TERRITORIALITÄT UND PERSONALITÄT

FESTSCHRIFT FÜR MORIS LEHNER ZUM 70. GEBURTSTAG

herausgegeben von

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Moris Lehners großes wissensch
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Luís Eduardo Schoueri* / Mateus Calicchio Barbosa**

Territorial and Worldwide Taxation in Brazil

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"Can taxation according to a concept of international tax neutrality support endeavors to solve global financial crisis?" The question served as motto for a most comprehensive lecture *Moris Lehner* delivered in a Brazilian conference in May 2012. In the article then presented to – and later published by[1] – the Brazilian Academy of Constitutional Law, *Lehner* argued that "basic principles of international fiscal neutrality and fiscal competition may help meliorate the current global financial crisis". The author further considered that capital import neutrality would be ahead of a credit-based worldwide taxation in building a fair and sustainable tax competition that could accommodate unbalanced national budgets and overcome global financial crisis.

The audience could hardly be more updated by the speaker. By then, international tax literature had already noticed the growing number of jurisdictions favoring territorial taxation and thus exempting certain foreign-sourced income (mostly dividends)[2] in a movement referred to as a "potential revival" of territoriality[3]. Tax systems previously worldwide-oriented were assuming a "hybrid character", either taxing or exempting foreign-sourced gains depending on factors such as the nature of the relevant income (if passive or active) and the application of tax treaty reliefs[4]. Later on, the tax reform in the United States demonstrated how accurate *Lehner* was in his predictions. The

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1 The article is available at http://www.abdconst.com.br/revista5/impactoMoris.pdf

2 See *Romano*, European Taxation 1999, 256.

3 See *Avi-Yonah*, 'Back to the Future? The Potential Revival of Territoriality', University of Michigan Public Law Working Paper n. 14, july 2008.

4 See *Blanluet/Durand*, 'General Report', in *Cahiers de Droit Fiscal International - Key Practical Issues to Eliminate Double Taxation of Business Income*, v. 96b, International Fiscal Association, 2011, p. 21.

large shift toward territoriality under the Trump administration finally met what has for long been a Republican goal, and a territorial income tax was praised as the outcome of a pro-business environment and the rising pressure of tax competition from peer countries – the United Kingdom and Japan had made their own systems more territorial[5]. All in all, *Lehner* presented international tax *Zeitgeist* to his friends and colleagues in Brazil, and anticipated many of the dilemmas to come in the country.

Years passed since the lecture above; Brazilian commentators are aware of the so-called "trend toward the development of territorial tax systems", and attribute it to the "fierce competition among countries for tax revenues, especially following a prolonged global economic crisis that lasted almost a decade"[6]. It seems clear that the thoughts of Moris *Lehner* were in line with the local tax community, particularly in view of the strong historical roots of Brazilian tax system in territoriality. It is regrettable, however, that federal law does not share the same enthusiasm for capital import neutrality.

Indeed, the trend for tax territoriality has not been fully captured by policymakers in Brazil. Broad source rules and an already proven transfer pricing legislation in place to curb the risks of profit shifting were not enough to dismiss the Brazilian multinationals from worldwide taxation. As a result, local taxpayers still have to cope with income tax on a current basis in a world where participation exemption and the like deferral rules drive the race for cross-border investments. Despite the major loss in competitiveness, certain legal misconceptions, budgetary pressure and demagogic reasoning still prevent federal legislator from delivering Brazil back to its long territorial tradition.

This article draws on the movement from a longstanding and full-bodied territoriality in Brazil to a disquieting and unparalleled worldwide corporate income tax basis. Starting with the full territorial system, the article presents the first shot made at the worldwide taxation under individual income tax. This article then analyzes the much longer way to worldwide basis under the corporate taxation, presenting the main features that for long (and many of them, still) qualified the classical Brazilian territorial system. Next, this article considers the final shift toward capital export neutrality, since the first rehearsal to the hassle that followed the current regime. Finally, this article addresses the current crossroad between smart tax competition and budgetary constraints that is in the heart of the debate. Considered all the features and difficulties presented, it suggests the move back to territoriality as the way ahead in fixing Brazilian international tax policy.

I. From territoriality to worldwide taxation in Brazil

Following the tradition in Latin America, Brazil has historically limited the tax levy to income sourced in the country. Gains earned abroad by resident taxpayers were simply exempted from income tax in Brazil. In 1926, Decree 17,390 established the

5 See *Shaviro*, Fixing U.S. International Taxation, 2014, p. 3.
6 See *Tomazela Santos*, Tax Notes International 2018, 925.

individual income tax ("IIT") solely on the income "owned in national territory, due to activities wholly or partly carried inside the country" (article 1). In the same decree, the corporate income tax ("CIT") was also shaped in a territorial fashion: if income was "produced partly inside and partly outside the country", the tax would "only be levied on the part derived from national sources" (article 38).

