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Time for a U.S.–Brazil Tax Treaty

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Time for a U.S.–Brazil Tax Treaty

by

Luís Eduardo Schoueri and Gustavo Lian Haddad***

Abstract

The U.S. is the most relevant trade partner with whom Brazil does not have a tax treaty. Previous attempts to conclude it were not successful, with the main alleged reason being Brazil's insistence on tax sparing. With the change in time and developments in treaty policy and in the domestic tax regimes of the countries, tax sparing should no longer be an obstacle. After discussing the potential benefits of a treaty for both countries and their respective taxpayers, this Article addresses the technical issues that may arise during negotiations resulting from differences of tax treaty practice and demonstrate that none of them seem significant enough to be a "deal breaker," with the most relevant currently being sourcing rules on technical services. Should the governments of both countries, which in recent months have given signs of political synchrony unseen in the past decades, decide to pursue the conclusion of a tax treaty, the technical conditions are more than ever present.

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I. Introduction

In recent years Brazil has made efforts to renegotiate and modernize existing tax treaties and to conclude new ones, with treaties signed with Switzerland,[1] Singapore,[2] and United Arab Emirates[3] in 2018 (all still pending ratification[4]) being the possible future additions to the country's network. Nevertheless, there continues to be relevant trade partners with whom Brazil does not have a tax treaty in place—the United States, Germany,[5] and the United Kingdom are important gaps in Brazil's treaty network.

1. Convention Between the Swiss Confederation and the Federative Republic of Brazil for Elimination of Double Taxation with Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance, Switz.-Braz., May 3, 2018, Tax Analysts Doc. 2018-19169 [hereinafter Switz.-Braz. Treaty].

2. Agreement Between the Republic of Singapore and the Federative Republic of Brazil for the Elimination of Double Taxation with Respect to Taxes on Income and the Prevention of Tax Evasion and Avoidance, Sing.-Braz., May 7, 2018, Tax Analysts Doc. 2018-19384 [hereinafter Sing.-Braz. Treaty].

3. Convention Between the Federative Republic of Brazil and the United Arab Emirates for the Elimination of Double Taxation with Respect to Taxes on Income and the Presentation of Tax Evasion and Avoidance, Braz.-U.A.E., Nov. 12, 2018, Tax Analysts Doc. 2019-42000 [hereinafter Braz.-U.A.E. Treaty].

4. *See* Larissa Hoaglund, *Brazilian Lower House Approves Tax Treaties with Singapore, Switzerland, UAE*, 2020 Tax Notes Today Int'l 46-12 (Mar. 9, 2020).

5. Brazil did have a tax treaty with Germany, which was terminated by Germany on April 7, 2005. For a discussion about the reasons and effects of such termination, please refer to Gerd Willi Rothmann, *A Denúncia do Acordo de Bitributação Brasil-Alemanha e Suas Consequências*, *in* 9 Grandes

During the Brazilian military period (1964–1988), the focus of the regime was to sign tax treaties with developed economies that could assist in fostering direct foreign investment in the country. Treaties with traditional Asian and European economies date from this period, including the ones with Japan (1967),[6] France (1971),[7] Spain (1974),[8] Germany (1975, currently no longer in effect),[9] and Italy (1978).[10]

It was only natural that an emphasis would be given to having a treaty with the United States, historically one of the political allies of the regime and the most important foreign trade partner of the country. Negotiators were successful in concluding a tax treaty with the United States in 1967,[11] under the U.S. presidency of Lyndon B. Johnson. However, the U.S. Senate rejected the tax treaty with Brazil. One of the key

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Questões Atuais do Direito Tributário 146 (Valdir de Oliveira Rocha ed., 2005).

6. Convention Between Japan and the Federative Republic of Brazil for the Avoidance of Double Taxation with Respect to Taxes on Income, Japan-Braz., Jan. 24, 1967, 682 U.N.T.S. 195 [hereinafter Japan-Braz. Treaty].

