MERCOSUR, NAFTA, FTAA and Its Effects in Federal Taxation of International Transactions between the United States and Brazil: A Comparative Study

Marcos Valadeo
Nora Galeb Porto
MERCOSUR, NAFTA, FTAA AND ITS EFFECTS IN FEDERAL TAXATION OF INTERNATIONAL TRANSACTIONS BETWEEN THE UNITED STATES AND BRAZIL: A COMPARATIVE STUDY

Marcos Valadao* and Nara Galeb Porto*

I. INTRODUCTION

The purpose of this article is to analyze the effects that the most important trade and economic integration treaties, signed by the United States and Brazil, have on the taxation of international transactions involving both countries. It should be noted that both the United States and Brazil have state and local taxes, but only the federal government is entitled to tax international transactions. The article will focus on this federal taxation.

Generally, international trade involves tangible goods or services, although there are other international transactions that do not involve tangible goods or services, such as loans, patents, and intellectual property rights (intangible property). United States and Brazil are members of

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* L.L.M. (SMU), S.J.D. Candidate (SMU) (sponsored by CAPES/MEC-Brazil ), LL.M. (UnB, Brazil), LL.B. (UCG, Brazil), M.B.A. (IBMEC, Brazil), Research Fellow of the Law Institute of the Americas (SMU), Professional Editor to Law and Business Review of the Americas (SMU), Professor of Tax and Economic Law at the Catholic University of Brasilia (UCB, Brazil), and Tax Auditor (Special Class) of the Secretariat of the Federal Revenue (Brazil). The author may be contacted at marcosapv@uol.com.br or mvaladao@mail.smu.edu.

** L.L.M. (SMU), LL.B. (PUC/S.P. - Brazil), Licensed to practice law in Brazil and New York, Special Editor to Law and Business Review of the Americas (SMU, 2002). The author may be contacted at mailto:naraporto38@yahoo.com.


2. Internet transactions make the regulation and treatment of the international trade of intangible goods more peculiar and difficult. The peculiarities are more evident when the whole transaction occurs on the Internet. In this case, there is no direct control over the transaction by the authorities of the countries involved, unless the
the World Trade Organization (WTO), a global international organization that encompasses the most important agreements in the trade of goods and services.\(^3\) Both countries are also parties to regional agreements. For example, the United States is a party to the North America Free Trade Agreement (NAFTA),\(^4\) and Brazil is a party to the Common Market of the South (MERCOSUR).\(^5\) The Trade Unit of the Organization of the American State (OAS) has incorporated OAS into the process of commercial integration.\(^6\) The analysis of these commercial agreements will serve as grounds to discuss the Free Trade Area of Americas (FTAA)\(^7\) focusing mainly on the FTAA’s aspects related to tariffs and the taxation of international transactions. Brazil and the United States have signed bilateral treaties that affect the commerce between the countries, especially those related to air and maritime transportation.\(^8\) However, Brazil and the United States have not yet signed a general treaty to avoid double taxation and prevention of fiscal evasion with respect to income taxes.

This article’s goal is not to cover all the topics concerning the issue, which would result in a much longer analysis, but to provide: (1) an overview that can lead to deeper questions and (2) precise directions for more research in specific issues. In addition, it is important to present an overview of the Brazilian system for foreign corporations,\(^9\) discussing how they might operate in Brazil and endure Brazil’s tax consequences,\(^10\) considering that the readers of this paper may be familiar with the U.S. system and unfamiliar with the Brazilian system.

\(^3\) The WTO agreements encompass more than trade on goods and services. It also addresses other issues, such as intellectual property (TRIPS) and government procurement and investment measures (TRIMS). See John Jackson et al., Legal Problems of International Economic Relations: Cases, Materials and Text on the National and International Regulation of Transnational Economic Relations, 960-996, 1136-1146 (4th ed. 2002). See also infra Part IV.A.

\(^4\) See Ralph H. Folsom et al., NAFTA: A Problem-Oriented Coursebook (2000); infra Part IV.D.

\(^5\) Folsom et al., supra note 4, at 790, 804-807; infra Part IV.C.

\(^6\) See infra note 134.

\(^7\) See generally, Folsom et al., supra note 4, at 766-818. For online information about the FTAA, see Free Trade Area of the Americas, http://www.ftaa-alca.org/alca_e.asp (last visited Aug. 23, 2004); Foreign Trade Information System, http://www.sice.oas.org/ftaa_e.asp (last visited Aug. 23, 2004). See also infra Part IV.E.


\(^9\) See infra Part III.C.

\(^10\) Taxation on outbound transactions (consider U.S. companies doing business abroad) varies depending on the way that the company performs foreign activity. For example, it may be a wholly owned subsidiary, may be merely an agent selling products abroad, or may be an acquisition of shares of stock from a foreign company. See infra Part III.H.
International taxation involves specific aspects that possess significant relevance, such as the transfer pricing issue. Almost 90 percent of the trade between Brazil and the FTAA countries are intra-firm transactions, and thus, this paper addresses this issue more deeply.\(^{11}\)

The relations between Brazil and the United States may be regarded as the cornerstone of the whole FTAA process, considering: (1) the ongoing FTAA negotiations; (2) the fact that the United States is the largest economy of NAFTA and Brazil the largest economy of MERCOSUR; and (3) the integration agreements (one in the north and the other in the south) are the two largest economic blocks of the Americas. In addition, considering the importance of the taxation to economic integration processes, a comparative study of the taxation on international transactions between the two countries requires a greater level of necessity. The text will present more details of the Brazilian tax system rather than the U.S. tax system, based on the relative lack of knowledge of the Brazilian system.

II. INTERNATIONAL TRANSACTIONS AND TAXATION IN THE UNITED STATES

The United States is the most powerful economy in the world. As a result, its international transactions affect the entire world. Because the United States taxes the worldwide income of its citizens, alien individuals residing in the United States, and corporations organized under its laws or the law of its states (domestic corporation),\(^2\) how the transactions are taxed is a very important issue for foreign taxpayers conducting business and investing in the United States and for U.S. citizens, residents, and corporations engaging in business abroad. This section will focus first on U.S. income tax and then on duties and tariffs, paying special attention to the trade treaties.\(^{13}\)

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11. Transfer price transactions are intra-firm transfers, meaning trade between related parties, which may occur between the parent corporation and its affiliate in another country, or companies in different countries. Thus, they have a closed relationship, meaning that they are working together, which may provoke distortion in the transaction prices between them. See Ministerio da Fazenda, supra note 1. See also infra Parts II.A.1.B.i and III.C.2.

12. U.S. corporations are taxed as separate entities. This may lead to the double taxation of dividends (a corporate-level tax on corporate profits, followed by a shareholder-level tax on dividends). It is important to point out that President Bush's 2004 fiscal year revenue proposal would replace the classical system with an integrated system, allowing shareholders to exclude dividends to the extent taxed to the corporation. See Joint Committee on Taxation, 108th Cong., Description of Revenue Provisions Contained in the President's Fiscal 2004 Budget Proposal, (2002) available at http://www.house.gov/jct/s-7-03.pdf. The proposal was not approved. However, the U.S. Congress enacted the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRR Act), taxing "qualified divided income" at a 15% rate, the same applied to net capital gains. JGTRR Act, 31 I.R.C. § 1(h)(3) (2003).

13. For an overview on treaties that affect foreign investment in the United States, see Judson Wood Jr.'s article, Treaties and International Agreements Affecting Foreign Investments in the United States, in Doing Business in Texas: A Guide for Foreign Investors Doing Business in the Lone Star State 69, 75-76 (Larry B. Pascal ed., 1999); See also Catherine Brown & Christine Manolakas, Corporate
A. Taxation in the United States

1. Income Tax

As noted above, the United States taxes its citizens, residents, and domestic corporations on worldwide income. The relevant change in the system for taxing international income took place at the beginning of the twentieth century and involved the adoption of capital neutral economic theories and prevention of tax avoidance. Since that time, many countries have adopted this technique (worldwide income tax, mainly for enterprises), which strengthened the occurrence of double taxation. Double taxation occurs when the same income taxed by the country where a good is produced (source country) is also taxed in the country where the enterprise was founded or incorporated (domicile criterion). Because internal statutes and regulations by means of tax credits and deductions are not sufficient to avoid the problem, the solution to double taxation is to implement tax treaties.

Reorganizations and Treaty Relief from Double Taxation Within the NAFTA Block, 59 LA. L. REV. 253 (1998) (dealing with discrepancies of treatment between the relief from double taxation available to the three NAFTA members considering the current bilateral tax treaties, resulting in an uneven playing field for the NAFTA partners); Brian J. Arnold & Neil H. Harris, Colloquium on NAFTA and Tradition: NAFTA and the Taxation of Corporate Investment: A View From Within NAFTA, 49 TAX L. REV. 529 (1994); Malcolm Gammie, Colloquium on NAFTA and Tradition: The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement, 49 TAX L. REV. 615 (1994); John P. Steines, Jr., Colloquium on NAFTA and Tradition: Commentary: Income Tax Implications of Free Trade, 49 TAX L. REV. 675 (1994) (these three articles analyze aspects of NAFTA interference with income taxation).


15. “Many (perhaps most) countries tax residents and domestic corporations on worldwide income, but the United States is virtually unique in taxing citizens on worldwide income, even if they reside outside the United States for reasons wholly unrelated to taxes.” See BORIS I. BITTIKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS 3 (3d ed. 2001).


17. The Sixteenth Amendment, taking effect on February 25, 1913, shaped the U.S. regime for taxing international transactions by permitting Congress to tax income “from whatever source derived.” During the following years, Congress enacted statutes governing the issue, and the Revenue Act of 1918 allowed a U.S. citizen or resident of foreign countries to credit against U.S. income those taxes derived from income earned outside the United States. In 1928, the League of Nations issued the draftmodel bilateral income tax treaties for the reciprocal relief of double taxation of international income. Indeed, the fundamental structure for international taxation of income announced nearly seven decades ago in the 1928 League of Nations Model Treaty forms the common basis for more than twelve hundred bilateral tax treaties now in force throughout the world. Despite massive changes in the world economy in the last seventy years, the international tax regime formulated in the 1920s has survived remarkably intact.

The United States and Brazil have never signed a treaty to avoid double taxation, although past treaties regarding air and maritime transportation covered topics commonly addressed in the tax treaties entered into to avoid double taxation. These past treaties also address specific tax issues related to air and airmile transportation.

In addition to double taxation, given the expansion of enterprises abroad and the rise of enterprise networks, the so-called inter-company pricing problems, such as the problem of valuation of the international transactions between related companies, have also increased.18

The U.S. tax treatment of a multinational corporate group depends on the location of the group’s parent corporation, whether the parent corporation is domestic or foreign. Place of incorporation determines whether a corporation is deemed to be foreign or domestic for purposes of U.S. tax law. The U.S. treats the remaining corporations, those incorporated under the laws of foreign countries, as foreign.19

a. Inbound Transactions

When a foreign taxpayer conducts business or invests in the United States, it is called inbound transaction; the concept may also encompass services rendered in the United States that will be taxed as such.20 The investor may be a passive investor, buying securities or other types of assets in the U.S. market,21 or a direct investor, acquiring or leasing assets and trading and doing business in the United States.

i. Passive Investment

In the United States, nonresident aliens22 and foreign corporations23 are generally subject to a gross basis tax at a flat rate of 30 percent on interest, dividends, rents, royalties, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits, and income.24 Therefore, the United States does not tax their worldwide income. Generally, the per-

18. See infra Parts II.A.1.b.i. and III.C.2
20. If the source of income is the United States and is not effectively connected to U.S. trade or business, the income is taxed at 30% on the gross basis. I.R.C. §§ 871(a), 881 (b) (2003). Generally, however, a taxpayer rendering services in the United States is considered to be in a trade or business in the United States so that this income is taxable as effectively connected income (net basis taxation). Id. § 864(b)(1).
22. See I.R.C. § 7701(b) (2003) for the definitions of nonresident and resident alien. This is important because a resident alien will be always taxed on the worldwide income.
23. Id. §§ 871(a), 881(b) (2003).
24. Known as FDAP income (Fixed or Determinable Annual or Periodical income).
son making the payment pays the taxes by withholding.\textsuperscript{25} Treaties generally provide a reciprocal exemption or reduction in the applicable withholding rate.\textsuperscript{26} However, to avoid treaty shopping, the Internal Revenue Code (I.R.C.) limits the treaty benefits to parties that have signed the treaty.\textsuperscript{27}

\textit{ii. Direct Investment}

The United States taxes a nonresident alien engaged in a trade or business in the United States in the same way as it taxes a U.S. taxpayer on income that is effectively connected with the conduct of the trade or business.\textsuperscript{28} The United States taxes a foreign corporation (that is, those incorporated abroad) engaged in a trade or business in the United States similar to a domestic corporation with regard to income that is effectively connected with the conduct of the trade or business.\textsuperscript{29}

Therefore, the definitions of “trade or business within the United States” and “effectively connected income” are very important for tax purposes, because if a nonresident alien or foreign corporation is engaged in trade or business within the United States and has effectively connected income, the United States will tax his income on a net basis (progressive rates) and not on a gross basis.\textsuperscript{30}

With respect to foreign corporations, there is one more tax aspect that must be considered given its relevance to the United States: the branch profit tax under I.R.C. section 884. The aim of the branch profit tax is to burden a foreign corporation’s U.S. business profits with the same taxes, whether the business is done through a domestic subsidiary or an unincorporated branch. The domestic subsidiary is subject to the corporate tax in accordance with the net basis taxation and dividends to the foreign parent are taxed in accordance with the gross basis taxation. If a foreign operation operates as a branch, income effectively connected with the U.S. branch is taxed by the net basis taxation. However, profits of a U.S. branch are not subject to withholding when they are repatriated to the corporation’s foreign headquarters because this payment represents a tax credit.