In brief, the territorial system above exempted the foreign source income from both the IIT and CIT. Years later, the legal regime of those two taxes would eventually turn to a credit-based worldwide income tax system. If the outcome was the same for both taxes, the timing and misadventures of the shifting were different for each of them. For the IIT, the worldwide basis came surprisingly early, but its practical implementation was retarded by the tax administration itself. For the CIT, the worldwide basis came late, but steady, ready and unparalleled with the practice of other jurisdictions. The next sections address this movement in specific.

1. IIT: a first shot at worldwide tax basis

The alignment between the IIT and CIT for a territorial levy would cease in 1939. That year, Decree 1,168 established an "additional progressive tax" on the "global income of individuals", including all income "belonging to taxpayers resident or domiciled in the country, whatever its origin and the circumstance of its source" (article 17). In 1942, the Decree 4,178 then classified under "Schedule F the income produced abroad, whatever its nature" (article 8). Early in time, a worldwide basis was established in Brazil for the income earned by individuals.

Its practical implementation, however, was uneasy. In 1939, Brazilian literature already recognized that "several countries tax the income earned from foreign sources by its resident individuals" given the "personal nature" of the IIT, but also posed the question about the convenience of the reform: "was the innovation a good one?"[7]. If the "income tax administration in Brazil" was "far from perfection", then how to "manage taxation of income from foreign sources, which are not obliged to report it?". The criticism as such was afraid that the global IIT would only be collected by a "naïve or good-willing taxpayer who wants to collect it", whereas the "smart and criminal one will not pay it, and the tax authority will not have the means to enforce the law". This would cause the "discredit of the tax authority" and a "serious injustice" vis-a-vis the "taxpayer in good faith", who will either "violate rules of tax collection against her conscious" or damage herself "by paying a tax that others do not pay, with no further consequences from the tax authority". This state of affairs would make it arguably better to maintain the previous territorial system, in a way that "the honest citizen is exempted from a wicked payment that is only demanded from her conscience".

Truly unfriendly to the worldwide system then enacted, the criticism above suggested that "literature could well distinguish, in the income produced abroad, the part that is remitted to Brazil, i.e. is here owned and consumed", and the other part that, "although belonging to a resident in Brazil, is not eventually used here, but kept in deposit

7 See *Resende*, Manual Prático do Imposto de Renda, 2nd ed. 1939, pp. 4-5.

abroad or employed there". The discrimination proposed would allow one to argue that the IIT should "only be levied on the first part, i.e. the amount consumed or owned in Brazil", even though the said "generic wording" of the 1939 Decree would hardly encompass any such interpretation.

The most unclear legal basis for the reasoning above did not dissuade administrative tax courts to uphold the position that IIT would only cover "income effectively transferred to the country, and not simply accrued abroad"[8]. The tax administration followed the literature above and resorted to the general regulation of 1926 – which mentioned income "owned" in the national territory – to reject IIT on gains that, although already accrued abroad, were not received in Brazil by the resident taxpayer. The overall result was similar to the English "remittance basis" that for long ruled the worldwide income taxation within the British Empire[9].

The creative argumentation allowed territoriality to somehow survive the 1939 Decree and its new basis for the IIT. It took decades for the worldwide system to overcome the restriction imposed by the tax administration itself, unexpectedly favoring the taxpayers. However early in the tax system, this half-baked worldwide basis did not provide for tools characteristic to regimes of this kind. Indeed, legislation shifted the tax basis to the worldwide system, but did not provide for a credit method, neither full nor ordinary. After all, the so-called "remittance basis" construed by the tax administration operated as a deduction method, thus already mitigating double taxation that any credit method would envisage to eliminate.

Law 4,862 would only establish the credit method for the IIT in 1965, possibly together with the practical enforcement of the worldwide tax basis. Law authorized the resident individuals to "deduct from the progressive tax" the "amount equivalent to the income tax charged by the nation of origin of the relevant income", always conditioned to the "reciprocity of treatment as regards income produced in Brazil" (article 5). Whereas it resembled a full credit, the method was limited to ordinary in the following year: as per Decree 58,400/66, the foreign income tax deducted could not "exceed the difference between the tax calculated without the addition of the relevant (foreign) income and the tax due with the addition of the said income" (article 98, paragraph 1).

The worldwide basis for the IIT was finally completed. By then, local literature found a certain "North American inspiration" in the rule enacted, even though it noted that the United States allowed the "offset of the tax paid abroad and the tax due in the U.S. irrespective of reciprocity"[10]. Also, at the time of the 1966 legislation, literature argued that the wording of the new credit rule – mentioning income "coming" from abroad – would mean the "income accrued abroad and transferred" to the country, thus keeping straight with "the old rule that our tax is only levied insofar as the income comes to the country". Commentators were not prepared to admit that the credit method could start "taxing foreign income of local residents". The old resistance to the

8 See *Bulhões Pedreira*, Impôsto de Renda, 1971, pp. 2-69.
9 See *Avery Jones*in John Tiley, Studies in the History of Tax Law, 2004, pp. 15-16.
10 See Escritório de Advocacia *Nabuco*, Jornal do Brasil, edition of 17-18 august 1969.

