax authority. The intended tax credit may be illegitimate, or maybe the taxpayer's position is illegitimate. Both parties run risks and are subject to this uncertainty, which is the result of how the law is interpreted and increases its role of qualifying facts and procedural aspects. Both parties spend significant resources in order to get involved in litigation. In other words, the economic value of the dispute is uncertain for both parties, often situated between each party's intentions. Litigation costs are high all round. Therefore, when they are negotiating the principal value of a tax credit lower than what is intended by the tax authority, compound interest[62], but without incurring fines, usually there is no economic loss for any of the parties, the taxpayer of tax authority. It is in this type of environment that the best publicising practices for uncertain positions compiled by BEPS Project Action 12 take place.

Cooperative compliance programmes have had excellent results for the countries that implemented them. In fact, in evolved countries, transaction is critical to these programmes (for example, this is very important in Japan). Despite there being no transaction to reduce the principal value, it is common for uncertain positions to be publicised abroad in the context of cooperative compliance programmes, which eliminate fines to encourage tax authority-taxpayer cooperation.

61 *See* OCDE, ***Co-operative Compliance: A Framework: From Enhanced Relationship to Co-operative Compliance*** *Vide também* Owens (2013), *See also* Owens (2013), *Op. cit n. 32., and* Owens e Tavares, *Op. cit.* n. 11.

62 Compound interest, not linear.

In Brazil, even the *voluntary disclosure* institute is the object of litigation. Although it is probable that taxpayers may have to pay an up to 20 percent fine, as understood by the National Treasury Attorney's Office (official opinion PGFN/CAT 1,347/2001)[63],this has not been pacified in relation to the Secretariat of the Federal Revenue (RFB). Many of the *uncertain positions* which would be the object of declarations of the BEPS Project Action 12 are seen by RFB as abusive planning and usually incurs a 150 percent fine on the outstanding tax. However, in several cases where legal action was taken, such positions were considered legitimate by the Ministry of Finance's Administrative Council of Fiscal Resources (CARF) and usually, the 150 percent fine does not prevail, but the 75 percent penalty on the tax owed[64], This is because in many cases, intention (fraud or sham) is not recognised in transparent operations, of complex interpretation and susceptible to justified controversy.

Despite these circumstances in Brazilian administrative litigation practices, at the level of the a *Programme for Reduction of Tax Litigation (PRORELIT)* ,implemented by Provisional Measure 686/15 and the *Statement of Relevant Operations Information* RFB tried to implement what would have been Brazil's first measure aimed at implementing the BEPS Project. The intention behind the implementation of BEPS Project results and converging international standards is indeed laudable. In addition, it is understandable that RFB sees the possibility of paying a fine of 20 percent on the value owned, in case of relevant operations being validated by the tax authority, as a benefit for taxpayers, after all, it would mean a regime equivalent to voluntary disclosure. However, it is also understandable that RFB sees as possible the incurring of the same 150 percent fine on non-declared operations (which would qualify as intentional omission).

Nevertheless, as a result of the law that governs both types of fines, the measure did not bring any advantageous prospects for taxpayers. Contrary to RFB's goal, this would not result in a reduction in litigation. It would actually mean the opposite, with lawsuits being filed to determine the mandatory aspect of the declaration incidence of the 150 percent fine, as well as in relation to the legitimacy of the 20 percent fine comparing it to the voluntary disclosure institute.

Therefore, recommendations made for Brazil in relation to Action 12, is for the country to adopt the best practices in Cooperative Tax Compliance in full and in this context establish:

(a) The option to buy into the new *Cooperative Tax Compliance (CTC)* programme aimed at the biggest taxpayers, which will be incorporated to PRORELIT and will qualify taxpayers in relation to certain advantages determined by law, to the extent that it will not allow for future buy-in to programmes for the reduction of tax litigation, which imply in the reduction of tax liabilities (e.g. future non-eligibility to REFIS). For those opting for the CCT, impose a mandatory Uncertain Tax Position Statement, as referred by Action 12 and provide a non-exhaustive list of examples of relevant operations, allowing taxpayers to inform other relevant operations and uncertain positions;

(b) Grant to those permanently enrolled in the *CCT* the ***non-incurrence of fines*** for operations declared timely (e.g. in the declaration of the first calendar-year where fiscal effects were in force) and establish the charging of compound interest, based on SELIC (Brazil's base interest rate) for cases when such charge is considered legitimate, after the taxpayer has had the chance to ample defence through administrative-fiscal action at CARF;

(c) Establish a transaction system that allows for the reduction of litigation, taking into consideration the probability of success by taxpayers in administrative disputes;

(d) Establish a mutually binding consultation system (including in transfer pricing matters, i.e. APAs) for taxpayers taking part in the CCT, as well as increase access to these taxpayers' cases, which were the object of consultation in DTAA's MAP procedures.

63 *See* Conde, H.P., ***Denúncia Espontânea em sede de Compensação***, *in Munhoz, F., Assis, J., Munhoz, R. E Tavares, R.J.S. (coords.), ,* ***Jurisprudência Administrativa Tributária Federal – Estudos Técnicos de Acórdãos do CARF***, Fiscosoft/EY/ThomsonReuters (2014).