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\textsuperscript{25} I.R.C. §§ 1441-1464 (2003).
\textsuperscript{26} Because the United States and Brazil have not signed such a treaty, the tax paid in the United States will be used as a tax credit in Brazil, but only to the limit allowed by Brazilian law, and vice versa. See Regulamento do Imposto de Renda—RIR/99, Decreto No. 3.000, de 26 de março de 1999, available at Ministerio de Fazenda, SRF, Regulamento do Imposto de Renda (Regulation of the Income Tax)—RIR/99, http://www.receita.fazenda.gov.br/Legislacao/RIR/default.htm (hereinafter Federal Decree 3.000-RIR/99) (addressing Brazilian individuals and companies). I.R.C. §§ 27, 901, 904, 960, 962, 1291(g), 1293(f) (2003) (addressing American individuals and companies).
\textsuperscript{28} I.R.C. §§ 1, 871(b) (2003).
\textsuperscript{29} Id. §§ 11, 882.
\textsuperscript{30} For a definition of “engaged in trade or business,” see id. § 864(b), and for a definition of “effectively connected income,” see id. § 864(c).
\end{flushleft}
corporate transfer and not a dividend. That reasoning provided the basis behind the U.S. Congress's enactment of the branch profit tax in 1986. The branch profit tax is generally a withholding tax on withdrawals from a U.S. branch.\(^3\)

The branch profits tax is an annual tax of 30 percent equivalent of the dividend equivalent amount. The branch profits tax is levied in addition to the tax on corporate income. The branch profits tax applies when a foreign corporation that makes a dividend distribution to its foreign shareholders does not owe any further tax.\(^3\)

Treaties generally provide a reciprocal exemption or reduction in the branch taxes. However, to avoid treaty shopping, the I.R.C. limits the treaty benefits only to parties that have signed the tax treaty.\(^3\)

The reasons for this limitation were described as follows:

Congress was . . . concerned that foreign investors resident in one country would attempt to use another country's tax treaty with the United States to avoid the branch profits tax and branch-level interest tax (i.e., they would treaty shop). In these cases, Congress believed such use of treaties to be improper. [Generally this is so] whether or not a third-country investor would have been entitled to treaty benefits had the investor made a direct U.S. investment since the United States is not certain, when an intervening entity in a second country is used to make an investment, if a residence country tax will be imposed on U.S. source income from the investment. The United States has particular reason to believe that there will be no residence country tax when a third-country investor routes U.S. investments through a low-tax jurisdiction. It was Congress' view that the United States should generally forego source basis taxation of dividends and interest only when residents of the treaty partner are taxed in the treaty country on this income. In cases of treaty shopping, then, Congress intended [§ 884] to override conflicting provisions in U.S. treaties.\(^3\)

Under the U.S. 1996 Model Tax Treaty,\(^3\) the limitation on treaty benefits to prevent treaty shopping is written in article 22.

b. Outbound Transactions

The term "outbound transactions" refers to U.S. residents, citizens, and corporations doing business and investing abroad.

Because the United States adopts a worldwide tax system, U.S. taxpayers doing business and investing abroad are affected by double taxation. In order to alleviate this double tax burden, the United States developed an internal mechanism called the Foreign Tax Credit. The United States

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31. Id. § 884.
32. For an introduction to this issue, see BITTKER & LOKKEN, supra note 15, at ¶ 67.8.
allows a credit to U.S. taxpayers against U.S. income taxes for income
taxes paid or incurred to foreign countries. But such a tax credit is sub-
ject to certain limitations and does not always alleviate double taxation.36

The profits earned by a domestic parent corporation from foreign oper-
ations conducted by foreign subsidiaries are generally subject to U.S. tax
only when the income is distributed as a dividend to the domestic corpo-
ration. Until such repatriation, the U.S. tax on such income is generally
deferred. However, an exception to the general rule eliminates the deferr-
al taxation. Certain anti-deferral regimes may cause the domestic parent
corporation to be taxed on a current basis in the United States with re-
spect to certain categories of passive or highly mobile income earned by
its foreign subsidiaries.37 Foreign tax credit is generally granted in order
to offset, in whole or in part, the U.S. tax owed on this foreign source
income. Bilateral income tax treaties are a way of resolving which coun-
try has the right under the treaty to tax the income in question.

In addition to double taxation, the domestic corporation and the
owned foreign subsidiaries abroad must address the issue of inter-com-
pany pricing. The domestic corporation and the foreign-owned subsidiar-
ies are submitted to transfer pricing rules mitigating the use of deferral
mechanisms. These rules are designed to avoid the transference of taxa-
ble income to the subsidiaries established in countries with lower tax
rates.

i. Transfer Pricing in the United States

Cross-border transfers of goods or services between commonly owned
or controlled entities are subject to an arm's length standard. The United
States, like many countries, is authorized to reallocate income and deduc-
tions between the parties if a transaction is determined not to have been
made at arm's length.38

In the United States, I.R.C. § 482 gives the Secretary of the Treasury
(or his delegate) discretion to allocate gross income, deductions, credits,
and other allowances among two or more organizations, trades, or busi-
nesses under common ownership or control whenever it determines that
this action is necessary to prevent tax evasion or to reflect the income of
such organizations, trades, or businesses.

The importance of this issue can be demonstrated by the proportional
amount of trade between related parties in relation to the overall trade;
maybe more than 25 percent of the overall trade in goods and services in
the world economy are intra-firm.39

36. Id. at 223-396.
37. See I.R.C. §§ 951-84 (2003), for controlled foreign corporations, and § 1291-98, for
passive foreign investment companies.
38. An arm's length standard means that related parties should engage in transactions
that are consistent with transactions that would have occurred between unrelated
parties under similar circumstances. Id. § 482.
39. Lorraine Eden states that perhaps half of all international trade in goods and ser-
vices in the world economy is now conducted through multi-national enterprises.
When two related parties are doing business, the final goal is the profit of the group, and not the profit of each one of its companies. In order to maximize the gains of the group, related companies may organize their transactions in such a manner that the profit is realized in a country with the lower income tax rate. For instance, suppose USCo, a U.S. corporation, has a wholly owned foreign subsidiary, BRCo, organized and operated in Brazil. USCo manufactures tractor parts and sells them to BRCo, which in turn sells the part to unrelated Brazilian purchasers. If tax rates in Brazil are lower than those in the United States, Brazil offers special tax incentives that are available for income earned in Brazil, or BRCo has large net operating losses, USCo and its subsidiary may want to structure transactions so that most or all of the combined profit of USCo and BRCo is isolated in BRCo. In the absence of transfer pricing rules, the tax savings achieved by manipulating prices can be significant.

In recent years, the United States enhanced reporting and documentation requirements and adopted a penalty regime for failure to report the documents. If an adjustment I.R.C. § 482 demonstrates a “substantial valuation misstatement,” a penalty equal to 20 percent of the adjustment is imposed, and the penalty rate doubles to 40 percent for a “gross valuation misstatement.”

Most bilateral income tax treaties contain a mutual agreement procedure, which allow the competent authorities of each of the contracting states to agree to resolve transfer-pricing differences. The United States and many of its treaty partners have adopted procedures that agree to control party transfer pricing in advance.

Manipulation of inter-company transfer prices by multinational corporations occurs within NAFTA and MERCOSUR, and, in the future, may occur within the FTAA. In these cases, the preferential rates applied
in the international trade of goods and services are added to the income tax benefits. This result shows that some harmonization of the transfer price rules is necessary. Indeed, harmonization of the transfer price methods within the free trade areas has been discussed for some time. The following analysis is focused only on NAFTA, but it can be expanded to the FTAA as well. According to one commentator:

Nevertheless, the treatment of transfers at arm's length is, at least in theory, a straightforward and unifying principle, which has been employed by the tax authorities of the Member States [NAFTA] for some time.

It seems likely, however, that the calculation of arm's length costs on an international basis will move to a type of hybrid between the current system of using comparables and the one in use by the United States and which has been proposed by the Organization for Economic Co-operation and Development (OECD). The adoption of the same transfer pricing rules among the Member States [NAFTA] would assist the coordination of cross-border activities. Canada and Mexico should consider adopting rules similar to either of those proposed by the OECD or, possibly, those currently used in the United States (despite the fact that these rules are dreaded by Canadian tax practitioners).\textsuperscript{44}

\textit{ii. Transfer Pricing Rules and Customs Rules}

The rules governing transfer pricing are different from the rules governing customs valuation (a very important issue in trade treaties, such as WTO, NAFTA, MERCOSUR and FTAA). The differences may pose a problem because of the conflicts that may arise. Multinationals face a dilemma when settling transfer price policies\textsuperscript{45} because the U.S. Customs Service also has authority to challenge and readjust transfer prices paid by U.S. entities to foreign related parties. The application of the rules differs because the Internal Revenue Service (I.R.S.) generally seeks to decrease the transfer prices paid in order to increase U.S. taxable income, while the Customs Service typically seeks to increase transfer prices paid to increase customs duties.\textsuperscript{46}

\textsuperscript{44} \textit{Id.} at 67-68.

\textsuperscript{45} See I.R.C. § 1059A (2003), which provides a ceiling rule to transfer prices related to customs valuation. The application of this disposition brings more uncertainty because the customs value is also based on methods having the arm's length principle as its grounds, and it may not be the actual value that the importer paid for the goods.

\textsuperscript{46} See Juan Martín Jovanovich, Customs Valuation and Transfer Pricing: Is It Possible to Harmonize Customs and Tax Rules? (2002) (the book addresses the issue of different treatment of custom and tax rules, and proposes harmonization); see also Marcos Valadao, Emerging Conflicts Between U.S. Income Tax and WTO Treaties (forthcoming) (the article analyzes the conflicts between U.S. income tax law and trade treaties, focusing mostly on those between the rules of transfer pricing and customs valuation and taxation of services and GATS).
2. Other Taxes

In addition to the income tax, companies pay another great federal government revenue-raiser called social security tax. The social security tax is a payroll tax levied on both employees and employers and is calculated as a percentage of salary income. Although most of this tax revenue is used to fund social security benefits, a portion of it is used to fund Medicare health benefits.

Other sources of internal revenue for the federal government include taxes on fuel, alcohol, tobacco, firearms, and estate and gift taxes levied on the transferor of significant wealth. In addition, each state in the United States has a broad range for taxation, and each state has its own particular tax system. These taxes are not relevant to the present analysis.