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71, pp. 2-69.
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worldwide tax basis was clear, even with its full provision for the IIT in the legal system. The resistance, though, did not prevail in time, and today individuals are taxed on a worldwide basis irrespective of repatriation, a foreign tax credit being granted upon reciprocity.

2. CIT: the long way to worldwide taxation

Completely oblivious of the innovations in the IIT, CIT remained formal and materially territorial. In 1942, the same decree that ruled the report of foreign income for the IIT purposes (above) maintained that the "legal entities, the results of which comes from activities carried partially inside and outside the country", should tax "only the part of the results derived from national sources" (article 35). Literature then had it clear that the CIT "only taxes the profits *sourced* in the country"[11]. Territoriality thus endured for resident companies, and foreign income, either derived by the parent or its subsidiaries abroad, was tax exempted in Brazil.

Concerns that for long motivated the major industrialized economies to shift toward a worldwide income basis were of secondary importance by that time in Brazil. As capital importer, efforts for capital export neutrality fell short of the tax agenda in the country. It was more pressing that inbound investments were subject to a single tax burden: that of the Source State, and nothing more. Congruent with the then intended capital import neutrality, the credit method was disregarded in favor of exemption: foreign income was relieved from tax in Brazil, *in totum*. The production of goods and services abroad by the resident company was not subject to CIT, even if the relevant income derived from the cession of its factors of production for their employment abroad (remunerated by the transferee in form of interest, royalties, or dividends paid)[12]. This broad exemption was compliant with the notion of source of production, which then guided the levy of CIT and required one to verify the link between the income and the place where the relevant activity was undertaken. Since produced elsewhere, the income above could not be taxed in Brazil.

The relief of foreign income as above was not seen as a benefit, but the reverse side of the capital import neutrality doctrine: if the Source State was the competent jurisdiction to tax the income produced therein, then income sourced abroad should not be taxed at all, since – solely – belonging to the jurisdiction of its Source State. Whereas the credit method opens room for taxation at the Residence State, exemption does nothing else than closing any venue for the like taxation. After all, the Source State is expected to *exhaust* taxation on income produced within its borders.

Fully aware of recommendations from capital import neutrality, Brazil duly employed its prerogatives as Source State, and vigorous withholding taxes were put in place on the income locally produced by non-resident taxpayers. In 1923, Lay 4,783 already set that "who pays income to persons resident outside the country is liable to the collection of the tax due by the latter" (article 3, paragraph 2). Without ascertaining the applicable

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11 See *Gomes de Sousa*, Pareceres 2 – Imposto de Renda, 1975, p. 50.
12 See *Xavier*, Direito Tributário Internacional do Brasil, 6th ed. 2004, pp. 435; 437.

rate, the legal provision was only made effective with Decree 19,550 of 1930, where it was clarified that "companies and individuals that pay income produced in the country to residents abroad are obliged to deduct 8% of the relevant amount upon remittance", and that "the levy shall charge the gross amounts" (chapter IV, session VII).

This broad withholding tax rule, covering all income produced in the country by non-resident taxpayers, would be excepted in the course of time, in most cases to encourage the acquisition of utilities strategical to the national economy. That is what happened with the "commissions paid by coffee exporters to their agents abroad" (Decree 5,844 of 1943, article 97), which were excepted from the "tax deduction" at source. The exemption was later extended to the "commissions paid by the national navigation companies to their agents abroad" (Decree 7,885 of 1945, article 1). Social concerns also grounded certain exceptions from source taxation. Under Law 4,862 of 1965, interest and commissions due to financial institutions and insurers abroad were exempted "when the relevant loan is contracted by the National Bank of Housing (...) to the benefit of entities integrating the financial system of housing, and is applied in financing of residential construction, either directly or through intermediation of professional unions" (article 26).

Whatever the motivation, exceptions from the withholding taxation would not be more than occasional. From the mid-1950s on, the apogee of the territorial system saw the main income streaming earned by non-residents – e.g. branch profits, dividends, interest and royalties – subject to tax rates equal to, or even above, 25% charged on a gross basis[13]. For instance, dividends and gains from the sale of immovable assets caused a 30% levy between 1963 and 1964. Branch profits were taxed at a 33% rate between 1965 and 1966. In the latter year, the withholding tax on royalties from exploitation of foreign movies went from 40% to 44%. It was evident that the Brazilian territorial system did not count with any additional taxation by the Residence State. Where the income locally produced was subject to a remarkable tax burden, it was natural that income sourced in the country would be taxed only in the country. As a necessary corollary of the territorial logic, the CIT exemption was consistent and well justified in Brazil.

Yet demonstrating the historic territorial inclination of the country, sturdy withholding taxation was also combined with broad source rules. Generally grounded on the source of production criterion above, the Brazilian income tax system eventually moved to a mere source of payment criterion for an important part of the income streaming derived by non-residents: services.

