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Brazil’s Approach Towards the BEPS Multilateral Convention

Ramon Tomazela (Mariz de Oliveira e Siqueira Campos Advogados) · Thursday, December 22nd, 2016

On 24 November 2016, the OECD released the Multilateral Convention designed for the implementation of tax treaty measures related to the Base Erosion and Profit Shifting (“BEPS”) Project. The Multilateral Convention is backed up by an Explanatory Statement, which clarifies the approach adopted to modify the provisions of existing bilateral tax treaties.

The Multilateral Convention will be open for signature by any country as from December 31, 2016, with a signing ceremony scheduled to take place in June 2017, in Paris.

The main objective of the Multilateral Convention is to update the tax treaty network in a rapid and coordinated manner, thus avoiding several rounds of burdensome bilateral negotiations between contracting states. Experience shows that several years (if not decades) would be required to renegotiate approximately 3,000 bilateral tax treaties for the inclusion of BEPS measures.[1]

The idea of developing a multilateral instrument to update the tax treaty network has been desired for a long time. The biggest challenge, perhaps, lay in the drafting of the provisions of the Multilateral Convention, which should reconcile BEPS measures of distinct statuses (best practices, minimum standards and reinforced standards) with the flexibility required to accommodate different tax policies of several countries.

In order to overcome this challenge, the Multilateral Convention used different types of clauses to modernize the tax treaty network in a feasible manner. The main solutions applied to provide the flexibility required by the parties, without introducing excessive complexity, were the following:

- The use of **alternative provisions** that allow contracting states to tailor their commitment with other countries.
- The inclusion of **opting-in and opting-out mechanisms**, which allow additional commitments or limitations to the effects of certain provisions.
- The introduction of a **notification system**, whereby countries should specifically indicate tax treaties and the respective provisions that will be amended or replaced.
- The use of **descriptive language in the provisions**, which replaces cross-references to specific articles and paragraphs of existing tax treaties that will interact with the BEPS measures.
- The inclusion of **compatibility clauses**, which expressly deals with the relationship between the Multilateral Convention and the existing provisions of bilateral tax treaties.

Overall, the Multilateral Convention will probably increase the complexity of interpreting modified

tax treaties, mainly to determine what is the wording and the scope of treaty provisions in force. Ideally, countries should produce consolidated versions of each tax treaty modified by the Multilateral Convention, in order to facilitate its application in practice.

Up to this point, the OECD reached expressive results, since over 100 countries have joined the initiative of the Multilateral Convention.

What remains to be seen is how certain countries, which follow very particular tax policies, will react to the new Multilateral Convention. This post covers possible responses that Brazil may adopt in the implementation of tax treaty measures related to actions 2, 6, 7 and 14 of the BEPS Project.

Action 2 – Hybrid Mismatches

With regard to the implementation of the recommendations outlined in the BEPS Action 2, the first measure introduced by the Multilateral Convention aims at preventing double non taxation obtained through fiscally transparent entities ("FTE"). Basically, this provision establishes that income earned through a FTE will only enjoy treaty benefits to the extent that the residence state treats the amount as income of its residents under its domestic law.

Brazil's initial approach would be to adopt this treaty provision, since it is designed to avoid double non-taxation and it is compatible with the Brazilian practice of treating all entities abroad as opaque for tax purposes.

The second measure proposed by the Multilateral Convention modifies the tiebreaker test for dual resident entities, requiring the competent authorities to determine the tax residence by mutual agreement procedure ("MAP"). Since Brazil does not adopt the place of effective management ("POEM") as the key tiebreaker test for entities in certain tax treaties,[2] submitting the case to the MAP, Brazil's initial approach would be to extend the MAP to all tax treaties.

Finally, the Multilateral Convention provides three alternative ways to address double non-taxation arising from the inclusion of the exemption method in tax treaties: (i) deny the exemption method to income that the tax treaty allows the other country to exempt or to tax at a reduced rate; (ii) restrict the exemption method with respect to dividends that are deductible in the source state; (iii) replace existing exemption methods by a full credit method.