B. FOREIGN TRADE AND TARIFFS

Foreign trade has many restrictions that can take the form of quotas, licenses, and tariffs, as well as counter-trade and antidumping laws. Regarding tariffs, all articles imported from outside the United States are either subject to duty or exempted from duty as provided by the applicable tariff statute.\textsuperscript{47} The Harmonized Tariff System (HTS) is an international system for the standardized identification of goods. American tariffs are established in the Harmonized Tariff Schedule of the United States (HTSUS). However, trade treaties, such as the WTO General Agreement on Tariffs and Trade (GATT) and NAFTA, may modify the basic schedule and give some preference to tariffs, for example, the so-called Generalized System of Preferences (GSP) and Andean Trade Preferences. This structure creates a very complex system of tariffs.\textsuperscript{48}

\textsuperscript{47} Duty is a tax levied on imports. Tariffs are the lists of articles on which duty is imposed.

An overview of the history of U.S. customs duties should help explain import compliance. In 1789, in an effort to stave off bankruptcy, the fledgling U.S. government enacted tariff regulations and trade protection by imposing the Tariff Act of 1789. That Act imposed a general duty of 5 percent on all imported goods unless specifically excepted. The import of luxury articles and articles of industry would work to the detriment of manufacturing interests in the United States; thus, they carried higher ad valorem rates and specific duties. The Tariff Act of 1930 raised U.S. tariffs on more than 20,000 dutiable items to record levels and brought the U.S. tariff to the highest protective level in the history of the country. As a reaction to the Tariff Act of 1930, a number of foreign countries implemented retaliatory tariff acts. As a result, U.S. foreign trade suffered a sharp decline, thereby intensifying the Great Depression. Between 1934 and 1993, Congress passed or adopted a variety of legislation to address import issues. Among the more important enactments were those involving the authorization of: (1) bilateral agreements for reciprocal tariff reductions; (2) unilateral trade retaliation instruments; (3) presidential authority for trade preferences; and (4) export restraint agreements. In 1993, U.S. import laws were dramatically changed with the passage of the North American Free Trade Agreement (NAFTA). Jo Anne Hagen, An Overview of U.S. Import/Export Regulations—Part II, Imports, 32 Colo. Law., Aug. 2003, at 47, 48.

\textsuperscript{48} See Jackson et al., supra note 3, at 339-43; Another concern is rules of origin or standards of preference because only the goods produced or deemed to be pro-
In addition, trade treaties also deal with other issues like the so-called technical and non-technical barriers to trade. The most important multilateral trade treaties for the United States are the GATT, NAFTA, and the future FTAA. The United States also has bilateral trade treaties with other countries.49

III. INTERNATIONAL TRANSACTIONS AND TAXATION IN BRAZIL

A. Taxation in Brazil

In Brazil, the National Tax System is based on the Federal Constitution,50 and the general tax rules are established by the National Tax Code (CTN).51 Brazil is a federation of three levels of government, the Federal Union, the States, and the local government, called Municípios. CTN rules apply to the Federal Union, the States, the local governments, and the Federal District. Each federal entity has its own tax law and regulations.52 The Brazilian Constitution details the tax species that each level of the Federation may impose. Some types of taxation may not be imposed by the Federal Union, States, and local government, as may happen in the United States with the income tax.

The Brazilian tax burden is high. In the last three years, the tax rate was above 30 percent.53 The taxes are classified by entity of the Federation. The Federal Union levies taxes on income, industrial production (IPI),54 import and export of goods (duties), rural land, financial market, insurance, currency exchange, and money market. States levy taxes on production and circulation of goods and services (ICMS), estates, and

49. These treaties are generally formed on the grounds of article XXIV of the GATT 1994 and article V of the GATT—General Agreement on Trade in Services Multilateral Trade Negotiations (Uruguay Round): General Agreement on Trade in Services, 33 I.L.M. 44 (1993) (hereinafter GATS). However, they also deal with other issues, for example investment and intellectual property rights. The U.S. has bilateral trade treaties with several small countries, and also free trade agreements: Israel (1985), Jordan (2000), and Singapore (2003). In Latin America, the only country with a bilateral free trade treaty with the U.S. is Chile (2003); Mexico is under the trilateral NAFTA. See United States Trade Representative, List of Trade Agreements, http://www.ustr.gov/Trade-Agreements/SectionIndex.html (last visited Aug. 23, 2004), and SICE/OAS Foreign Trade Information System, http://www.sice.oas.org/investment/main_e.asp (last visited Aug. 23, 2004).


51. For an overview of the evolution of the current Brazilian tax system, which has its roots in the 18th Amendment (1965) to the 1946 Brazilian Constitution, see MARCOS VALADAO, LIMITAÇÕES CONSTITUCIONAIS AO PODER DE TRIBUTAR E TRATADOS INTERNACIONAIS 50-75 (2000).

52. For a general overview of the Brazilian tax system, see HUGO DE BRITO MACHADO, CURSO DE DIREITO TRIBUTÁRIO (2003).


54. The Imposto sobre Produtos Industrializados (IPI) is a value-added tax (VAT) that is levied only in industrialized products within the production chain, so it does not reach the wholesalers and retailers, such as the distribution chain.
gifts. Local governments levy taxes on urban land and some services (retail tax on services).

The three levels of government can also levy taxes for certain services provided directly to the taxpayer, for the police power, and for public infrastructure works, when the value of the taxpayer's property is increased as a result of the work. States and municipalities cannot create new sources of tax revenue. The sources of tax revenue are only those enumerated in the Brazilian Constitution. Only the federal government may create new taxes, unlike the United States, where the tax power of the states is limited only by interstate and international trade.

The following is a brief description of the taxes levied under the Brazilian tax system by source of taxation, which will be further detailed with a focus on the federal level.

1. **Income Tax**

   Individuals and domestic companies are taxed based on income. A federal tax is also levied on profits arising from activities carried out in Brazil or abroad. Neither dividends nor profit distribution to shareholders or partners is subject to income tax.\(^{55}\)

2. **Turnover taxes**

   Companies also pay turnover taxes, called social contributions, which are the Social Contribution for the Financing of Social Security (COFINS) and the Contribution to the Social Integration Program (PIS). Both taxes are levied under a VAT system on a monthly basis relying on total revenues obtained by a company.


   Taxes on domestic production and circulation of goods and services comprise the tax on industrialized products (IPI), the state value added tax (ICMS), and the local service tax (the ISS that is not a VAT).\(^{56}\) The most important is the ICMS, in which the revenue is more than 25 percent of the total tax burden. The federal government can also levy a tax on financial operations (IOF), which applies to credit operations, insurance, securities transactions, foreign exchange transactions, and gold.

4. **Foreign Trade**

   Import and export transactions are subject to Import Duty (II) and Export Duty (IE), also known as customs duty. The IPI and ICMS are also levied on the importation of goods, which are levied based on the principle of destiny. Duty rates are based on the Common External Tariff Schedule of MERCOSUR (the so-called Tarifa Externa Comum—

\(^{55}\) *See infra* Part III.C
\(^{56}\) However, the services subject to ICMS are not subject to ISS.
TEC), in which the nomenclature is also based on the Harmonized System.

5. Tax on Property, State (Inheritance), Gifts, and Real Estate Transactions

Taxes are levied on property of vehicles (IPVA), real estate property (IPTU), rural estate property (ITR),\(^{57}\) inheritance (state tax) (ITCD), and real estate transactions (ITBI). Except for the ITR, the others are levied by states (IPVA and ITCD) and municipalities (IPTU and ITBI).

Another important aspect of the Brazilian tax system at the federal level is the integration of the administration of internal taxes, foreign trade taxes, and social contributions (those that are not levied on payroll and wages of private employees). The taxes are under the same federal agency, the Secretariat of the Federal Revenue (Secretaria da Receita Federal – SRF), within the Ministry of Finance. This aspect is generally positive, considering the integration of internal operations and international transactions are under the same database and are audited by the same agency, avoiding unnecessary duplication of work and personnel, and the taxpayer who is working with international transactions only has to face one department, instead of two.

B. 2003 Tax Reform

The Brazilian tax system was submitted to a constitutional reform,\(^{58}\) following other important non-constitutional changes. The changes were related to fiscal competition between the states (revenue sharing), tax incentive (privilege) to small companies and capital goods, and export exemption. One important change affected the turnover taxes PIS/Pasep and COFINS; these two contributions changed to a VAT system, and will no longer be cumulative.\(^{59}\) Generally, VAT taxes are more suitable to the integration process. In addition, Constitutional Amendment No. 42 made clear that contributions (levied by the federal government) can be assessed on imports.\(^{60}\)

Actually, since the 1988 Constitution was promulgated there have been some proposals to modify the tax constitution. From 1988 to 2003, four-

\(^{57}\) This tax is used for environmental purposes (low tax rate for good conservation) and to tax big areas that are not being used efficiently.


\(^{60}\) See Emenda Constitucional No. 42, supra note 58. The 2003 tax reform was also planned to deeply address the problem of harmful tax competition among states. However, this aspect of the tax reform was postponed. It is worth remembering that for a federal country that faces increasing economic integration, allowing states to take measures that interfere in the coordination of external affairs and negotiations is not an advisable feature.
teen amendments were enacted to change articles pertaining to the tax system.

C. Income Tax

All domestic companies and individuals must pay federal income tax imposed on all income, which is defined as the product of capital and labor, or a combination thereof, as well as on any and all gains. Profits arising from activities carried out in Brazil or abroad are subject to the Corporate Income Tax (CIT).\textsuperscript{61} The basic rate of CIT is 15 percent, increased by a surtax of 10 percent on taxable profits exceeding R$240,000. As in the United States, Brazil also adopts a worldwide system of taxation. Dividends are exempt from tax, and thus, the distribution of profits (net income) to shareholders or partners is not taxed. In the United States, partnerships and limited liability companies (LLC) are taxed as an aggregate of taxpayers, not a separate entity, such as a pass through approach, while in Brazil, partnerships and LLCs (the overwhelming business structure in Brazil)\textsuperscript{62} are considered separate entities for tax purposes.

Income tax legislation is consolidated into the Income Tax Regulation (Regulamento do Imposto de Renda), a federal decree\textsuperscript{63} that encompasses the general rules to levy such tax. In addition to this decree there are several normative instructions issued by the Secretariat of Federal Revenues.

1. Inbound Transactions

The term inbound transactions includes transactions involving foreign taxpayers who do business and invest in Brazil. The concept may also encompass services rendered in Brazil that will be taxed as such. The investor may be a direct or passive investor, meaning the investor buys securities or another type of asset in the Brazilian market without dealing with the business directly. The treatment of inbound transactions in Brazil is different from the treatment in the United States.\textsuperscript{64} Take for instance taxing services rendered in Brazil. Brazilian law taxes with different rates depending on the type and conditions of such service, while the U.S. system uses a general 30 percent tax rate on a gross basis. Generally speaking, the taxation of inbound transactions, such as services on other payments to foreign taxpayers, are subject to detailed regulation and are taxed on tax rates from 0 to 25 percent.\textsuperscript{65} Brazil does not have double levels of taxation affecting payments of dividends in either direct or passive investment.

\textsuperscript{61} Companies are also subject to social contributions on net profits (the so-called CSLL) imposed at the rate of 9%. Lei No. 10.637, de 30 de dezembro de 2002, D.O. 31.12.2002 (Edição extra), art. 37.

\textsuperscript{62} See infra note 108.

\textsuperscript{63} Federal Decree 3.000-RIR/99, supra note 26.

\textsuperscript{64} See supra Part II.A.1.a.

\textsuperscript{65} Federal Decree 3.000-RIR/99, art. 682-762, supra note 26.
a. Passive Investment

Dividends paid by Brazilian companies to resident or nonresident shareholders are not subject to Brazilian withholding tax, and as a general rule capital gains earned by nonresidents are subject to a 15 percent withholding tax. The remuneration of shareholders, by paying interest on shareholder equity, is taxed at 15 percent (withholding). Interest paid to foreign companies or a nonresident with respect to loan transactions are also subject to withholding income tax at a rate of 15 percent. To avoid tax evasion, the rates are increased to 25 percent when the beneficiary of the payment is a resident of designated countries.66 Foreign owners of quotas in investment funds of stocks and money markets may be subject to reduced taxes.67

All of the income mentioned above may be subject to reduced taxation if the recipient of the income is a resident of a country that is party to a double tax treaty with Brazil.6869 To avoid the double taxation, Brazilian residents are allowed a credit, equivalent to income tax paid abroad, to the limit of the internal tax liability.

b. Direct Investment

Companies domiciled in Brazil and Brazilian branch offices, agencies, and representative offices of companies domiciled abroad, are all subject to Brazilian corporate tax.