64 *See* Tavares, R.J.S., ***Multa Qualificada – Fraude e Simulação***, *and* Villas, M., ***Multa Qualificada por Ocorrência de Fraude***, *in* Munhoz, Assis, Munhoz e Tavares, *Op. cit. n. 61 supra*

International Tax Policy:
OECD, BEPS and G20 –
Implications for Brazil?

4

CONCLUSION

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IN THE AFTER BEPS AGE, countries try to redefine their position in Global Value Chains (GVCs) through a new international tax standard system in a coherent manner, with the aim of climbing on these chains to capture more wealth. This clash will affect the competitiveness of multinational companies and consequently, different countries' capital markets. It will also influence the location of technological advances, geographic distribution of productivity gains and *human capital* development and thus, will determine each nations' growth and prosperity.

Adopting new stricter standards than the ones previously in place consistently and coherently will allow each country to curb abuse in the same extent as its competitors – which allows for a level playing field. This measure of anti-abuse standard neutrality between countries that are big producing and consumer markets is critical to make competitiveness among them viable, as they need to protect their tax base without sacrificing their economic efficiency and social well-being. Being selective and not adopting the whole set of anti-abuse measures would not solve the BEPS problem. On the other hand, being inconsistent and keeping unilateral anti-abuse measures, stricter than the international standard, would lead to equally serious economic distortions by reducing insertion in GVCs and burdening foreign investment. Indeed, it is this competitive setting and the prospect of international balance that should guide Brazil's international tax policy.

The new international system emerging from the BEPS Project presents itself as a viable alternative for Brazil. The new rules and practices will be used in a transparent environment in global value chains and multinational companies. They will also be of great service for the cooperation between tax authorities throughout the world, particularly those that are part of a wide ranging treaty network.

Increasing the treaty network and converging with the new standards with sovereignty and aplomb , using international best practices, in cooperation with OECD and in tune with fiscal policy options applied by big emerging economies (like India), ***(is the only way for Brazil to not incur any damages (but gains).*** In addition, it will protect the National Treasury and Brazilian investment abroad, allowing the country to insert itself in global value chains, adding to foreign investment in Brazil.

On the other hand, if Brazil continues to keep a limited network of treaties, not taking up the OECD space accessible to it, still diverging from the world standard tax rules established and enhanced through the BEPS Project, the National Treasury and industry will incur substantial damages.

The present study presented the following suggestions for converging rules and policies for Brazil:

(a) increase its DTAA network *inimum standardsresulting from Action 6, as well as emphasising a sound version of the LOB clause in its treaties and oversight activities;*

(b) Start using the *Permanent Establishment,* iconcept, utilising the *minimum standards* of Action 7 assertively and fully exercising its tax jurisdiction on foreign investment in Brazil, in a coherent and consistent manner with other G20 members (drawing away from the excessive use of tax retention at the source, eliminating the taxation of technical and administrative services that do not represent abuse or artificiality);

(c) Start using Mutual Agreement Procedures (MAP) when dealing with other tax authorities, complying with *minimum standards* din Action 14 in order to avoid the improper proliferation of permanent establishments of Brazilian companies abroad and allocation of profits to such presumed establishments, including the use of international arbitration as part of MAP;

(d) ***Only if all minimum standards above described are adopted,*** adopt Action 13's minimum standard, editing accessory obligation that will allow it to collect the Global Master File and CbCR of Brazilian transnational companies, as well as sharing information with foreign tax authorities. As a matching action, Brazil may use the same types of information to better oversee foreign capital and ensure the appropriate characterisation of permanent establishments in Brazil of foreign exporters and multinationals, which have access to the Brazilian market;

(e) Restore and widen technology innovation incentives, allowing for the expenditure and calculation of said incentive to be consolidated in a period of up to five years (and not only for each separate year), not limiting the deduction based on taxable income (with the possibility of registering tax loss) – by definition, this system would be strictly compatible with Action 5's 'modified nexus' *minimum standard*;

(f) Favour the increase of the DTAA network by not imposing income tax on royalties as per terms in Article 12 of the OECD Model Convention, even if keeping the *Contribution for Intervention in the Economic Domain (CIDE)* which is incurred on royalties only as a specific anti-abuse rule (similar to 'Diverted Profits Tax' in the United Kingdom and Australia, related to BEPS Project Action 1). The CIDE tax rate would be increased from 10 to 15 percent, but enforceable only in cases when the tax incidence on profits originating from royalty related revenues would be effectively lower than 15 percent, or over the limits imposed by the new Action 5 minimum standard. This would be easily verified through information exchange procedures, particularly from CbCRs abroad resulting from Action 13.