Similarly to what have been reported in the practice of countries like Chile, Colombia, the Czech Republic and Portugal[14], Brazilian Decree 1,418 of 1975 established taxation on services supplied by non-residents "regardless of the form of payment and of the

13 See Comissão de Reforma do Ministério da Fazenda, Manual do Impôsto de Renda na Fonte, 1966, *passim*.

14 See *Pickering*, 'General Report', Cahiers de Droit Fiscal International 2012 – Enterprise Services, v. 97a 2012, p. 31.

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place and date in which the transaction has been hired". It means that, for the purposes of withholding taxation in Brazil, it is not necessary to determine where the service was rendered (source of production), but is merely enough that the source of the relevant payment is located in the country. The 1975 Decree was enacted to reverse previous case law of the Supreme Court that denied the claim of authorities to tax income derived from activities undertaken abroad, even though the source of payment was located in Brazil[15]. Since 1975, it is settled that whenever a Brazilian resident pays a non-resident for services, taxation will be triggered, regardless of where the services were rendered. In terms of policy, this strictly territorial-based criterion is justified by the fact that local companies are usually allowed – via deduction – to reduce (local) tax base when paying consideration for the services supplied. If the relevant payment is deductible on the one hand, it seems reasonable that tax should be due on the other hand. Where the notion as such is not equally applied across all situations in Brazil (e.g. service expenses are not deductible by individuals, who are nevertheless required to collect tax at source), the source of payment was perceived a very practical tool for curtailing base erosion and enforcing territoriality, especially if the relevant services do not demand the supplier to be physically present in the country. Since foreign currency exchange is subject to a strict control by the Central Bank of Brazil, tax authorities found an efficient tool to make sure that every remittance of currency would (in principle) be subject to taxation, unless the source of payment would prove that this is not the case.

In this general context of deep territorial roots, it was not before the late 1980s that the government found it convenient to leave some room for capital export neutrality under the CIT. This first attempt to introduce worldwide taxation for the Brazilian companies is analyzed below.

3. A rehearsal for (broad) worldwide taxation under the CIT

In December 1987, Decree 2,397 established that "net results from hedge operations made at future exchange markets abroad" should be "included in the calculation of the corporate taxable income" (article 6). With a simple legal provision, the first exception to the territorial system under the CIT was addressed to resident companies involved in hedge operations elsewhere.

The rule was said by literature to cause an "open flank in the territoriality principle", given the "complaints of exporters that have to engage in hedge operations abroad to mitigate the risks of price variation, but were not allowed to recognize the economic result of this practice in Brazil"[16]. It was thus perceived that the legal provision intended to "encourage our exports": taxation of positive results from hedge operations abroad was only set as the reverse side of the recognition of losses from the relevant contracts. Congruent with the export-oriented purpose, the legal provision set that "if

15 See Supreme Court, Extraordinary Appeal 71.077, Reporting Justice *Gallotti*, Official Gazette of 26 march 1971.

16 See *Carrazza, Revista Dialética de Direito Tributário* 1997, 164.

the relevant operation does not qualify as hedge", but is rather intended to mere speculation, then "the profits obtained shall be taxed and the losses shall not be deducted".

Article 7 of the 1987 Decree, however, went further on the worldwide taxation and provided for a general worldwide tax basis. It stated that "the taxable base of resident companies shall include results obtained abroad, either directly or through branches, agencies and representations". In February 1988, the legal provision was amended by Decree 2,413 to include the "subsidiaries" among the investments abroad to be taxed in Brazil. The 1988 Decree only maintained the "results from the activities of sea and air navigation, and communication with other countries" away from the worldwide tax basis to come (article 8).

However late, the worldwide tax basis established between 1987 and 1988 for the CIT was thus remarkably broad. Not only income directly earned by the resident company and its branches abroad would be taxed in Brazil, but also the profits of subsidiaries incorporated elsewhere. The entities were separate and independent for the purposes of private law, but the corporate link between parent and subsidiary seemed enough for tax law to demonstrate the material nexus between the results of the latter and the Brazilian income tax, which would be charged regardless of any dividend distribution.

A regime as such surprised local scholars and practitioners. It was well known that the international experience had the taxation of foreign profits deferred to distribution, the only exception being abusive situations qualified under the CFC-type of rules. The rule in Brazil was considered bold, and literature soon pointed out the deviation of local law to practice of countries like the United States and United Kingdom. While those countries only taxed the results from "direct activities" by the resident company, it was noted that Brazil took a step further when including also the results of the "indirect activities", i.e. through subsidiaries, "similarly to the consolidated profit established in France, but that only applies exceptionally and upon request of the taxpayer"[17].