Brazilian tax law distinguishes between an individual and a juridical

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66. Instead of 15%, the tax rate is 25% if the beneficiary resides in a country, which is considered a tax-favored jurisdiction (tax haven). There is no tax relief on transactions with such countries (favorable tax countries, such as a jurisdiction with a tax rate at a maximum rate of 20%), which are listed in the No. 188 of the Secretariat of Federal Revenues. See Ministerio da Fazenda, SRF, SRF Normative Instruction No. 188 (August, 6 2002), available at http://www.receita.fazenda.gov.br/Legislacao/ins/2002/ln1882002.htm. Countries considered tax havens are: American Virgin Islands, Andorra, Anguilla, Antigua, Bahamas, Bahrain, Barbados, Barbuda, Belize, Bermuda, British Virgin Island, Cayman Islands, Channel Islands (Jersey, Guernsey and Alderney), Cook Islands, Costa Rica, Cyprus, Djibouti, Dominican Republic, Gibraltar, Granada, Isle of Man, Labuan, Liberia, Liechtenstein, Madeira Islands, Malta, Marshall Islands, Mauritius Islands, Monaco, Montserrat, Netherlands Antilles, Nauru, Nevis, Nieu, Panama, Saint Kitts, Saint Lucia, Saint Vincent, Samoa Islands, San Marino, Seychelles, Tonga, Turks and Caicos Islands, and Vanuatu. Id.


68. Brazil has signed a tax treaty to avoid double taxation on income with the following countries: Argentina, Austria, Belgium, Canada, China, Czech Republic, Slovakia Republic, Denmark, Ecuador, Finland, France, Germany, Hungary, India, Italy, Japan, Korea, Luxembourg, the Netherlands, Norway, the Philippines, Portugal, Spain and Sweden. See Ministerio da Fazenda, http://www.receita.fazenda.gov.br/Legislacao/AcordosInternacionais/AcordosDuplaTrib.htm.

69. For treaty shopping under Brazilian tax law, see HELENO T. TORRES, DIREITO TRIBUTARIO INTERNACIONAL: PLANEJAMENTO TRIBUTARIO E OPERACOES INTERNACIONAIS 320-83 (Revista dos Tribunais ed, 2001).
Every association of individuals or other juridical person is deemed to be a separate entity and is taxed as such, but without taxation of paid dividends or distributed profit to the owners. The repatriation of invested capital is not taxed, and dividends distributed to residents or nonresident shareholders are not subject to Brazilian withholding tax.\footnote{Juridical person encompasses all the concepts of associations, partnerships, limited liability companies, corporations, and the like with or without business purpose, and even individual enterprises, when established in accordance to the law.}

2. **Outbound Transactions**

The term "outbound transactions" refers to transactions involving Brazilian residents who do business and invest abroad.

Brazilian companies are also subject to worldwide income.\footnote{Federal Decree 3,000-RIR/99, *supra* note 26, at arts. 690-II, 692.} The taxes that are paid to foreign countries are allowed as tax credits in Brazil in order to avoid double taxation. Tax treaties may give some relief to outbound transactions, but the operations will still be taxed under Brazilian tax law.

In addition to double taxation, the Brazilian corporation and the foreign-owned subsidiaries abroad also have the problem of inter-company pricing explained below.

a. **Transfer Pricing in Brazil**

In Brazil, the Transfer Pricing Law took effect on January 1, 1997 (Law 9,430/96).\footnote{C.T.N. art. 43. The change in the law that allowed the taxation on a worldwide basis was made in 1995 by means of the Federal Law 9.249. *Lei No. 9.249, de 26 de dezembro de 1995.*} In general, the legislation adopts the arm's length principle,\footnote{The current transfer pricing rules are detailed in the Normative Instruction No. 243, issued on November 11, 2002 and No. 321, issued on April 14, 2003. *SRF Normative Instruction No. 243, Nov. 11, 2002, D.O.U. of Nov. 2002; SRF Normative Instruction No. 321 of Apr. 14, 2003, D.O.U. of Apr. 2003.*} but if this principle is not observed, the law authorizes the tax authorities to reallocate income for income tax and social contribution collection purposes.

The transactions examined under Brazilian Transfer Pricing Regulations include (1) imports and exports of goods, services, and rights with related parties; and (2) payments or credits for interest paid or received on loans with related parties not registered with the Central Bank of Brazil. Transactions with parties established in countries that do not tax income or that tax income up to a maximum rate of 20 percent, regardless of whether the latter is a related part, are also examined under the Brazilian Transfer Pricing Regulations. In addition, Provisional Measure No. 22, enacted on January 9, 2002, extended the application of the rules of
transfer pricing to operations effected by a natural person or legal entity in Brazil with any natural person or legal entity, even if not related, residing or domiciled in a country that offers secrecy to the ownership structure of legal entities. The Cayman Islands is an example of such a country.

However, the Brazilian Transfer Pricing Regulations are not applicable to royalty payments, technical assistance, and scientific and administrative fees.75

b. Valid Transfer Pricing Methods in Brazil

There is flexibility in Brazilian pricing methods. When more than one method is available, the method that provides the most favorable results to the taxpayer may be used as the preferred transfer pricing method.

Brazil's available methodologies are formulary in nature and are separated for imports and exports.

(A) The methods applied on import transactions in Brazil:

(1) Comparable Uncontrolled Price Method:76 It is defined as the arithmetic mean of prices for equivalent or similar goods, services and rights, in the Brazilian domestic market or other countries, in purchase or sale transactions under similar payment conditions. The prices will only be considered in transactions between unrelated parties (uncontrolled transactions).77

In the event that conditions based on matching the same period do not exist, the matching could occur based on previous or posterior operations, as long as they are adjusted for eventual variations occurring in the exchange rate between different dates.78

(2) Resale Price Method:79 It is defined as the arithmetic mean of the resale prices for goods or rights, after a deduction of the following:

(a) – unconditional discounts granted;
(b) – taxes and contributions due on sales;
(c) – commissions and brokerage fees paid; and
(d) – profit margin of:

Sixty percent in the case of imported goods used in the production process, calculated on the resale price after deducting the amounts mentioned above and all the value added in Brazil; and

Twenty percent in all other cases, calculated on the resale price.

75. Lei No. 9,430/96, art.18, § 9, de dezembro de 27 de 1996, D.O. de 30.12.1996; See also SRF Normative Instruction No. 243/2002, art. 43 de 11 de novembro de 2002, D.O. de 13.11.2002. See supra note 73. According to Professor Heleno Torres, Brazilian Tax law has an effective mechanism to control this type of transactions. HELENO TORRES, DIREITO TRIBUTARIO INTERNACIONAL, supra note 69, at 259.
77. Lei No. 9,430/96, art.18(I), § 2.
78. SRF Normative Instruction No. 243/2002, art.11.
The resale prices to be considered will be the ones accounted for by the import company, in retail and wholesale operations with purchasers, natural persons or legal entities, which are not related.\textsuperscript{80}

(3) Cost Plus Method:\textsuperscript{81} It is defined as the average cost of production of equivalent or similar goods, services, and rights in the country of origin, plus taxes and fees due on the export transaction, and a profit margin of 20 percent on the total cost.

The profit margin will be applied to the costs before taxes in the country of origin, on the value of goods, services, and rights by the company in Brazil.\textsuperscript{82}

(B) The methods applied to export transactions in Brazil:

First, with respect to export transactions in Brazil, it is important to point out that article 14 of the Brazilian Transfer Pricing Regulations provides that there will be a transfer pricing adjustment only when the average export price of products, services, or rights are less than 90 percent of the average sale price charged for the same products, services, or rights in the Brazilian market during the same time period and under similar payment terms. Article 35 of the Brazilian Transfer Pricing Regulations provides that if a company demonstrates a net profit derived from export sales to affiliates of at least 5 percent of its total related party export revenue, it can avoid a full disclosure of its inter-company transactions to the tax authorities. This safe harbor net profit margin of 5 percent is computed before social security contributions and income taxes. Moreover, article 36 provides that if a company’s net export revenue has never exceeded 5 percent of the total net revenue reported in the same time period, the company can also avoid full disclosure of its inter-company transactions to the Brazilian tax authorities.

Second, the Comparable Uncontrolled Price Method, Wholesale Price in the Country of Destination Less Profit Method, and Retail Price in the Country of Destination Less Profit Method allow adjustments for the following factors that affect comparability:

(a) – payment terms;
(b) – volume;
(c) – payment guarantees;
(d) – marketing and advertising expenses;
(e) – costs related to quality control (tangible property and services) and hygienic standards;
(f) – intermediate costs in buying and selling operations;
(g) – packing;
(h) – freight and insurance costs; and
(i) – export credit risk.

\textsuperscript{80} Id. §1.
\textsuperscript{81} Custo de produção mais Lucro–CPL, id. at art. 13.
\textsuperscript{82} Id. at art. 13, §7.
(1) Comparable Uncontrolled Price Method: It is defined as the average sales price for exports made by the same company to other customers (uncontrolled parties) or exports made by another Brazilian exporter of equivalent or similar goods, services or rights, under similar conditions.

(2) Wholesale Price in the Country of Destination Less Profit Method (PVA): It is defined as the average sales price for equivalent or similar goods in the wholesale market of the country of destination, under similar conditions, less the taxes included in the price in the country of destination, and a profit margin of 15 percent on the wholesale price. The taxes included in the price are taxes similar to the (ICMS) and (ISS"), and contributions similar to COFINS and PIS/Pasep.

(3) Retail Price in the Country of Destination Less Profit Method (PVV): It is defined as the average sales price for equivalent or similar goods in the retail market of the country of destination under similar conditions, less taxes included in the price in the country of destination, and a profit margin of 30 percent on the retail price.

(4) Cost Plus Method: It is defined as the average purchase cost or the average production cost of exported goods, plus the taxes paid in Brazil, and a profit margin of 15 percent over the total cost, plus taxes.

In conclusion, compulsory profit margins are set between 15 and 60 percent, depending on the Transfer Pricing Method, and they differ for inbound and outbound transactions. The law specifies minimum and maximum profit margins and grants the Ministry of the Economy the authority to change these margins; that is, the profit margins are statutorily set in the Transfer Pricing regulations and are not dependent on comparable, uncontrolled transactions. However, it is also important to point out that the law foresees the possibility of modifying those margins through an individual request submitted by the taxpayer.

A request to modify a profit margin must be accompanied by documents that prove that the margin used by the taxpayer conforms to normal practices between unrelated parties under comparable circumstances. Accordingly, the law requires that the following elements be presented as documentation:

Official publications or reports from the government of the seller or buyer's country of origin, or a declaration of the tax authorities when said country has a tax treaty in force with Brazil;

83. Preço de Venda nas Exportações-PVEX, id. at art. 23.
84. Preço de Venda por Atacado no País de Destino, Diminuído do Lucro-PVA, id. at art. 24.
85. Id. art. 24. §1.
86. Preço de Venda a Varejo no País de Destino, Diminuído do Lucro-PVV, id. at art. 25.
88. Professor Heleno Torres explains that these ranges of profit levels will bind the taxpayers only until they are in accordance with the arm's length price. See TORRES, supra note 69, at 292.
89. SRF Normative Instruction No. 243/2002, art. 32.
Market research performed by a recognized institution or technical publication that specifies the industry sector, period, companies researched, and the profit margins for each selected comparable company;

Domestic and international stock market price quotes; and

Research performed under the auspices of international research institutions, such as the OECD and WTO.

This alternative mitigates the bias imposed by the fixed profit margins.

OECD is important because it helps members and non-members deal with an increasingly globalized world. Although Brazil is not a member country of the OECD, this entity is important to Brazil and was duly recognized in the Exposition of Reasons of Law No. 9,430/96 that clarified, "In this specific case, in compliance with rules adopted by the integrity countries of the OECD, are proposal norms that make the control of Transfer Pricing possible. . . ." However, the Business and Industry Advisory Committee (BIAC),\(^9\) shortly after the publication of the Brazilian Transfer Pricing Law, criticized the Brazilian law, opposing the text of the above Exposition of Reasons.