7. Convention Between the French Republic and the Federative Republic of Brazil for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Fr.-Braz., Sept. 10, 1971, 857 U.N.T.S. 3 [hereinafter Fr.-Braz. Treaty].

8. Convention Between the Federative Republic of Brazil and the Spanish State for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Braz.-Spain, Nov. 14, 1974, 1031 U.N.T.S. 7 [hereinafter Braz.-Spain Treaty].

9. *See* Agreement Between the Federative Republic of Brazil and the Federal Republic of Germany for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital, Braz.-Ger., June 27, 1975, 1016 U.N.T.S. 193 [hereinafter Braz.-Ger Treaty]; Ann M. Miller, *Brazil, Germany to Negotiate Tax Treaty*, 2015 World Tax Daily 160-5 (Aug. 19, 2015) (describing termination effective January 1, 2006, of Brazil-Germany Tax Treaty).

10. Convention Between the Government of the Federative Republic of Brazil and the Government of the Italian Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Braz.-It., Oct. 3, 1978, 1242 U.N.T.S. 179 [hereinafter Braz.-It. Treaty].

11. Convention Between the Government of the United States of America and the Government of the United States of Brazil for the Avoidance of Double Taxation with Respect to Taxes on Income, U.S.-Braz., 13 March 1967, Tax Analysts Doc. 93-30154 (abandoned).

reasons was the inclusion of tax sparing and matching credit provisions in favor of U.S. investors into Brazil.[12]

As explained by Francisco Dornelles, Brazil's chief tax treaty negotiator at the time, the inclusion of tax sparing provisions was a demand by Brazil to avoid the reduction in Brazilian source taxation provided by the treaty so it would not result in actual benefits for the U.S. resident investor (and be otherwise transferred to the U.S. Government through a reduction of the tax credit to avoid double taxation).[13] This was Brazil's policy in signing tax treaties with other developing countries during that period also.[14]

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12. Yariv Brauner, *Por Que os Estados Unidos Firmam Tratados Tributários? E Por Que Não Têm Tratado Tributário com o Brasil?*, 26 Revista Direito Tributário Atual 109, 122 (2011) (Célia Korn trans.); Luís Eduardo Schoueri, *Contribuição à História dos Acordos de Bitributação: A Experiência Brasileira*, 22 Revista Direito Tributário Atual 267, 274 (2008).

13. In a speech on the Brazilian House of Representatives in 2003, Francisco Dornelles stated:

> A inclusão das cláusulas de isenção e tax sparing nas convenções fiscais internacionais celebradas pelo Brasil reveste-se de fundamental importância, já que são esses os mecanismos garantidores de qualquer incentivo, subsídio, isenção ou redução do imposto brasileiro significará efetivo benefício para o investidor e não uma mera transferência de recursos do Tesouro brasileiro para o do outro país.
>
> [The inclusion of exemption and tax sparing clauses in international tax conventions entered into by Brazil is of fundamental importance, as these are the mechanisms that guarantee any incentive, subsidy, exemption, or reduction of the Brazilian tax will mean effective benefit to the investor and not a mere transfer of resources from the Brazilian Treasury to that of another country.]

Natalie Matos Silva, *As Cláusulas de* Tax Sparing *e* Matching Credit *nos Acordos de Bitributação* 104 n.363 (2013), https://teses.usp.br/teses/disponiveis/2/2133/tde-23032017-145757/publico/Natalie_Matos_Silva_Dissertacao_As_clausulas_de_tax_sparing.pdf (Master's in Economics, Financial and Tax Law dissertation, University of São Paulo Law School) (Luís Eduardo Schoueri, adviser).