The 1987-1988 legal regime, however, never entered into force. A few months later, government itself withdrew the rules by Decree 2,429 of 1988, and the Income Tax Regulation of 1994 once more consolidated a territorial system for the CIT. The small number of Brazilian resident companies able to operate as multinationals at the time could not deny the fact Brazil remained a major capital importer. In the primary condition of State of Source, it did look reasonable that Brazil should abandon, still in the 1980s, its historical cause for capital import neutrality and the territorial tax system built thereof. In any case, a shift to the worldwide tax basis was foreshadowed, and the second half of the 1990s would bring the new tax basis for good.

17 See *Xavier*, Direito Tributário Internacional do Brasil – Tributação das Operações Internacionais, 4th ed. 1995, pp. 308-309.

4. Law 9,249/95: final shift to worldwide tax basis under CIT

The failure of the 1987-1988 regime above did not terminate worldwide income tax in Brazil. In 1995, the global trend towards the worldwide taxation once more reverberated in the country. That year, article 25 of Law 9,249 reestablished a worldwide tax basis for the CIT. The reasoning attached to the bill presented to the Congress claimed the will to "harmonize the tax treatment of income of legal entities with individuals, whose foreign income is already subject to tax". Government also claimed to be "combating the evasion and tax planning, since the current system – based on territoriality – allows companies to allocate profits to branches or subsidiaries in tax havens".

Law 9,249/95 was as broad as the previous regime described above. As per article 25, "profits, income and gains earned abroad shall be included in the corporate taxable basis". The wording as such was considered a "generic rule" by literature, which promptly understood that, under the scope of the worldwide tax basis, it was included the "income and gains that derive from the activities of the resident company (e.g. financial investments, commissions)" together with the "profits obtained by branches, and controlled or affiliate entities abroad"[18]. It was clear that the 1995 Law "taxes the income and capital gains directly produced abroad by the resident Brazilian company, as well as the profits indirectly produced abroad by the Brazilian resident company"[19]. In a time of international convergence for a worldwide tax basis, literature did not doubt that "taxation of foreign result by Brazil is naturally possible in view of the constitutional tax principle of universality": after all, the relevant "beneficiary of the income produced abroad is domiciled in Brazil, duly submitted to its laws and sovereignty"[20].

Also considered the international practice by the then, the only point of concern raised was the taxation of *profits* earned abroad by subsidiaries. Like the previous 1987-1988 regime, Law 9,249 did not focus on abusive situations. Different from the CFC-type of rules, the 1995 Law demanded the foreign profits to be included in the taxable basis of the Brazilian parent company as of December 31st of each and every year. In other words, foreign profits were invariably deemed available to the Brazilian parent on an annual term, and no distinction was made whatsoever as to the jurisdiction where the subsidiary was located (the "designated jurisdiction approach") nor to the nature of the income derived by the company (the "tainted income approach")[21].

The enormous deviation from the international standard spoke loud enough, and the tax administration itself took the initiative to fix the legal regime. After all, the very validity of the legal regime itself was at stake, since it violated the realization criterion

18 See *Costa* in de Oliveira Rocha, *Imposto de Renda – Alterações Fundamentais*, 2006, p. 12.
19 See *Martins de Andrade*, A Tributação Universal da Renda Empresarial, 2008, pp. 202-203.
20 See *de Brito Machado Segundo/Cavalcanti Ramos Machado* in da Silva Martins/Magalhães Peixoto (coord.), *Imposto sobre a Renda e Proventos de Qualquer Natureza - Questões Pontuais do Curso da APET*, 2006, p. 184.
21 See *Maisto/Pistone*, European Taxation 2008; *De Broe et. al.*, BfIT 2011, 375.

that guides the income taxation in Brazil. While some consider the adoption of such a principle for the taxation of wholly-owned foreign subsidiaries as "silly"[22], the realization doctrine was adopted by the Brazilian Tax Code for better and for worse. In Brazil as elsewhere, the criterion is considered to be linked to the constitutional ability to pay principle[23]. Income tax after an accrual basis is deemed unequal and a compromise of the taxpayers' property[24]. This was the context that encouraged Revenue Service itself to cautiously clarify in Ruling 38 of 1996 that the foreign profits should only be taxed in Brazil where made available to the Brazilian resident company (article 2).

Despite its meritorious intent, the administrative guidance could not overrule the legal regime: the legality principle required a statute of the same level to modify the 1995 Law. The issue soon reached the Congress, and in 1997 new legislation was enacted to safeguard the deferral. Law 9,532/97 specified situations where foreign profits would be deemed available to the Brazilian parent company which, despite some contention from taxpayers, largely met the requirements of the realization doctrine[25].

Through this compromise first achieved between the taxpayers and tax administration, and later endorsed by the legislator, Brazil finally entered the worldwide income basis in 1996 well aligned with the international standards. Not for long, though, as the next section demonstrates.

5. Provisional Measure 2,158/01: the worldwide tax basis hassle

Much to the dismay of Brazilian taxpayers, the budgetary concerns eventually broke the compromise above. In 2001, government launched itself into a radical change of terms, and a new attempt to tax undistributed profits of foreign subsidiaries was set in motion.