BIAC considers the Brazilian transfer pricing law to be one of the most important and, at the same time, most threatening developments in the Brazilian taxation arena. BIAC has pointed out that although the methods mentioned in this law seem to be inspired by the OECD transfer pricing guidelines (CUP, cost plus and market minus), they are far from being compatible with the international (OECD) concepts and the rules for the determination and application of the arms length principle.

In the end, BIAC finalizes its comments with:

As defined in the legislation, the new transfer pricing rules in fact seem to be an attempt by the Brazilian authorities to set minimum export prices and maximum import prices, based on arithmetic average prices as determined on the Brazilian market and with high fixed local Brazilian margins. The best method in practice is the method that gives the highest taxable result in Brazil. From an international point of view, such fixed margins, conceptually, are not acceptable, and the economic reality is not taken into account at all (such as, e.g., different markets, different functions, and risks and individual prices). Furthermore, it is highly likely that such rules will lead to double taxation.\(^9\)

However, as set forth above, the taxpayer may request the modification of the profit margin stated by the regulations, thus eliminating such bias.

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\(^9\) The Business and Industry Advisory Committee to the OECD (BIAC) was created in 1962 to officially represent and communicate the views of the business community to the OECD. Its members include the principal industry and employer organizations from all OECD countries. The BIAC Committee on Taxation and Fiscal Policy comprises senior tax experts from the private sector within the BIAC membership.

D. Turnover Taxes and Contributions

The current Brazilian tax system allows the federal government to levy two turnover social contributions (PIS/Pasep and COFINS), and the social contribution on net profit (CSLL). The latter is quite similar to the income tax, except for the destination of the revenue. The destination of the revenue of social contributions is the national social security system, encompassing retirement, health, and social assistance. There are also contributions levied on payroll and wages, which are directed to the public retirement program and pensions under the social security system. They are all referred to as social contributions.92

The PIS/Pasep and COFINS were originally cumulative, implying that they were levied on every transaction of the taxpayer, becoming a cost to the purchaser of goods or services.93 However, Federal Law No. 10.637/2002 transformed the PIS/Pasep into a VAT contribution on turnover and Provisional Measure No. 135/2003 altered the COFINS contribution in the same manner.94

The federal government can also levy contributions of intervention in the economic domain (CIDE).95 The CIDEs are used to control and facilitate the intervention of the government in specific fields of the economy. The current CIDEs are levied on fuel (liquid and gas), which function to control and stabilize the price of gasoline, diesel, alcohol, and gas. The tax rates are high and may vary depending on the circumstances of the market.96 The other is levied on the import of certain services (payment of royalties and licenses and services related to technology transfer).97 The first is used to regulate the market for fuels, and the second to promote the development of research in technology by funding projects in Brazil (the rate is 10 percent).

There is a contribution, also a type of CIDE, called freight additional to the renewal of the merchant navy (AFRMM), which is levied on the value of freight paid (including imports), and funds the improvement of the Brazilian merchant navy.98

The federal government also levies a contribution on banking debts and transfers under the bank system (Provisional Contribution on Finan-

92. The states and local governments cannot levy social contributions, unless to finance their own social security system (benefitting public employees), and collect it from their own public employees. C.F. art. 149.
93. PIS/Pasep and COFINS are very similar in levying, although the destinations of the collected revenues are different (PIS/Pasep goes to specific funds and COFINS is more general).
95. The 1988 Brazilian Constitution allows the federal government to create other types of social contributions, for example, on revenue of lotteries and for professional categories that are not relevant to this paper. C.F. art. 149-95.
E. Consumption Taxes

Taxes on production and circulation of goods and services (consumption taxes) are comprised of the IPI, the ICMS, and the local service tax.

The ICMS is levied on goods at the time they physically leave an industrial plant or when they enter the state as imports. Exports of manufactured goods and raw materials are exempt. In addition, the ICMS is also imposed on interstate and inter-municipal transportation and communication services. The ICMS on domestic transactions is considered part of the price of the goods, so it is comprised in the basis of other taxes.

The IPI is a federal value-added tax levied on products at the time they physically leave an industrial plant or when they enter the country as imports. Exportation of manufactured products is exempt from IPI.

The IPI and the ICMS can be levied simultaneously on the same transaction. On imports, the ICMS basis includes the import duty and the IPI. As a VAT, IPI and ICMS are recoverable to the extent that tax paid upon import or acquisition of products can be offset against tax due upon subsequent transactions. The ISS is a municipal tax levied on services in accordance with a list provided under federal law. Services not listed are not subject to ISS.

F. Other Taxes

Transfers of real estate by donation or inheritance are subject to the municipal tax upon disposal of real estate (ITBI). Federal Land Tax (ITR) is levied annually on the ownership or possession of real estate in rural areas, while IPTU is levied annually on real estate in urban areas.

The CPMF is levied on funds from one individual or legal entity to another. The contribution is collected in cascade (cumulatively) by the...
financial institutions. Under certain circumstances, the Financial Operations Tax (IOF) is imposed by the federal government on investments of fixed income funds, transfers of amounts from foreign to local financial institutions, and investments by nonresidents in short-term funds.

G. FOREIGN TRADE, TAX AND TARIFFS

The Brazilian internal taxes that may affect international transactions are levied on production and circulation of goods and services: IPI and ICMS. IPI rates vary from 0 percent to 360 percent, and ICMS rates vary from 0 percent to 25 percent. Exports are exempt from both taxes, but they are imposed on imports (destination principle). The tax paid on previous transactions, assumed as tax credits, may be refunded when it is part of the costs of the exported production (also in accordance with the destination principle). The same treatment to exports also applies to the contributions to PIS/Pasep and COFINS.

The CIDE levied on fuel (and on imports of oil and gas and the fuels derived from it), and the CIDE levied on imports of some services (royalties, licenses, and services related to technology transfer), interferes with foreign trade of goods and services, respectively.

Imports of tangible goods pay duties, and services pay income tax. The negotiation of duties has been a part of the international agenda for a long time; however, the discussion about services, which also involves payment of intellectual property rights, is a relatively new issue.

Import transactions are subject to three taxes: the II, IPI, and ICMS. A few products (leather and tobacco products) are subject to export tax, for purposes of controlling internal supply, and to control the smuggling of tobacco products. The tariff schedules comply with the MERCOSUR and WTO rules.

The duty rates (import and export tax) and the IPI rates are based on the Common Nomenclature of MERCOSUR, which is based in the Harmonized System that is also used by the United States. The Brazilian tariff schedule is called Common External Tariff (Tarifa Externa Comum—T EC), which is valid to all members of the MERCOSUR (actually, it brings some exceptions).

The current Brazilian Customs Code (RA 2002), which is based on several customs laws, regulates the administration of customs activities, au-

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102. Under a VAT system, importation of goods, the act of putting the imported good in the internal chain of commerce, is levied on by the VAT tax. However, the tax paid will be credited to the next operation; therefore it works like an anticipation of the tax that will be paid at the end of the chain of consumption. On the same token, it is levied on goods imported directly by the consumer because otherwise there would be an exemption to imports in comparison with domestic production (which pays the VAT).


105. For more details on the exceptions and the timing of the phase out to some products, see Ignacio J. Randle, The Legal Framework of Mercosul, in DOING BUSINESS IN BRAZIL 75, 77-78 (Ricardo Barreto ed., 2002).
diting, control on taxation of international trade transactions, and was updated and published in 2002.\textsuperscript{106} It contains all the GATT/OMC and MERCOSUR regulations under the Brazilian legal system. The control of import-related activities is very advanced. A company involved in Brazilian international trade can follow the whole operation systemically via a software program known as the Integrated Foreign Trade System (SISCOMEX).\textsuperscript{107}

H. How Foreign Companies Can Operate in Brazil

U.S. companies may operate in Brazil in several ways, such as buying shares of Brazilian companies, or shares of funds specially designed for foreign investors by establishing branches or subsidiaries (offshore companies).

Under Brazilian law, foreign legal entities may operate in Brazil as foreign companies, assuming rights and liabilities, or becoming Brazilian corporate shareholders. For a company to operate regularly in Brazil, it must have governmental authorization.\textsuperscript{108}

Foreign legal entities may operate in Brazil under five basic approaches: (1) establish branches or agencies; (2) acquire equity interest, as a subsidiary or controlled company;\textsuperscript{109} (3) establish holding companies that have controlling or equity interest in Brazilian companies; (4) purchase minority interest in Brazilian companies; or (5) directly, but without a permanent establishment (merely engaged in trade or business).

Nevertheless, most of the time, foreign corporations do not ask for authorization to operate. They (foreign corporation) use the following procedure:(1) they incorporate a Brazilian company, which will perform


\textsuperscript{107} For an overview of the system, Borges, supra note 106, at 9.

\textsuperscript{108} New Civil Code article 1.134 states that foreign societies cannot operate in Brazil without authorization from the Government. See C.C. art. 1.134.

\textsuperscript{109} The articles of the Brazilian Commercial Code, Federal Law 556, which regulated the commercial societies was revoked by the new Civil Code, Federal Law 10,406. The Civil Code now governs all forms of commercial associations, which are admitted in the Brazilian system, and Federal Law 6,404 (Corporation Law), as amended, governs corporations that are incorporated like an anonymous society (similar to the American corporation) and may sell stocks on the exchange stock market. The anonymous society is characterized by having the words "Sociedade Anônima" or the abbreviation "S.A." in its name or the word "Companhia" in the beginning of its name. In short terms, one can say that in Brazil there are three basic forms of commercial societies: (1) the limited liability society (sociedade limitada characterized by the abbreviated form LTDA); (2) the companies of anonymous society, that may be with open capital (sell shares in the stock exchange market); (3) and close capital (the shares are not sold or bought at the stock exchange market). There are other forms of founding a commercial society, but they are ancient and rarely used. In the last twenty years, over 99% of legal entities in Brazil were structured in the form of limited liability societies. See Joaquim de Paiva Muniz, Management and Corporate Control of Limited Companies Under the New Brazilian Civil Code, 8 LAW & BUS. REV. AM., 455, 455-61, n.1 (2002).
activity directed by the foreign corporation by means of a third party (at this phase the Brazilian third party is the sole owner or the majority shareholder); and (2) they buy the equity interests or the stocks that represent control of the Brazilian company. By these means, the foreign company operates in Brazil with an intermediate company (founded under Brazilian Law), but without any control or acknowledgment of the Brazilian Government as predicted by the Civil Code.

The planning operation starts with acquisition or incorporation of a Brazilian company with the same business purpose, and then the foreign investor buys the control of the Brazilian company. It is not illegal but should be the exception, not the pattern. The legal allowance for subscribing to equity interest in a Brazilian corporation by foreign corporations is not fraudulent, it is just a disguised way to avoid the need for governmental authorization. The Brazilian Supreme Court, Supreme Federal Tribunal, recognized that acquisitions of equity interest or shares of stock do not mean that the foreign corporation is operating within the territory directly.\textsuperscript{110}

The specific rules for foreign companies to operate in Brazil, by means of a branch or a subsidiary, are governed by the Código Civil (C.C.) articles. 1134-1141. If the offshore company follows the rules of the C.C., there will be no discrimination between a foreign owned and a domestic company, unless provided in the C.C. and constitutional exceptions. The Brazilian Federal Constitution does not establish any differences between Brazilian companies and foreign companies, which are established in Brazil according to Brazilian law (there are a few exceptions related to specific economic activities).

It must be noted that Brazil is a federal state, but the states of the federation do not have autonomy to enact legislation governing commercial and corporate law. Therefore, there is legislative uniformity among the states.

IV. THE ROLE OF THE INTERNATIONAL TRADE TREATIES AND ECONOMIC INTEGRATION

The United States and Brazil are parties to several multilateral and bilateral trade agreements. The WTO is the most important multilateral trade agreement because it is the most significant global international organization dealing with the rules of trade between nations. Bilateral trade agreements are also important,\textsuperscript{111} but they will not be addressed specifically in this work.