14. For examples of treaties containing tax sparing or matching credits provisions, see Convention Between the Federative Republic of Brazil

From a U.S. perspective, such inclusion seemed appropriate at the time as the major principle underlying the U.S. international tax regime until the Eisenhower Administration was the idea that taxing jurisdiction should be based on benefits conferred by the taxing state.[15] In addition to Brazil's treaty, others with Pakistan, India, and Israel were also concluded by the United States including tax sparing provisions.[16] Nevertheless, these tax sparing provisions did not become effective, as the Foreign Relations Committee of the Senate accepted the argument presented by Stanley Surrey (Assistant Secretary of the Treasury for Tax Policy during Kennedy's and Johnson's

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and the Republic of Austria for the Avoidance of Double Taxation with Respect to Taxes on Income and Fortune, Braz.- Austria, May 24, 1975, 1046 U.N.T.S. 241 [hereinafter Braz.-Austria Treaty]; Convention Between the Federative Republic of Brazil and the Kingdom of Belgium for the Avoidance of Double Taxation and the Regulation of Certain Other Matters with Respect to Taxes on Income, Braz.-Belg., June 23, 1972, 920 U.N.T.S. 137; Convention Between the Government of the Federative Republic of Brazil and the Government of the Kingdom of Denmark for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Braz.-Den., Aug. 27, 1974, 962 U.N.T.S. 253 [hereinafter Braz.-Den. Treaty]; Fr.-Braz. Treaty, *supra* note 7; Braz.-Ger Treaty, *supra* note 9 (terminated); Braz.-It. Treaty, *supra* note 10; Japan-Braz. Treaty, *supra* note 6; Braz.-Spain Treaty, *supra* note 8; Convention Between Brazil and Sweden for the Avoidance of Double Taxation with Respect to Taxes on Income, Braz.-Swed., Apr. 25, 1975, 1020 U.N.T.S. 59.

15. In his economic report to Congress, President Eisenhower stated:

> Under proper safeguards, we should be prepared to give full credit for income taxes that are waived by a foreign country for a specified initial period, just as we now grant credit for taxes that are imposed. This change would give maximum effect to the laws of other countries designed to encourage new enterprises.

Economic Report of the President Transmitted to Congress 54 (1955); *see also* Kim Brooks, *Tax Sparing: A Needed Incentive for Foreign Investment in Low-Income Countries or an Unnecessary Revenue Sacrifice?*, 34 Queen's L.J. 505, 518 & n.24 (2009) (quoting and discussing same statement from President Eisenhower).

16. Howard M. Liebman, *A Formula for Tax-Sparing Credits in U.S. Tax Treaties with Developing Countries*, 72 Am. J. Int'l L. 296 (1978).

Administrations) that tax sparing provisions would not be in the best interest of the United States.[17] They would result in an unacceptable reduction in U.S. taxation of its residents on U.S. source income and would be inconsistent with the purpose of the foreign tax credit mechanism, being equivalent to a tax exemption.[18]

In 1998, a report by the OECD expressed the view that tax sparing provisions should be discouraged as they would not be an effective instrument of foreign aid by developed economies to emerging or underdeveloped countries and would provide opportunities for tax planning and tax avoidance.[19] The authors have serious reservations about the arguments supporting the view of the OECD and believe that the idea of tax sparing as a subsidy by developed economies to developing countries is misleading. Tax sparing should be seen as a way to preserve the integrity of the tax treaties' distributive rule allocating taxing powers between source and residence countries.[20]

From the U.S. perspective, the Senate believed that it would not be appropriate to encourage investment in foreign countries due to an allegedly growing deterioration of U.S. internal and international fiscal situations.[21] To date, this is still the standard policy, and no tax treaty the United States is a party to has a tax sparing provision. Against this background and despite the desire of the business community, no significant progress has been made since the 1960s in advancing negotiations for a tax treaty between Brazil and the United States.[22]

In this short Article, we argue that with the change in time and some developments in policy and in the domestic tax regimes of the

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17. André de Souza Carvalho, *Acordo Brasil-EUA: O Que Ainda Falta para a Sua Conclusão?*, Revista de Direito Tributário Internacional, no. 4, 2006, at 9, 36.