First, Complementary Law 104/01 amended the concept of taxable income at the Tax Code to specify that foreign profits shall be deemed available according to conditions and in the moment defined by ordinary law. Thereafter, Provisional Measure 2,158/01 set forth that "profits earned by a foreign controlled or affiliated entity shall be deemed available to the Brazilian controlling or affiliated entity on the date of the balance sheet in which they have been assessed" (article 74). Finally, Ruling 213/02 of the Revenue Service provided that, in order to comply with the new legislation, taxpayers should include any positive result from equity accounting adjustments of relevant investments abroad on their taxable base.

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22 See *Shaviro*, 'Columbia Law School/Davis Polk Panel on Corporate Inversions', in Start Making Sense Blog, available at http://danshaviro.blogspot.com
23 See *Polizelli*, O Princípio da Realização da Renda, 2012.
24 See *Zilveti* in Schoueri (coord.), Direito Tributário – Homenagem a Alcides Jorge Costa, 2003.
25 See *Rosanova Galhardo/Ney de Figueirêdo Lopes Jr.*, Journal of International Taxation 2007, p. 41.

Once more, the profits earned abroad by foreign subsidiaries were made automatically taxable in Brazil. In this second round, the criticisms grew much stronger in literature. It was stated that the 2001 tax regime was "illegal since violating the Tax Code, and also unconstitutional since far outside the federal jurisdiction to income taxation"[26]. Besides assuming as "available profits that are not and might never be available"[27], the regime set in 2001 was said to have been enacted in "unreflective"[28] and "disproportional" way, since "unnecessarily damaging the taxpayers" when reaching "companies incorporated both in tax havens and regular jurisdictions"[29]. The rule would violate the ability to pay requirement since demanding "income tax payment with any concrete sign of economic capacity"[30].

Litigation raged at federal courts between taxpayers and authorities, and the matter soon reached the Supreme Court. In a series of long-lasting and controversial judgments, the Court came to a most inconclusive decision[31]. Due to the diversity of opinions among the Justices, the outcome was (i) the constitutionality of the current taxation of profits earned by subsidiaries located in tax havens and (ii) the unconstitutionality of the rule to affiliate companies located outside tax havens. The decision was severely deceptive, both from legal and policy perspectives.

Despite the several arguments put forward by literature, the legal reasoning adopted by some Justices made it believe that the taxation of equity accounting adjustments by the Brazilian parent company would comply with the constitutional and legal concepts of ability to pay and realization.

The reasoning is flawed. The Justices did not *realize* that, although the criterion does not necessarily demand the foreign profits to be distributed to the parent, any changes to the investment account due to adjustments in equity are certainly not taxable once made on a merely accrual basis. For the realization requirement to be met, the positive equity adjustments should be distributed by the parent company to relevant shareholders, as it is exceptionally allowed by Brazilian corporate law. Insofar as equity adjustments are accrued but not distributed, the corporate legislation itself treats the relevant result as an "unrealized gain". Realization is therefore not in place to allow taxation of the accounting adjustment. The argument ignored that, for no other reason than complying with this notion, equity method adjustments are tax neutral for purposes of Brazilian income tax legislation since Decree 1,598 of 1977. Otherwise, multiple taxation of equity adjustments carried out in each and every tier of a holding structure after a single profit earned by the operating company could easily surpass the amount of the profit itself, implying a clear confiscation.

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26 See *Mariz de Oliveira Revista Fórum de Direito Tributário*, n. 4 2003, p. 33.
27 See *Ayres Barreto* in de Oliveira Rocha, Grandes Questões Atuais do Direito Tributário, v. 6, 2002, p. 341.
28 See *Seabra de Godoi* in de Oliveira Rocha, Grandes Questões Atuais do Direito Tributário, v. 6, 2002, p. 284.
29 See *Bianco*, Transparência Fiscal Internacional, 2007, pp. 82-83.
30 See *Ávila* in de Oliveira Rocha, Grandes Questões Atuais do Direito Tributário, v. 7, 2003, p. 239.
31 See Supreme Court, Judgments 2.588/DF, 611.586/PR and 541.090/SC, dated april 10, 2013.

From the policy perspective, the outcome of the decision was surprisingly silent with respect to the circumstance crucial to Brazilian multinationals: the subsidiaries located in regular tax jurisdictions, which remained taxed on a current basis in Brazil. If entities located in tax havens may be taxed under a CFC-type legislation, it is astonishing that a country intending to export its own capital believes it is authorized to currently tax the profits obtained abroad by subsidiaries through genuine economic activities carried out in heavy-tax jurisdictions. Since no other industrial and exporting economy establishes a similar taxation, the additional tax burden locally imposed on Brazilian subsidiaries abroad may eventually put Brazilian players out of the global competitive market. Since going against clear constitutional values, this effect of the 2001 Law over competition should deserve much more attention in the reasoning developed by the Justices.