\textsuperscript{111} See José M. Salazar-Xirinachs, Proliferation of Sub-Regional Trade Agreements in the Americas: An Assessment of Key Analytical and Policy Issues, in OAS Trade Unit Studies 2-5 (Oct. 2002); see also Jose M. Salazar-Xirinachs, Proliferation of Sub-Regional Trade Agreements in the Americas: An Assessment of Key Analytical and Policy Issues, 13 J. Asian Econ. 181 (2002).
The multilateral economic integration treaties important to the present discussion are: MERCOSUR; Latin American Integration Association (ALADI); NAFTA; and FTAA. However, only the FTAA is designed to include both the United States and Brazil. There is no doubt that the formation of such economic blocks triggered important changes in trade relations between the two countries.

MERCOSUR, ALADI, NAFTA, and FTAA are multilateral treaties but are also regional. In this sense, they are called regional or sub-regional trade agreements, in contrast to the WTO agreements, which are global.¹¹²

Generally speaking, the clauses in multilateral trade agreements that directly affect taxation are: (1) the most favored nation (MFN) clause, according to which preferred treatment cannot be granted to only one country or a group of countries, but extended to every country party; (2) the national treatment clause, which grants similar treatment to national and regular imported goods; and (3) the prohibited subsidies, generally tax exemptions and tax refunds to exports.¹¹³ However, if one considers the agreements on service (GATS) and investments, more conflicts or possibility of conflicts may arise.¹¹⁴

Regional trade agreements also have an important role in the global struggle for trade liberalization and development, as they contribute to the whole process instead of being a barrier to the process.¹¹⁵

¹¹². The term multilateral is commonly used to identify non-regional plurilateral trade agreements.


¹¹⁴. See generally Alvin C. Warren Jr., Income Tax Discrimination Against International Commerce, 54 TAX L. REV. 131 (2001) (analyzing some incoherencies of trade and tax regimes); Paul R. McDaniel, The Impact of Trade Agreements on Tax Systems, in INTERNATIONAL AND COMPARATIVE TAXATION: ESSAYS IN HONOUR OF KLAUS VOGEL 151, 151-62 (Kees van Raad, ed., 2002) (the work studies the effects of tax expenditures, such as subsidies, focusing on the prohibited and non-prohibited subsidies under trade agreements and discussing the distinction between export subsidies, which are prohibited, and the subsidies that are part of the benchmark or normative tax structure under the WTO and UE systems). Jinyan Li asserts that there are generally two types of clauses of multilateral trade agreements that generally affect international income taxation: “The first type prevents the use of tax provisions as disguised trade barriers, such as export subsidies,” and the other is the non-discrimination clause (most favored-nation principle) LI, supra note 2, at 34.

¹¹⁵. See Salazar-Xirinachs, supra note 111, at 22-23 (rebutting the existence of a true dilemma between multilateralism and regionalism). The author says that in spite of the fact that some trade diversion is created by such agreements, the multiple-track strategy is more efficient than the one track, which is also slower to achieve results. Secondly, there are empirical evidences that regionalism is not an alternative to multilateralism (instead, they can work together), and it is not serious trade diverting (at least to Latin American countries). Finally, the author says that “it can be argued that it might even be counterproductive to portray regionalism and multilateralism as mutually exclusive alternatives, because in practice governments will most likely continue to pursue both simultaneously. In fact, in Doha RTAs obtained increased legitimacy. Paragraph 4 of the Ministerial Declaration recognizes ‘that RTAs can play an important role in promoting the liberalization and
Another development relating to this issue is the treaties between American countries and the European Union (EU)\textsuperscript{116} and between MERCOSUR and the EU.\textsuperscript{117} These negotiations are important to the development of the FTAA. For instance, if the EU decides to give preferential treatment to agricultural products of South and Central American countries offsetting the EU subsidies, it will put the negotiations under the FTAA agreement into a stalemate position (the EU as a better alternative), pushing the FTAA negotiations to another step without disregarding the influence of these developments to the WTO system as a whole.

A. WTO

The current GATT/WTO system, which is the most important trade treaty in the world, was established as the GATT in 1947.\textsuperscript{118} The United States was one of the countries that founded the system, along with Brazil.\textsuperscript{119} Following the GATT/1947, the development of the system occurred by means of the so-called rounds of GATT. In the beginning, it focused only on tariff and quota issues, but then it expanded the scope, mainly after the Kennedy Round (1964-1967). Following the Kennedy Round, came the Tokyo Round (1973-1979), when the basis for the Uruguay Round was launched. These meetings included participation from most of the countries of the world. The Rounds that followed the first agreement worked in the sense of making the scope of the GATT more

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\textsuperscript{119} The WTO has 146 affiliated countries. \textit{Id.}
comprehensive. The apex was the Uruguay Round, which became the foundation of WTO.

The WTO Agreements consolidated many issues, including services (GATS). Services are not subject to tariffs, but income taxes, and therefore, a new field of potential conflicts was created because both GATS and the treaties to avoid double taxation comprise services.

The WTO agreements allow the parties to engage in regional agreements and even bilateral agreements without implying a breach of the MFN clause. For this reason ALADI, MERCOSUR, and NAFTA were feasible.

1. **WTO and Brazil**

Brazil was one of the founders of the GATTI/1947, and has been active in the organization since then. The Brazilian Government has followed the rules agreed upon in the WTO/GATT system, and has introduced alterations in Brazilian legislation to ensure compliance with the trade treaties.

The tariffs in Brazil are under the WTO systems and the allowed exceptions as regional agreements. As it was said before, the tariff schedule is based on the Harmonized System. Due to the Valuation Agreement, Brazil does not adopt specific tariffs, hence, there are only ad valorem tariffs within the Brazilian Tariff Schedule.

Under the WTO dispute resolution system (Dispute Settlement Understanding - DSU), Brazil has presented claims against the United States related to iron and steel sectors and some agricultural products because the United States imposed surtariffs, alleging dumping or prohibited subsidies from Brazil. The discussion is underway and, because these are sensible products, it will have some influence in FTAA negotiations. Contrary to the United States, Brazil is a developing country and historically has been asking for preferential treatment.

It is worth noting that one of the most important principles of the GATT/WTO system (the national treatment clause) was introduced in article 152 of the 1988 Brazilian Constitution. Although this constitutional disposition binds only the states and municipalities, and not the federal government, it is still very important because it bars prima facie conflicts between local and state legislation in violation of the national treatment principle.\(^{120}\) The federal government is bound only by the GATT/WTO treaty.

2. **WTO and the United States**

The Uruguay Round Agreements Act provides that U.S. federal law

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\(^{120}\) The Brazilian Superior Court of Justice (STJ) has established the position that states cannot tax vehicles with different rates, discriminating between those imported and those manufactured in Brazil, based on article 152 of the Federal Constitution. See, e.g., S.T.J., 1a Turma, RMS/DF No. 14462, Relator: Min. Luiz Fux, 04.06.2002, 159 R.S.T.J. 138 (Brazil); See C.F. art. 152.
prevails over a Uruguay Round Agreement in case of conflict, and that the Uruguay Round Agreements prevail over state law in actions brought by the U.S. Government. The Act further states that only the United States has a cause of action or defense under any Uruguay Round Agreement, or by virtue of congressional approval of such agreement, no person may challenge a federal, state or local law, action, or inaction, by any department or other instrumentality of the United States, or any state, or any political subdivision of a state, on the ground that such action or inaction is inconsistent with any of the Uruguay Round Agreements.

Sometimes the internal rules of international trade enacted by the United States conflict with the GATT/WTO system. The most recent example occurred when several members of the WTO, including Australia, Brazil, Canada, Chile, the European Communities, India, Indonesia, Japan, Korea, Mexico, and Thailand, presented complaints before the DSU/WTO related to the Byrd Amendment, arguing that the remedy was not appropriate regarding multilateral rules.

The tariff preferences of WTO/GATT are under the MFN clause, which means that the United States cannot grant reduced-duty treatment to a country without extending this benefit to other WTO parties. However, there are some exceptions, including NAFTA.

B. ALADI

In order to understand MERCOSUR, it is important to highlight what happened with its predecessor, ALADI. The signature and implementation of the Treaty of Rome in 1958, constituting the Common Market European, provoked repercussions in Latin America. In 1960, the Treaty of Montevideo created the Latin American Free Trade Association (ALALC), integrated by Argentina, Brazil, Colombia, Chile, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela. ALALC's objective was to constitute a regional common market under the rules of GATT. From 1960 to 1964, there were negotiations within the scope of ALALC, and it was agreed to create some tariff reductions, break protectionist measures, and implement the Agreement on Credits and Reciprocal Pay-

121. 19 U.S.C. § 3512(a) (2003). It is interesting to note that the statute only mentions federal law, but not other treaties.
122. Id. § 3512(b).
123. Id. See JACKSON ET AL., supra note 3, at 244-45.
124. The Continued Dumping and Subsidy Offset Act of 2000 (CDSOA), the so-called "Byrd Amendment," was a piece of U.S. legislation that was declared inconsistent with the WTO Agreements. The Panel came to the following conclusion: "In the light of our findings, we conclude that the CDSOA is inconsistent with AD Articles 5.4, 18.1 and 18.4, SCM Articles 11.4, 32.1 and 32.5, Articles VI:2 and VI:3 of the GATT 1994, and Article XVI:4 of the WTO Agreement." Panel Report, United States—Continued Dumping and Subsidy Offset Act of 2000, WT/DS217/R, WT/DS234/R (Sept. 16, 2002). The Panel issued this recommendation: "Consistent with Article 19.1 of the DSU, we recommend that the Dispute Settlement Body request the United States to bring the CDSOA into conformity with its obligations under the AD Agreement, the SCM Agreement, and the GATT of 1994." Id. at 337.
ments (CCR). From 1964 to 1969, ALALC was paralyzed as a result of strong protectionist policies (high tariffs and restraints) and political misunderstandings between the countries. In 1970, the program was revised and extended to 1980, the period of transition for the implementation of zone-free commerce. By that time, ALALC virtually stopped and would be superseded by ALADI.

In 1980, the Treaty of Montevideo was signed instituting ALADI. ALADI is a very flexible treaty that permits bilateral and multilateral agreements within its scope, and eliminates some blocking commitments under ALALC, such as the obligation to elaborate common lists.\footnote{This flexibility allowed the formation of the MERCOSUR. The Ministry of Foreign Relations of Brazil state, "In ALADI, Brazil maintains a network primarily of trade agreements with the other members of the association: Uruguay, Argentina, Paraguay, Chile, Peru, Bolivia, Ecuador, Colombia, Venezuela and Mexico. Among these instruments is the Economic Complementary Agreement number 18, foreseeing the establishment of the common external tariff of Mercosur and the adoption of a common trade policy in relation to third states." Ministerio das Relaçoes Exteriores, Aladi—Latin American Association of Integration, available at \url{http://www.mre.gov.br/cdbrasil/itamaraty/web/ingles/relex/mre/orgreg/aladi/index.htm} (last visited Aug. 23, 2004).}

C. MERCOSUR

In 1985, the presidents of Argentina and Brazil, representing the two most important economies of South America, signed the Statement of Iguazu, in which they expressed their "firm will to accelerate the bilateral trial of integration."\footnote{Marcos Valadao, \textit{Mercosul e União Europeia: Um Estudo Comparativo dos Sistemas Jurídicos} (1999), \url{http://www.comparativeiuris.hpg.ig.com.br/Mercosul%20e%20UE%20Um%20estudo%20comparativo.html} (quoting Declaration of Iguazu, Arg.-Braz., Nov. 30, 1985).} After bilateral negotiations, they decided to conform the bilateral common market on December 31, 1994, establishing a method appropriate for such ends. Paraguay and Uruguay also joined the proposal. In March of 1991, they signed the treaty "For the Constitution of a Common Market Between Argentina, Brazil, Paraguay and Uruguay," the Treaty of Asuncion, which created the MERCOSUR and was effective as of January 1, 1995.\footnote{The Treaty was approved in Brazil by Legislative Decree No. 197, on September 25, 1991, and promulgated by Decree No. 350, on October 21, 1991. The ratification instrument was deposited on October 30, 1991.} In 1991, the Protocol of Brasília was signed, providing mechanisms for the solution of controversies (ad-hoc mechanisms for the solution of arbitral commercial conflicts between the member countries of the MERCOSUR). From 1993 to 1994, negotiations resulted in a Common External Tariff (TEC) in MERCOSUR. Differences in structure and industrial levels of development between Brazil and the other partners resulted in the acceptance of a list of exceptions during the transition phase that covered the years 2001 through 2006. The member countries also decided to harmonize the incentives of the exportations respecting GATT arrangements. This harmonization began...
The TEC governs the Brazilian schedule of tariffs. It also adopts the Harmonized System as a nomenclature basis. The four countries use the same tariff schedule with some exceptions that apply to such areas as automotive, communications, and goods related to computer hardware sectors.