Brazil only adopts the exemption method for dividends in the tax treaties signed with Austria, Argentina, Ecuador, Spain and India. Some of these tax treaties are exploited by taxpayers in international structures, in order to prevent the application of Brazilian CFC rules. For this reason, Brazil would be in favour of the adoption of measures to restrict these exemptions, thus opting for the full application of the credit method to relieve double taxation.

The problem is that, in several tax treaties signed by Brazil, the other contracting state adopts the exemption method for the elimination of double taxation. The exemption method may have played an important role in the negotiation of these tax treaties with developed countries, since this method does not affect tax incentives granted by developing countries. In fact, when the residence state applies the exemption method, it leaves to the source state the decision whether or not to tax the relevant income. This is the tax policy pursued by Brazil in its negotiations with developing countries, in which exemption, tax sparing and matching credit are common features.

It makes much more difficult to predict the Brazil's approach, since Article 5(9) of the Multilateral Convention provides that a country that does not choose to apply the full credit method may reserve the right not to permit the other country to apply the credit method. Therefore, Brazil may prefer to address a potential change to the credit method through bilateral negotiations.

Action 6 – Abuse of Tax Treaties

The minimum standard for protection against the abuse of tax treaties requires countries to implement: (i) a principal purpose test ("PPT"); (ii) a PPT provision and a simplified limitation on benefits ("LOB") provision; or (iii) a detailed LOB provision, supplemented by an anti-conduit rule. In addition, countries must include in the preamble of their tax treaties a statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or tax avoidance.

As the PPT is the only provision that satisfies the minimum standard on its own, the simplified LOB works as an optional provision. The adoption of a detailed LOB provision depends on bilateral negotiations, since it requires a level of customization incompatible with a multilateral instrument.

In general, the OECD argues that, when there are different possible ways to meet the minimum standard, countries are free to adopt the most convenient. The problem is that the alternative rules to address treaty abuse contained in the Multilateral Convention will rarely lead to the same result.

On one hand, LOB provisions consist in a series of objective tests, which must be satisfied by the taxpayer for obtaining treaty benefits. These tests focus on determining whether the taxpayer has a sufficient nexus to the residence state, without investigating the principal purpose of any arrangement or the real business reason that drives the taxpayer. On the other hand, the PPT is drafted as general anti-avoidance rule based on the principal purpose of transactions or arrangements, including treaty shopping. Therefore, it is highly unlikely that these alternative rules lead to the same result.

It is true that certain degree of flexibility in the implementation of the minimum standard is required, as these anti-abuse provisions need to be adapted to the specificities of each country and its respective tax treaty policy. Nevertheless, it is still awkward to try to achieve a minimum standard of protection against treaty shopping applying very different rules.

As the introduction of a PPT rule is the only approach that satisfies the minimum standard on its own, Brazil will probably choose this alternative to comply with Action 6 of the BEPS Project, based either on the openness and flexibility of a principal purpose test or on the past experience of the Brazilian administrative courts with the "business purpose doctrine". In fact, despite the United States and few countries with a favorable attitude towards LOB clauses, most countries seem likely to adopt the PPT.

However, from a theoretical perspective, the compatibility of a PPT clause with the Brazilian tax system is debatable among tax scholars.

In 2001, a general anti-avoidance rule ("GAAR") was introduced in the Article 116, sole paragraph, of the National Tax Code, according to which tax authorities may disregard transactions carried out with the purpose of concealing taxable events or of modifying the tax liability, in accordance with procedures to be established through ordinary law. Since then, the application of

the GAAR requires further regulation by an ordinary law, which must set conditions, criteria and procedures to be followed by the tax authorities.