6. The tax treaty conundrum

However misleading, the Revenue Service took advantage of the reasoning adopted by certain Justices in the decision above and attempted to override the application of tax treaties to the foreign profits of Brazilian subsidiaries abroad.

In Ruling 18 of 2013, the Revenue Service argued that Brazilian law "imposes tax on the income of the Brazilian shareholders, derived from their participation in companies located abroad. In other words, the internal law concerns Brazilian resident taxpayers, and does not violate the provisions brought by treaty on the taxation of profits".

The influence of the OECD's argument over the Revenue Service was unequivocal. The Ruling 18 went so far as to transcribe paragraph 14 of the 2010 Commentary on Article 7 as grounds for its rationale. Similar to the position adopted by the Organization as from 2003, tax authorities claimed that Article 7 would not prevent a Contracting State from taxing "the profits earned by shareholders themselves, despite the calculation of the taxable base with reference to the value of the profits earned by the company located in the other State". In brief, no contradiction between internal legislation and the treaty provision could be found.

Fortunately, a leading judgment at the Superior Court of Justice correctly dismissed the argument of tax authorities[32]. The Superior Court well recognized that the relevant law did not authorize the taxation of profits attributed to the Brazilian parent via equity adjustments. Instead, relevant rules were not aimed at profits both earned by and attributed to the foreign company. In the absence of any "full transparency" or "look through" approaches under Brazilian rules, the separate entity approach adopted made the application of Article 7 mandatory, thus preventing income taxation in Brazil if no permanent establishment of the foreign subsidiary is in place.

Moreover, the Superior Court also stated that accounting adjustments in equity would be tax neutral under Brazilian law in view of Decree 1,598/77. It was duly confirmed

32 See Superior Court of Justice, Appeal 1.325.709/RJ, dated april 24, 2014.

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that this provision on tax neutrality was not revoked by Law 9,249/95 and Provisional Measure 2,158/01.

7. Law 12,973/14: a (minor) step forward

Following the Supreme Court decision above on constitutionality of the 2001 regime, Law 12,973 was enacted in May 2014 to provide for a change in the taxation of the Brazilian multinationals. It adapted previous legislation to the conclusion obtained by the Supreme Court, and thus relieved the profits from affiliate companies in regular tax jurisdictions from taxation on a current basis in Brazil.

This legislation truly represented a step forward compared to previous law. For instance, until then not only did Brazil tax profits earned abroad immediately, but there was no right to offset foreign losses and gains. The new law allowed the companies to put all foreign results in one basket, provided that they were not in low-tax jurisdictions, thus allowing profits and losses to be offset. Under Law 12,973/14, the tax is also deferrable for up to 8 years (but provided that 12.5% of the amount due is immediately collected).

The current 2014 rule also somehow contemplated the importance of competitiveness. Until 2022, the Brazilian parent is allowed by Law 12.973/14 to claim a deemed-paid foreign tax credit equivalent to 9% of the foreign profit in addition to ordinary foreign tax credit. The mechanism can fully neutralize the Brazilian tax burden (34%) if CFCs are located in jurisdictions with income tax rate above 25%.

The 2014 Law, though, turned out to be only a minor step, both from a legal and from a policy perspective. As to the legal concepts employed, Law 12,973/14 refers to certain "adjustments in the investment value" as its subject matter. The wording is a clear attempt to circumvent the requirements of the realization criterion for taxation: if relevant rules concern Brazilian resident shareholders themselves and the profits they record in positive adjustments derived from the equity accounting method, then tax may naturally be due in Brazil without distribution of the foreign profits. At the same time, the legal wording rejects the separate entity approach and corresponding tax treaty limitations: after all, relevant profits would be attributed to the Brazilian parent company via the equity accounting, with no violation to Article 7.

Despite its tortuous and misleading language, Law 12,973/14 was not able to inaugurate a "full transparency" regime with the taxation of local profits computed by reference to the investment abroad. Taxpayers may rightfully argue that the tax neutrality of equity adjustments is untouched, and the scope of relevant rules remains one and only: profits earned by and attributed to foreign subsidiaries under genuine separate entity approach, now merely disclosed in the financial statements of the parent and likewise added in the calculation of the taxable profit. The litigation at courts will continue insofar as the Tax Code maintains the realization doctrine as criterion for income tax, and Law 12,973/14 observes the separate entity approach.

From the policy standpoint, Law 12,973/14 did not effectively depart from the previous capital export-oriented mindset. Brazil continues to tax the undistributed dividends as a rule, and any deferred tax as above is subject to an interest charge. Neither should the contribution of the deemed-paid foreign tax credit to the competitiveness of Brazilian multinationals be overstated. The mechanism is time-limited (2022) and selective: law itself lists the sectors entitled to it (construction, manufacture of foods and beverages), and the inclusion of any other sector is at the full discretion of the government, always provided that the inclusion "does not result in prejudice to investments in the country". An order (427/14) from the Ministry of Finance later granted the deemed-paid foreign tax credit mechanism to general manufacturing industry and mining. The government order demonstrates how discretionary the selection can be. Instead of a conscious and deliberate legal option for competitiveness, the mechanism rather indicates the strength of the lobby from certain sectors of the economy and its circumstances.