MERCOSUR has among its goals more than a mere common market. It seeks the coordination of macroeconomic and sector policies, the creation of common trade policy towards third parties, the adoption of a common customs code, and the free transit of goods, services, and means of production. In this sense, MERCOSUR has a broader scope than NAFTA.

On December 17, 1994, the Protocol of Ouro Preto was signed, which partially modifies the Treaty of Asuncion and gives an international legal personality to MERCOSUR. At the meeting of the presidents of the South Cone on January 2, 1996, Bolivia and Chile began to negotiate their association to the MERCOSUR. They followed the parallel negotiations of Bolivia and Venezuela, both members of the Andean Community. In 1998, the Andean Community and MERCOSUR agreed on the integration of the two blocks. Presently, Chile and Bolivia have partner status in MERCOSUR. MERCOSUR is also negotiating trade preferences with the EU. One area of contention, however, is the agricultural subsidy. The same argument over agricultural subsidies can be seen in FTAA negotiations.129

Also, under MERCOSUR, there are the most favored nation and national treatment clauses, the same concepts found within the WTO/GATT system. Under this perspective, commercial relations between Brazil and the United States are directly affected by the MERCOSUR agreement. The possibility of bilateral agreements and the FTAA agreement have to be considered under the appreciation of the other three countries.

The Common Tariff Schedule of MERCOSUR provoked changes in the Brazilian Tariff Schedule. It did not, however, provoke expressive changes in the Brazilian internal tax system. But the other member states fostered some tariff changes to achieve harmonization.130 There are calls

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128. According to the Ministry of Foreign Relations, "[A]round 95% of intra-MERCOSUR trade is currently being carried on free of tariff barriers, a position that should apply to all intra-regional trade by the year 2000. The Common Foreign Tariff is specified for practically all the Mercosur tariff area, with widespread implementation since January 1st, 1995. By 2006, with the termination of the period of ascending or descending convergence of the national tariffs that are still excluded, the Foreign Common Tariff will be used for all the tariff area." Ministério das Relações Exteriores, Mercosur—The Common Market of the South, available at http://www.mre.gov.br/cdbrasilitamaratylweb/ingles/relext/mre/orgreg/mercom/index.htm (last visited Aug. 23, 2004).

129. Id.

130. See Edison Carlos Fernandes, Sistema Tributário do Mercosul (Revista dos Tribunais 1997) (providing analysis of the tax systems of the members of MERCOSUR under the perspective of tax harmonization).
for the adoption of a Common Customs Code from MERCOSUR members. Its accomplishment, however, faces some barriers, such as the different constitutional treatment of some issues and practical problems for customs integration itself.

Income tax and other taxes were not affected by MERCOSUR. Indeed, considering the other three countries of MERCOSUR and the associate countries (Chile and Bolivia), only Brazil and Argentina signed a treaty to avoid double income taxation. However, considering the EU experience, there is no doubt that in order to increase economic integration, it is necessary to harmonize tax systems.

D. NAFTA

In 1993, the United States, Mexico, and Canada entered into NAFTA. One of the goals of NAFTA is to eliminate all tariff and non-tariff barriers within North America over the next fifteen years. But NAFTA also addresses other issues like trade in services, foreign investment, intellectual property, labor, and environment. Labor and environment are side agreements because NAFTA is not intended to be a common market, but a free trade area.

In terms of trade treaties, NAFTA goes farther than the WTO agreements. NAFTA is a free trade area, meaning that there is no tariff barrier on trade. Under the WTO, the goal is to reduce tariffs and have uniform and reliable rules in trade.

Under NAFTA, by 2008 "essentially all North American trade in goods [will be] duty free. Four stages lead to this result, subject to agreement upon accelerated two-way or three-way reductions." In terms of trade treaties, NAFTA goes farther than the WTO agreements. NAFTA is a free trade area, meaning that there is no tariff barrier on trade. Under the WTO, the goal is to reduce tariffs and have uniform and reliable rules in trade.

Under NAFTA, by 2008 "essentially all North American trade in goods [will be] duty free. Four stages lead to this result, subject to agreement upon accelerated two-way or three-way reductions."132

The WTO agreements directly affect trade between the United States and Brazil. But NAFTA, as a regional trade agreement, does not have a direct impact, although it may have some indirect consequences. As mentioned earlier, a regional trade agreement is an exception to the WTO’s MFN clause. Therefore, Brazil, under the WTO rules, cannot complain about the tariff reductions that the United States and Canada grant to Mexico. If one considers that, as a consequence of NAFTA, Mexico’s economy will be favored over Brazil’s economy, and if the two economies are fighting for the same space in international scenery, the Mexican economy will be favored in comparison to Brazil in terms of trade relations with the United States and Canada.

131. Due to the cross-border facilities among the three countries, services and labor issues tend to be tough questions. See Folsom et al., supra note 4, at 179-285, 672-741.
132. Id. at 48.
133. It seems to be a strategic decision taken by Mexico. Mexico is implementing a net of trade treaties that may have, as a result, put the country in the center of the chain of commerce in the Americas, and in some sense, in the world. See Alberto de la Pena, supra note 116, at 369, 381-82.
One of the escape alternatives available to Brazil is the implementation of the FTAA that will offset some advantages of the NAFTA group over other countries of the Americas.

E. FTAA

One action of the OAS was to integrate the economies of the affiliated countries into a single free trade agreement.134 This effort began in December 1994, when thirty-four countries of the Americas agreed to construct an FTAA in which barriers to trade and investments would be progressively eliminated, with complete elimination effective by 2005.

The FTAA addresses the tariff issue, but it also has specific commitments to agriculture, government procurement, investment, market access, subsidies, antidumping and countervailing duties, dispute settlement, services, intellectual property rights, competition policies, and the like. It also includes the classical national treatment and MFN clauses.135

The last ministerial meeting that took place in Miami, Florida during November 2003 suffered a stalemate similar to the one experienced during the WTO negotiations in Cancún, Mexico in September 2003. Developing countries are claiming to end agricultural subsidies granted by the United States as a tradeoff mechanism to open their markets to services and accept new rules for investment and intellectual property. The proposed FTAA text encompasses all these issues and more. However, the final agreement reached in Miami in November 2003 allowed the negotiating parties to agree to individual provisions not contained in the agreement without having to agree to all provisions of the FTAA. The FTAA is not a take it or leave it agreement.136 For this reason, it was called FTAA á la carte.

On January 12-13, 2004, the Special Summit of the Americas took place in Monterrey, Mexico. It focused on corruption and other issues, but did not advance any agricultural issues such as U.S. subsidies. Regardless, the Monterrey Summit echoed and expanded upon the decision of the Miami Declaration. It enhanced the commitment of the countries of the Americas, as stated in the Declaration of Nuevo Leon. That declaration addresses economic growth issues such as combating poverty, fostering social development, achieving democrat governance, and fighting

134. See FOLSOM ET AL., supra note 4, at 781-82. The Trade Unit of the Organization of OAS, which was created in 1995, has as primary functions to support the OAS member states in matters related to trade policy and economic integration and to join the efforts to negotiate a Free Trade Area of the Americas (FTAA). See OAS-TRADE UNIT, available at http://www.sice.oas.org/Tunit/unite.asp (last visited Aug. 23, 2004).


The United States has been negotiating bilateral trade treaties with Central and South American countries. This seems to be a strategy to circumvent the FTAA process. There has been criticism of U.S. strategy to build up bilateral agreements instead of forcing negotiations within the FTAA multilateral agreement. These bilateral agreements, however, have not been made with Brazil and Argentina, but were made with countries having smaller economies. Brazil and Argentina are fundamental to the process of achieving the FTAA's goals. As long as Brazil and Argentina are negotiating with the NAFTA members under the FTAA proposal, mainstream negotiations are preserved. In this sense, the bilateral trade agreements, far from being discriminatory, may become paths to a large multilateral agreement. By way of the bilateral agreements (and here, one may considerer the agreements between MERCOSUR and other countries), the small differences between the countries will be settled. This will pave the road for the big treaty because those questions will no longer be part of the whole negotiation. For this reason, it is reasonable to view the bilateral trade treaties between the United States and Canada with Latin and Caribbean countries not as nuisances to the FTAA integration process, but as shortcuts.

Undoubtedly, as the process of integration under the FTAA proposal progresses, tax implications will become more evident. As discussed above, traditional tax treaties will become obsolete, and new rules for investment and intellectual property will be necessary. Considering that the United States and Brazil do not yet have a tax treaty that avoids double taxation, any future tax treaty will have to consider the new free trade scenario that will emerge. The same problems iterated for NAFTA will arise, and new ones will appear as well. This becomes evident when one considers the economic disparities that will join the biggest economic block in the world, and the nondiscrimination and MFN clauses that they will have to accept and apply without imposing a heavy burden on one another, which implies the acceptance of some concessions. The FTAA draft chapter XVI (Services), article 9.1, (d) and (e) states:

Subject to the requirement that the following measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable

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139. Mutatis mutandis, it is the same rationale that can be used to demystify the apparent contradiction between multilateralism and regionalism in trade agreements. See Salazar-Xirinachs, supra note 112.

140. See supra note 13.

141. See FTAA Draft Agreement, supra note 135.
discrimination between Parties where like conditions prevail, or a disguised restriction to trade in services, nothing in this Chapter shall be construed to prevent the adoption or enforcement by any Party of measures:

d) inconsistent with Article 4 (National Treatment), provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Parties;

e) inconsistent with Article 3 (Most-Favored-Nation Treatment), provided that the difference in treatment is the result of an agreement on the avoidance of double taxation in any other international agreement or arrangement by which the Party is bound. (emphasis added)\(^\text{142}\)

Thus, in the case of services, the bilateral tax treaties will prevail over the dispositions of the FTAA agreement. This seems to be discriminatory with respect to the taxation of services. In spite of the fact that harmonization of the taxation of such transactions is important to enhance commerce, and is thus a desirable measure, one has to consider that there is a kind of net of bilateral tax treaties addressing this issue and that there are expressive differences in the tax rates among the countries of the FTAA. This situation is quite different from that of the NAFTA\(^\text{143}\) and MERCOSUR countries where they are considered to be blocks.