18. Reuven Avi-Yonah, *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, 25 Va. Tax Rev. 313, 327–28 (2005); Brooks, *supra* note 15, at 519–20.

19. OECD, *Tax Sparing: A Reconsideration* (1998), https://doi.org/10.1787/9789264162433-en [hereinafter OECD, *Tax Sparing*].

20. Luís Eduardo Schoueri, *Tax Sparing: A Reconsideration of the Reconsideration*, *in* Tax, Law and Development 106, 113 (Yariv Brauner & Miranda Stewart eds., 2013); *see also infra* Part III.B.

21. Brauner, *supra* note 12, at 123.

22. *A Roadmap to a U.S.-Brazil Tax Treaty*, Braz.-U.S. Bus. Council 2 (Mar. 2019), https://www.brazilcouncil.org/wp-content/uploads/2019/03/Roadmap-U.S.-Brazil-Tax-Treaty_1.pdf [hereinafter Braz.-U.S., *Roadmap*].

countries, tax sparing should no longer be a technical obstacle for the conclusion of a tax treaty between the countries. In Part II, we discuss the potential benefits of the treaty for both countries and their respective taxpayers. In Part III, we examine the technical issues that may arise during negotiations resulting from differences of tax treaty practice and demonstrate that none of them seem significant enough to be a "deal breaker." We actually conclude that tax sparing is unlikely to be the main issue in negotiations, with the most relevant difference in tax policy currently being sourcing rules on technical services, which has a significant impact in the flows of the digital economy. We conclude that should the governments of both countries, which in recent months have given signs of political synchrony unseen in the past decades, decide to pursue the conclusion of a tax treaty, the technical conditions are more than ever present.

II. Potential Benefits of a Tax Treaty between Brazil and the United States

It has become conventional wisdom that tax treaties are a tool to facilitate Foreign Direct Investment (FDI). Policymakers frequently resort to them for that effect. The effectiveness of that link between conclusion of tax treaties and FDI is, however, difficult to prove empirically. After analyzing several studies that attempted to examine it, Barthel, Busse, and Neumayer asserted that they were inconclusive.[23]

They then decided to use a new approach considering a largely unpublished dataset on bilateral FDI, concluding that tax treaties could be an instrumental tool in increasing FDI in the host country, especially for developing and emerging economies. For these economies, the possible reduction in tax collection resulting from lower withholding taxes at the source could be outweighed by the increase in the tax collection resulting from incremental FDI.

For developed economies, tax treaties at minimum result in facilitating the expansion of their business abroad by providing safer mechanisms to avoid double taxation and by reducing taxation at source (potentially reducing the cost of transaction in case of territorial regimes in the residence country, which are becoming increasingly popular). To

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23. Fabian Barthel et al., *The Impact of Double Taxation Treaties on Foreign Direct Investment: Evidence from Large Dyadic Panel Data*, 28 Contemp. Econ. Pol'y 366 (2010).

a certain extent, these factors do apply to a potential tax treaty between Brazil and the United States.

A. Brazilian Perspective

The existing literature in Brazil has at different times defended that efforts should be made for a tax treaty to be concluded with the United States, usually pointing out tax sparing as one of the most difficult issues to overcome.[24] Indeed, from the Brazilian perspective, it is difficult to argue against the benefits of such a treaty.[25]

Despite its growing relevance as a global player, Brazil is still a net importer of capital in need of FDI,[26] with the United States being one of its largest investors. According to the Brazilian Central Bank's Foreign Direct Investment Report published in 2018, the United States appears as the second largest source of FDI into the country from 2010 to 2016, with the Netherlands being the first.[27] Needless to say that despite the absence of hard data to confirm this, it is likely that a significant part of the investment that appears in the name of the Netherlands also originates from U.S. multinationals that use holding companies in that country as their platform for foreign investment.