In brief, Law 12,973/14 shows that government itself, although aware of shortcomings associated with worldwide income taxation in Brazil, does not seem to really understand the significance of tax law in encouraging Brazilian multinationals to expand overseas. Instead of fixing the Brazilian international taxation in view of the current global trend, it launched the country into a crossroad between smart tax competition and budgetary concerns. In-between, the separate ways of capital import neutrality (territoriality) and capital export neutrality (worldwide taxation) got blurred.

II. Crossroad and the way ahead

Although Brazilian multinationals now fight to compete on equal footing with foreign companies and major global players, this long move in the direction of being a capital-exporting country has still not been consistently reflected in Brazilian law. While up to the 1980s Brazilian tax policy was fully consistent with a capital-importing country and territoriality was rigorously applied, the current legal position is the most unclear.

On the one hand, Brazil continues to follow a source approach to inbound investments, almost in disregard of the right of the State of Residence of foreign investors. The broad concept of source developed during the days of die-hard territoriality still survives. In the dawn of a digital era, this is very convenient for the tax administration, especially in view of the combination of a source of payment approach with rigid foreign exchange control exercised by the Central Bank. Brazilian taxation of services on a gross basis is a good example of how the country is willing to manage many of the dilemmas that now occupy European countries and the United States. However, while, in the past, this could be explained by the traditional Brazilian position in favor of territoriality, this clear choice for a certain policy is not true anymore.

On the other hand, Brazil taxes the income of Brazilian companies investing abroad, even if profits are not distributed. Deviating of any international practice to consider, this policy is not limited to passive income or low-tax jurisdictions. This may lead to

double taxation, even where a tax treaty is applicable. Where Brazil taxes undistributed profits, typically no tax credit is available because taxation in the source country would occur only upon the effective distribution of the dividends. If this policy is compared with that of most European countries, which adopt participation exemption, it is notable that even where dividends are distributed (which usually does not occur in the initial years due to the normal reinvestment needs), Brazilian multinational companies are still subject to a higher burden, as the country will tax the dividends, and usually the foreign tax credit is not enough to fully offset the residence tax.

Faced with this, some amazingly argue that Brazilian companies should not go abroad, because this would "export jobs" from the country. The argument is barely sustainable, since multinationals can increase the export revenue. Some politicians, however, seem to prefer a more demagogic way round. Similarly, the current worldwide tax rules are defended on the grounds that it would be unfair for Brazilian companies to profit abroad yet not pay taxes in the country. This completely ignores the fact the relevant company is paying taxes abroad, where it is on an equal footing with its direct competitors.

Where the defense of the unparalleled worldwide tax basis flirts with demagogy, facts demonstrate that all the hassle created by those rules may well have involved significant amounts of Brazilian monies, corroding the local investment climate. The alternative of leaving the country by means of corporate reorganizations is no longer a case for a mere theoretical exercise.

In particular, the absence of an exit tax coupled with the fact that the regime is not applicable to individual shareholders made the system rather vulnerable to inversions. Take the case of the InBev group, a major player in the beverage market. The corporate governance charter of the group shows that control is evenly split between the Brazilian and the Belgium stakeholders, likely as a result of the 2004 merger between Ambev and Interbrew. However, the main entity of the group (where the free-float is allocated) is resident in Belgium. All remaining corporate structure is located outside Brazil, where the main individual shareholders (Brazilians) would presumably reside. Regardless of the reasons for the merger and reorganization of Ambev in 2004, the company likely avoided much of the hassle described above – and still does (as individual shareholders are not included in the scope of the new regulation either). Also, major meat producer JBS, originally created and controlled in Brazil, has made it public that it entered into certain corporate reorganization that will move assets responsible for about 80% of its revenues to Ireland under a "JBS Foods International" holding structure[33].

33 See http://www.valor.com.br/agro/4558625/jbs-transfere-ativos-para-empresa-na-irlanda-que-abrira-capital-em-ny; https://exame.abril.com.br/negocios/irlanda-o-quase-paraiso-fiscal.

The Brazilian tax treatment of its own multinationals, if ever adopted elsewhere, is far abandoned by the industrial economies previously capital export-oriented, which have decided not to subject their companies to domestic taxation when they are attempting to open up new markets. When the winds of tax competition are blowing from a previous consensus on export neutrality to the capital import neutrality, the classical dichotomy between territoriality and worldwide taxation is still left open in Brazil. It is the perfect timing for the country to remember its historical income taxation roots and embrace its strong vocation to territoriality for good.

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II. Personalität als Status
1. Vielzahl der Statusverhältnisse
2. Personalität und Universalität
3. Personalität und Präzision in d
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III. Personalität in den Strukturen
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2. Entkoppelung von Personalität
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