(g) Faced with the new sounder system resulting from BEPS Project's Actions 8, 9 and 10, as well as good practices employed by other G20 countries that cooperate with Brazil (like India and China), and considering the transparency age resulting from Action 13 and the better capacity-building of Brazil's Secretariat of the Federal Revenue (which has significantly evolved in relation to human and material resources since the creation of the Brazilian methods), converging with the international system in transfer pricing matters starts being viable and interesting for Brazil. The experience acquired by Brazil with methods using fixed profit margins established by law, very administratively efficient and not harmful in some cases, would be very much useful: *All fixed margin methods would remain in force, but would start being optional (safe harbours), solution justified by administrative efficiency.* However, all other methods recommended by OECD and the UN, as per terms in OECD Guidelines and the UN Manual, would be incorporated to the national legislation. Through international cooperation (including through bilateral or multilateral APAs) and joint international oversight, effectively using information from Master Files, Local Files and CbCRs, Brazil's Secretariat of the Federal revenue would be able to manage this new *hybrid*, system, which brings together the Brazilian experience with the best international standards.

(h) Review its interest deductibility rules in financial instruments, which have their legal nature of debt in Brazilian law, being able to qualify as equity instruments abroad (e.g. Profit Sharing Debentures or Convertible DPLs), creating a specific anti-abuse rule, in terms of Action 2 (linking rule) [65] similar to the top withholding tax on remittances to tax havens; **the new rule will allow Brazil to ban the deduction of financial expenses in these hybrid instruments;**

65 Brazil would use international cooperation instruments, like the exchange of information with foreign tax authorities to identify cases when terms in Action are not being complied with.

(i) Reformulate JCP, so that it may eliminate tax of interest assumption on share capital and accrued income that remain reinvested, instead of payment made directly to partners.

(j) Reduce nominal corporate tax from 34 to 23 percent and increase JCP's deductibility, allowing for interest rates equivalent to Brazil's sovereign risk to be deducted in its national currency instruments (still lower than interest and negative exchange variation resulting from taxpayers' debt);

(k) Establish withholding income tax on dividends at a 20 percent rate and present a new Brazilian ***DTAA Model*** with this rate reduced to 5 percent, motivating the renegotiation of existing treaties to adapt them to the post-BEPS anti-abuse standard and increase Brazil's DTAA network;

(l) Adopt Action 4's recommendation and establish rule that limits the deduction of interest to 30 percent of EBITDA for intragroup financing. This rule should come hand in hand with the conversion of current undercapitalisation rules in ***safe harbors***, optional simplified rules that allow for the level of debt or interest deduction to be supported by an economic study, as per OECD transfer pricing guidelines;

(m) Establish withholding income tax on interest at a rate of 20 percent and present the new Brazilian ***DTAA Model*** with the rate reduced to 5 percent for long term financing (e.g. average amortisation period of over 5 years), with interest exemption in the case of infrastructure projects, so as to incentivise productive investment in Brazil. As in the case of dividends, this positioning will incentivise the renegotiation of existing treaties, in order to adapt them to the post-BEPS anti-abuse standard, as well as increasing Brazil's DTAA network.

(n) Adopt the most rigorous and restrictive anti-deferral best practices in the world, identified by the BEPS Project Action 3, as well as establish efficient rule to fight abuse, artificiality and accrued unproductive capital abroad. The suggestion is for an enhanced version of the system to be established, which combines the best features of the American rule with the best characteristics of the German rule. It will certainly curb abuse and artificialities, as well as the unreasonable income accrued abroad. Nevertheless, it should establish a rule that does not discourage investment and reinvestment in foreign operations, bringing the punitive rule released in 2001 to an end. The age of international transparency and cooperation resulting from the BEPS Project enables the Brazilian system to evolve.

(o) Adopt the best practices in Cooperative Tax Compliance in full in the following terms:

(i) Establish a new optional *Cooperative Tax Compliance (CCT)* programme aimed at the biggest taxpayers, which will be incorporated to PRORELIT and will qualify taxpayers in relation to certain advantages determined by law, to the extent that it will not allow for future buy-in to programmes for the reduction of tax litigation, which imply in the reduction of tax liabilities (e.g. future non-eligibility for REFIS); for those opting for the CCT, impose a mandatory Uncertain Tax Position Statement, as referred by Action 12 and provide a non-exhaustive list of examples of relevant operations (which must be informed), allowing taxpayers to inform other relevant operations and uncertain positions;

(ii) Grant to those permanently enrolled in the *CCT* the ***non-incurrence of fines*** for operations declared timely (e.g. in the declaration of the first calendar-year where fiscal effects were in force) and establish *the charging of compound interest* based on SELIC (Brazil's base interest rate) for cases when such charge is considered legitimate, after the taxpayer has had the chance to ample defence through administrative-fiscal action at CARF;

(iii) Establish a transaction system that allows for the reduction of litigation, taking into consideration the probability of success by taxpayers in administrative disputes;

(iv) Establish a mutually binding consultation system (including in transfer pricing matters, i.e. APAs) for taxpayers taking part in the CCT, as well as increase access to these taxpayers' cases, which were the object of consultation in DTAA's MAP procedures.

How to defend Brazil's interests? Through broad and sovereign convergence of new standards and best practices of the international tax system.