The FTAA draft,\(^\text{144}\) in chapter XVII (Investment), also addresses tax-related provisions. It is worth mentioning that the provisions in this chapter exclude small economies from rules under article XII that grant free transfers of capital, in addition to those related to secure tax compliance. Under article XV, there are exceptions to national treatment and MFN treatment regarding agreements that establish provisions that avoid double taxation and other international agreements related to tax matters. It seems that the scope of the draft is to maintain the compliance with existing laws related to taxation (which include tax treaties), even as general exceptions, which prevent conflicts (article 17). The draft makes

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142. These provisions are quite similar to the provisions found in the GATS, article XIV (General Exceptions), (d) and (e).
143. As stated by Brian J. Arnold and Neil H. Harris, The complete elimination of tax barriers to free trade and investment within North America requires the harmonization of the tax systems of the three countries. At this time, the possibility of achieving such harmonization is remote. Canada, Mexico and the United States all have sophisticated corporate income tax systems that differ in important respects. These domestic corporate income tax systems contain provisions that, intentionally and unintentionally, impede cross border transactions. One of the primary functions of tax treaties is to reduce or eliminate these impediments by limiting the source country's jurisdiction to tax, ensuring that the residence country provides relief from double taxation where both countries tax the same income, and protecting nonresidents from discriminatory tax measures. The existing tax treaties between Canada, Mexico and the United States fall short in eliminating tax barriers to cross border activity. Although NAFTA is a multilateral agreement, the tax treaties are bilateral.
Arnold, supra note 13, at 578.
144. See FTAA Draft Agreement, supra note 136.
clear that tax matters will be preserved when faced with general rules, such as those dealing with transnational investments that protect the free movement of capital. The Canadian Department of Foreign Affairs issued a document with some conclusions and concerns that are worth keeping in mind.145

The ANNEX shows two tables with data from the FTAA. Between 1997 and 2000, Brazilian exports to the United States have been slowly increasing, outpacing the average of 4.64 percent per year. During that time, exports to MERCOSUR countries decreased. Regarding the other two NAFTA countries, the exports increased to Mexico, and decreased to Canada. The principal factor in the Canadian case may be the trade battle between Brazil and Canada involving planes and beef. It is possible that this trend may not soon change. Thus, the trend indicates that in the case of implementation of the FTAA, Brazil may increase its exports to the United States. With respect to imports, Table 2 shows that the real tariff Brazil levies on imports from the United States is about 8 per-

145. See Canadian Department of Foreign Affairs & International Trade, Canada's Positions and FTAA Draft Text, Canada's Positions and Proposals, and Frequently Asked Questions (Jan. 2002), available at http://www.dfait-maeci.gc.ca/tna-nac/Note-FM-en.asp. The most relevant parts regarding the present analysis are taxation measures that distinguish, based on residence, the issue of their interplay with the national treatment obligation applicable to investment.

The issue arises as to whether income taxation measures, which distinguish based the residence of taxpayers or on the basis of the nationality of the controlling shareholders of corporate taxpayers, can be considered to impose de facto a discriminatory treatment on the basis of the national origin of investors. The interaction between the FTAA and bilateral double taxation agreements must be examined.

Countries enter into double taxation agreements (DTAs) because there is a potential overlap between DTAs and the FTAA. The extent of this overlap must be analyzed and the proper interface between both must be considered. Certain provisions of existing DTAs might come in conflict with obligations of the FTAA. For example, withholding taxes authorized under a DTA may not be in accordance with a national treatment obligation in respect of investments.

Since DTAs include mutual agreement procedures (MAPs) to address issues arising between parties to a DTA, the issue could arise as to which of the FTAA's dispute resolution procedures and a DTA's MAP would have precedence over a given dispute involving a taxation measure. Therefore, there is a need to coordinate fully the application of the FTAA with the operation of bilateral double taxation agreements. The current text of the Chapter on Investment (for example, in articles 4 and 12) already contains references that similarly suggest the need to provide in the Agreement for the interface between DTAs and the FTAA.

The relationship between taxation measures and obligations of the FTAA in respect of expropriation must be addressed. In addressing taxation issues, consideration should be given to the way any discipline on expropriation, including the FTAA dispute settlement procedures, would apply to tax measures.

In the course of addressing the tax issues raised in the context of the FTAA, it is worth recalling that taxation measures were the object of a specific article in NAFTA. While it is beyond the scope of this note to provide an analysis of how NAFTA addressed taxation issues, it can be said that careful consideration was given by the parties to the issues raised in this note. The parties ultimately included a provision dealing with taxation in which income tax measures were substantially carved-out of the Agreement.
cent. This is a low rate providing little room for the growth of Brazilian imports from the United States in case of FTAA implementation.

V. TRENDS, PERSPECTIVES AND RECOMMENDATIONS

The problems that arise from the fact that transfer pricing rules and customs valuation rules apply to the same economic transaction, while resulting in different consequences, is a very interesting issue. In order to harmonize the legislation, it should also be the object of more concern. Resolution of this inconsistency would result in a more rational system as a whole and would be a positive factor in distinguishing the FTAA from other regional trade treaties.

With regard to the issue of tariffs, rules of origin, and technical barriers, the experiences of GATT/WTO, MERCOSUR, and NAFTA have aided the FTAA negotiations, resulting in a high degree of harmonization and integration. The questions will rely on the tariff schedules (a case-by-case discussion), subsidies, and time to phase out the differences of the tariff schedules. This kind of negotiation is not deemed to be definitive. In the long-run, the negotiation process tends to achieve high levels of stabilization.

A. CHANGES IN TAXATION

On January 7, 2003, President Bush announced a proposal to integrate the two levels of taxation on corporate income, which would, among other things, exclude dividends from taxable income. Nevertheless, the Department of Treasury took the position that the withholding tax would still apply to dividends paid by a U.S. corporation to its foreign shareholders. The Department of Treasury recommended that foreign shareholders not be granted benefits by statute, but through treaty negotiation. In spite of the fact that the proposal to extinguish the double level of corporate taxation was not approved by Congress, the message is still valid for the future.

146. It is interesting to point out that the real tariffs levied from the MERCOSUR countries (Argentina, Paraguay, and Uruguay) are very, very low (almost close to zero).
148. See generally Jovanovitch, supra note 46.
150. Actually, the double level of taxation has been mitigated. See supra note 12. The relief to dividends also applies to dividends received from qualified foreign corporations. I.R.C. § 1(h)(11)(C) (2003). However, the requirements to qualify as a foreign corporation depend on the existence of a comprehensive income tax treaty with the United States, exchange of information between the two countries, and
Thus, Brazilian investors in the United States will not benefit from this shift in U.S. taxation, unless Brazil and the United States come to an agreement on tax issues by implementing a double-tax treaty. However, from the point of view of the U.S. investor in Brazil, there is a tax gain. The corporate and dividend tax in Brazil (exempted) is lower than in the United States, even though there is no tax treaty between Brazil and the United States that would allow an investor to avoid double taxation.

The current corporate double-tax in the United States is a negative feature in comparison to other countries, as well as to Brazil. The point is that in a free trade area, where the mobility of capital and investments tends to increase, tax advantages from one country to another with respect to corporate tax that is taxed on a global basis, will be stressed and become a very sensitive issue. In other words, it will be easy to arbitrate the preferred tax rate without considering other issues because investments will be under an international treaty.\(^{151}\)

Brazil also had a change in taxation policy. The 2003 Tax Reform sought to reduce tax competition between the states and economic distortions of the tax system.\(^{152}\)

Considering the current economic structures of the American countries and considering that a great majority of them depend on agricultural commodities, one may say that the agriculture issue is very important to any discussion regarding the huge subsidies the United States grants to that economic sector. In agriculturally based countries, these subsidies are seen as a barrier that should be eliminated. It is not far from the truth to say that agricultural subsidies are the key to the entire FTAA agreement.

The FTAA is still a process, and there are strong concerns about whether the United States should put more effort into the FTAA or should shift its focus to stronger markets such as Japan.\(^{153}\) Regardless, the evolution of the negotiations is very important for both the United

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other conditions to be determined by the Treasury and the IRS. See Press Release, U.S. Dep’t of Treasury, U.S. Treasury Issues Tax Rate Guidance on Foreign Dividends (Sept. 30, 2003), available at http://usinfo.org/wf-archive/2003/030930/epf207.htm. In terms of attracting equity investments, this is quite a disadvantage to Brazil (that does not have such treaty) in comparison to other countries that signed income tax treaties with the United States. It is worth noting that this provision will only last until December 31, 2008. See JGTRR Act, supra note 12, § 303.


A number of economists have argued that, regardless of the strength of the traditional arguments supporting a corporate tax, with increased globalization, countries will be unable to sustain the tax. As investment capital becomes increasingly mobile, firms will be able to locate their assets in the most tax-advantaged jurisdictions. The corporate tax will be a victim of the resulting race to the bottom to attract investment capital. It is also argued that the development of e-commerce and the increasingly sophisticated use of financial instruments will make administering and enforcing the corporate tax impossible. \textit{Id.}

\(^{152}\) See Emenda Constitucional No. 42, supra note 58.

\(^{153}\) See FOLSON ET AL., supra note 4, at 783.
States and Brazil. Whatever direction these negotiations take, they will affect both economies.

It is possible that some of the issues commonly addressed in the double-tax treaty may be addressed in the FTAA (especially tax on services) and may alleviate the taxation on international transactions between the United States and Brazil.

Regarding the rules related to services and investment under the FTAA agreement, it is clear that the bilateral treaties and other agreements related to taxes will be problematic to the harmonization of the rules under the FTAA community. In the end, the solution for this case is the harmonization of the tax systems, which, considering the great disparities among the FTAA economies, will remain as a utopia for a long time.

For this reason, it is advisable that the countries of the Americas come to bilateral agreements that avoid double taxation and tax avoidance in order to harmonize the tax treatment on a bilateral basis (under the general rules of the FTAA agreement).

The FTAA will increase trade and other transactions among its members while increasing the possibility of tax arbitrage due to different tax regimes. The aspects analyzed above also indicate the necessity of harmonizing the treatment of transfer pricing rules, and other internal tax-related issues affecting international transactions (which are different from one country to another and conflict with each other), in order to establish intra-community tax neutrality. Without tax neutrality, the resulting bias will impose a burden on the countries that are not profitable, but it would still contribute to the overall result of the FTAA community.

After FTAA implementation, it is not difficult to see that Brazil will lose its competitive edge in comparison to other American countries that have tax treaties with the United States. It is easy to predict that companies will search for countries with more administrative and tax privileges, without disregarding the possibility of tax arbitrage. The preeminence of the U.S. economy is a huge factor that affects the allocation of investment. This occurs despite the double level of taxation on corporations, a feature that does not exist in Brazil. In this situation, a tax treaty that avoids double taxation between the United States and Brazil will give an advantage to the United States in collecting tax revenue, considering that dividends are still taxed, even though some relief is granted under such treaties, and will attract more Brazilian investments to the United


155. Similar effect is a concern under the NAFTA agreement. See Cockfield, supra note 43.

156. See supra notes 12 and 150 and accompanying text.

157. See, e.g., 1996 MODEL TAX TREATY, art. 10, supra note 17.
States, regardless of the lower corporate income tax rate and the absence of dividend tax in Brazil.

It is also very likely that the total workforce may increase among the NAFTA countries, and residence criteria for tax purposes may be changed in order to be more suitable to the new reality.

VI. FINAL REMARKS

Both the United States and Brazil tax a corporation's worldwide income and apply transfer-pricing rules. Both countries apply different regulations, but those regulations are based on similar principles. There are some regulatory similarities if one considers the fact that both countries apply withholding tax when the source of income is within the country and the company or person that is receiving the income is considered a non-resident alien. Transactions in a specific sector like communications and transportation are submitted to specific treaties (not analyzed in this paper). These treaties also bring tax relief dispositions. Brazil and the United States have treaties for specific activities, but not a general tax treaty that avoids double-taxation.

With respect to the trade of goods and services, both countries are leaders. The United States is the most powerful economy of the northern part of the Americas, as well as the rest of the world, and Brazil is the leading economy of South America. The process of integration targeted by the FTAA will put the NAFTA, ALADI, and MERCOSUR together. In spite of criticism based on short-term results, the long-term is unpredictable. Nevertheless, it seems that NAFTA will bring more stability to the commercial relationship between all the countries of the Americas. Stability must be considered as a very important factor to development. Perhaps it will be the reason that countries join the FTAA, at a time when the problems of protectionism and subsidies from the United States and Canada will be over.

It seems that the most important barrier to the FTAA negotiations is the United States providing subsidies for agricultural products and the imposing barriers on other products, especially those from Brazil such as orange juice and steel.

Because of market integration, the tariff schedules tend to be the same in relation to third world countries, and the tariff rate between the parties will decrease (to lower rates or to zero, in certain cases). One cannot forget that imports will still be taxed internally, and most of the countries apply value added taxes (VAT) (at least in the most important countries like Brazil and Argentina), a tax that the United States does not have this kind of taxation (VAT imposed at destination). In the end, harmonization will be required for tax neutrality on transactions between countries.

If one considers integration and harmonization as a whole, harmonizing the transfer price rules may also become a goal. Due to the absence of a double-tax treaty between the United States and Brazil, the implementation of the FTAA may create some relative advantages to other
countries of the Americas that have such a treaty with the United States. There is no doubt that as a result of the integration process, the taxation of transactions between the United States and Brazil will be harmonized.