From an outbound perspective, with Brazil applying a worldwide regime of taxation of foreign source income, Brazilian residents investing in the United States are currently subject to a very high rate

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24. Carvalho, *supra* note 17, at 36; Daniel Hora do Paço & H. David Rosenbloom, *Considerações Sobre a Negociação de um Tratado para Evitar a Dupla Tributação da Renda com os EUA*, Revista Dialética de Direito Tributário, no. 174, 2010, at 16, 17–19; Schoueri, *supra* note 12, at 274; Agostinho Toffoli Tavolaro & Antonio Carlos Florêncio de Abreu e Silva, *Tratado Brasil/Estados Unidos para Evitar a Dupla Tributação*, Revista de Direito Tributário Internacional, no. 15, 2010, 9, 43–44.

25. Sergio André Rocha defends the opposite. He argues that in general the conclusion of tax treaties by Brazil brings more losses than benefits for the country and that there is no evidence to the contrary. Sergio André Rocha, Brazil's International Tax Policy 156 (2017).

26. Jamie McGeever & Marcela Ayres, *Brazil Current Account Deficit Doubles, FDI Inflows Rise in 2018*, Reuters (Jan. 28, 2019, 8:54 AM), https://www.reuters.com/article/us-brazil-economy-current-account/brazil-current-account-defic it-doubles-fdi-inflows-rise-in-2018-idUSKCN1PM1JZ.

27. Banco Central do Brasil, Foreign Direct Investment in Brazil Report (2018), https://www.bcb.gov.br/Rex/CensoCE/ingl/FDIReport2016.pdf.

of 30% withholding tax on dividends, interest, and royalties from U.S. based sources,[28] in a disadvantageous position when compared to residents of U.S. treaty countries. By comparison, one could consider the other relevant G20 country based in Latin America and with whom the United States has a tax treaty—Mexico. Mexican residents are subject to maximum withholding tax rates of 5% or 10% for most types of passive income under that country's treaty with the United States,[29] while Brazilian residents are subject to 30% absent a tax treaty.

One may argue that this rate is still lower than the Brazilian combined corporate income tax rate of 34%[30] and that Brazilian domestic law allows corporate taxpayers to deduct a tax credit corresponding to the U.S. withholding tax regardless of the existence of a tax treaty,[31] thereby preventing double taxation. Indeed, double taxation is avoided through Brazilian domestic tax legislation; however, the application of a high U.S. withholding tax tends to result in an excess of tax credits that cannot be recovered and become a cost of the transaction.

In relation to dividends, Brazilian legislation allows the deduction of both the indirect (underlying U.S. corporate income tax) and the direct credit (U.S. withholding tax). This combined with a reduction of the Brazilian corporate income tax rate to 25% through a presumed credit mechanism for profits earned by controlled entities operating in certain sectors (manufacturing in general, construction, food, and beverage)[32] makes it more likely that a Brazilian parent company has excess tax credits when investing in a U.S. resident enterprise.

Table 1 illustrates this incremental cost and its potential reduction in case of a future tax treaty between the United States and Brazil. In doing so we assumed: (i) a U.S. corporate income tax rate of 21%

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28. I.R.C. §§ 1441, 1442.

29. The tax treaty between the United States and Mexico provides the following maximum rates of withholding tax: 4.9%, 5%, 10%, and 15%. Convention Between the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Mex, Sept. 18, 1992, Treaty Doc. 103-7 (as amended).

30. Brazil has two taxes on corporate income: Imposto de Renda da Pessoa Jurídica and Contribuição Social sobre o Lucro. The sum of the nominal rates of these taxes equals the 34% nominal rate.

31. Decreto No. 9.580, de 22 de Novembro de 2018, art. 456, Diário Oficial da União [D.O.U.] de 23.11.2018.

32. *Id.* art. 458, § 9.