Attempts to regulate the Brazilian GAAR have been repealed by the Brazilian National Congress. In fact, taking the entire existence of the Brazilian tax system into account, it is possible to say that domestic GAARs have been repealed by the Brazilian National Congress at least in four opportunities: (i) around 1966, when Article 74 of the project of the National Tax Code ("CTN") attempted to introduce the economic interpretation in the Brazilian tax system; (ii) in 2001, when the project of the Supplementary Law nº 104/2001 tried to pass a very broad GAAR, which has been amended and restricted by Brazilian congressmen; (iii) in 2002, at the time the Provisional Measure nº 66/2002 was approved without the anti-abuse provisions originally envisaged; and (iv) in 2015, when the Provisional Measure nº 685/2015 attempted to introduce a mandatory disclosure of tax planning in Brazil.[3]

Despite that, the Administrative Tax Appeals Council ("CARF") has been adopting the "business purpose doctrine" in the analysis of tax planning structures, even in the absence of sham, fraud or any other flaw into the act or legal transaction practiced by the taxpayer.

At the international level, Brazil has simplified anti-abuse rules in its tax treaties with Israel, Mexico, Peru, South-Africa, Trinidad Tobago and Turkey, which basically allow tax authorities to deny treaty benefits in situations of abuse.

As Brazil supports the position that tax treaties play an important role in attracting foreign direct investment ("FDI"), the adoption of LOB provisions seems very unlikely, since it would jeopardize genuine investments conducted through holding companies established in treaty countries. Holding companies would hardly satisfy one of the LOB tests ("stock exchange clause", "ownership and base erosion clause", "activity clause" or "derivative benefits clause"), in which event the treaty entitlement would become dependent on the discretionary relief of the tax authorities.

In this context, the PPT rule offers more flexibility to the tax administration, since it covers various forms of treaty abuse in a less complex and burdensome way. A holding company may satisfy a PPT rule when it is incorporated in a jurisdiction for valid business reasons, without the principal purpose of obtaining treaty benefits. As an example, a regional holding company that exercises substantive economic functions managing equity investments through its own personnel located in the residence state, using assets and assuming risks, may pass though the PPT test.

Therefore, when it comes to the Brazil's approach towards the Multilateral Convention, the introduction of PPT rules and the amendment of the preamble of the Brazilian tax treaties are expected outcomes.

Action 7 – Artificial Avoidance of PE status

The Multilateral Convention aims at amending the definition of permanent establishment in order to prevent the avoidance of the current threshold set forth in tax treaties through: (i) commissionaire arrangements and similar strategies; (ii) specific activity exemptions; and (ii) the splitting-up of contracts into multiple parts to avoid the time period required for specific projects.

The provisions addressing the PE concept constitute reinforced standards. Therefore, Brazil and other countries are not obliged to follow the proposals available in the Multilateral Convention.

Brazil does not use the concept of permanent establishment in its domestic law, generally opting for the collection of withholding income tax (WHT) on payments made to non-residents, sometimes even when this mechanism is not compatible with tax treaty obligations. Thus, even if Brazil agrees to amend its tax treaties based on the Multilateral Convention, the changes in the PE concept will probably not have significant effects within the country.

Action 14 – Dispute Resolution

The Multilateral Convention introduces a minimum standard for improving dispute resolution mechanisms in tax treaties. The rationale behind Action 14 is that the introduction of tax measures to tackle base erosion and profit shifting should not lead to unintended double taxation.

The mutual agreement procedure has been recently regulated, for the first time, in the Brazilian domestic law, with the edition of the Normative Ruling RFB nº 1.669, of 9 November 2016. In general, Brazil may adopt the provisions included in the Multilateral Convention in order to ensure that treaty-related disputes will be resolved in a timely and effective manner.

An interesting issue, from a Brazilian perspective, lies in the adoption of the MAP with respect to the economic double taxation derived from transfer pricing adjustments. As Brazilian domestic transfer pricing rules are primarily based on predetermined profit margins, with few exceptions, Brazil does not include Article 9(2) of the OECD MC in its tax treaties.

Under Action 14 of the BEPS Project, the inclusion of Article 9(2) of the OECD MC in existing tax treaties is only a best practice, for which reason Brazil is authorized to maintain its current practice against corresponding transfer pricing adjustments. However, the minimum standard of Action 14 requires Brazil to provide access to MAP in transfer pricing cases, even in the absence of a treaty provision based on Article 9(2) of the OECD MC.

In this regard, Article 5, paragraph 2, of the Normative Ruling RFB nº 1.669 already mentions advance pricing arrangements ("APA"), which suggests that Brazil will grant access to MAP in transfer pricing cases. What remains to be seen is whether Brazil will effectively apply corresponding adjustments to avoid economic double taxation. Since countries are only obliged to use their best efforts to resolve the situation of the taxpayer, Brazilian tax authorities may still refuse to grant tax relief in relation to transfer pricing cases.

This underscores the importance of mandatory binding arbitration, since it puts pressure on tax authorities to resolve treaty-related disputes before the arbitration. The problem is that, within the framework of the Multilateral Convention, the mandatory arbitration is intended to apply only to countries that explicitly choose to introduce this mechanism in their tax treaties.

The Multilateral Convention adopts, as a default rule, the so-called "baseball arbitration", also known as "final offer arbitration", in which each Contracting State should submit a position paper with a resolution to all unresolved issues and the arbitration panel should select one as its decision, without modification. Thus, the "baseball arbitration" limits the discretion of the arbitration panel, since it has to choose one of the position papers submitted by the countries.

Alternatively, the Multilateral Convention establishes that countries may reserve the right to introduce an arbitration clause based on the "independent opinion approach", in which the Contracting States will provide all relevant information to the arbitration panel, which will then decide the case based on domestic laws and tax treaty provisions applicable to the matter at hand.

In Brazil, the introduction of mandatory binding arbitration in tax treaties is a highly controversial topic. Brazilian tax authorities argue that arbitration is incompatible with the national tax system, based on “the principle of non-availability of the tax credit”, which implies that tax authorities may not dispose of the tax credit properly constituted in accordance with domestic tax laws. For this reason, Brazil has no arbitration clause in its tax treaties.

It is about time for Brazil to change its opinion against mandatory binding arbitration. When there is uncertainty and controversy about the interpretation of a treaty provision that restricts the right to tax of a contracting state, the very existence of the tax credit is no longer absolute and definite. If such is the case, “the principle of non-availability of the tax credit” does not apply and the mandatory binding arbitration is perfectly possible and even desirable.

However, from a practical standpoint, it is highly unlikely that Brazil changes its position at the signing of the Multilateral Convention. Therefore, the Multilateral Convention will probably improve the mutual agreement procedure in Brazil, but without the introduction of mandatory binding arbitration.

On these grounds, it is possible to conclude that the Multilateral Convention will have a significant impact on the international tax treaty network, especially when it comes to BEPS measures that require a minimum standard. These provisions will materially affect the entitlement to treaty benefits and cross-border tax planning, even in the perspective of countries like Brazil.

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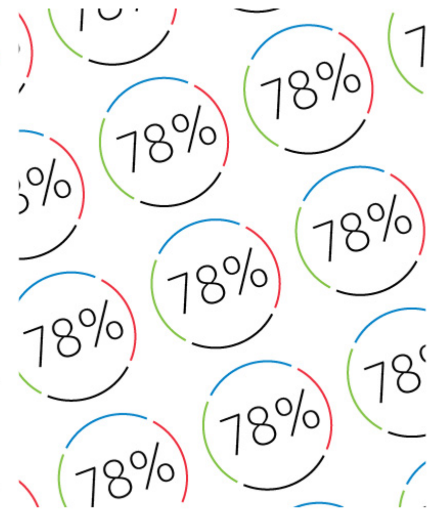

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