Table 1

	Description	(1) No Treaty	(2) No Treaty	(3) With Treaty	(4) With Treaty	
A"	Brazil CIT	34%	25%	34%	25%	A"
A'	U.S. WHT	30%	30%	10%	10%	A'
A	Profit U.S. Entity	100	100	100	100	A
B	U.S. CIT	21	21	21	21	B = A * 21%
C	Net Profit	79	79	79	79	C = A − B
D	U.S. WHT on Dividends	23.7	23.7	7.9	7.9	D = C * A'
E	Total U.S. Tax	44.7	44.7	28.9	28.9	E = B + D
F	Brazil Taxable Income	100	100	100	100	F
G	Brazil CIT Due	34	25	34	25	G = F * A"
H	Foreign Tax Credit	34	25	28.9	25	H = IF (E > G; G; E)
I	Additional CIT Payable	0	0	5.1	0	I = G − H
J	**Excess Tax Credit (Cost)**	**10.7**	**19.7**	**0**	**3.9**	**J = IF (E > G; E − G; 0)**

(general U.S. rate after the 2017 Tax Cuts and Jobs Act (TCJA)) and (ii) a withholding tax on dividends capped at 10%, similar to that of the U.S. treaty with Mexico and the lower rate seen in tax treaties Brazil is a party to.[33]

In Scenario 1, the lack of a tax treaty causes the Brazilian parent company to have a tax leakage of 10.7% of the pre-income tax profit of the U.S. resident subsidiary. This increases to almost 20% if the U.S. subsidiary is engaged in one of the sectors that benefits from the reduced 25% Brazilian CIT (Scenario 2), which includes, for example, any manufacturing business. The reduction of withholding tax on dividends that a treaty would provide reduces this leakage to zero or less than 4% (Scenarios 3 and 4, respectively) and puts the Brazilian resident investor in a more level playing field with residents of jurisdictions that have a treaty with the United States, reducing the competitive disadvantage it currently has.

These favorable effects of a treaty would also apply if Brazil would in the future move toward a territorial regime for taxation of foreign sources profits, in which case any U.S. withholding tax would be a cost (and therefore any reduction in such withholding tax would be beneficial). For interest and royalty income earned by a Brazilian corporate investor, the benefits in case of a tax treaty with the United States are less obvious as the current 30% withholding tax rate is nominally lower than the Brazilian CIT of 34%. However, as foreign source income is taxed as ordinary income (mixed with Brazilian source income), a reduction in withholding taxes on interest and royalties provided by the treaty would avoid or reduce the potential for accumulation of foreign tax credits that arise when the Brazilian entity has losses in the same period it earns foreign source income. This would at minimum have a cash flow impact and reduce the burden of carrying these credits over in the financial statements.

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33. The 10% rate on dividends applies in case of qualifying companies of Argentina, Belgium, Chile, Finland, Israel, Republic of Korea, Mexico, Peru, Portugal, Russia, South Africa, Spain, Turkey, Ukraine, and Venezuela. *See Brazil: Corporate—Withholding Taxes*, PwC, https://taxsummaries.pwc.com/brazil/corporate/withholding-taxes (last updated Jan. 7, 2020). In most of these cases, the rate generally applies with respect to participations of at least 25% of the capital or voting power (as the case may be).

B. U.S. Perspective

From the U.S. perspective, the benefits are less apparent from an inbound/FDI standpoint as the globalization of Brazilian multinationals (although increasing) is still relatively new. It is clear, however, that reducing the tax cost of Brazilian FDI into the country could facilitate additional investment by Brazilian corporate entities in the United States, arguably generating new business, employment, and U.S. tax collection.

On the other hand, the United States could use the opportunity to negotiate lower withholding taxes at the source in Brazil. Brazil currently applies rates of 15% to most non-resident income (other than dividends) but has accepted to limit these to 10% in some treaties already in force (like Spain[34] and Israel[35]) and others that have been signed or amended more recently with developed countries (but are pending ratification like the treaties with Switzerland[36] and Singapore[37] signed in 2018 and the amendment to the treaty with Sweden signed in 2019[38]). With the relevance of U.S. investment into Brazil, one could think that even lower rates could be considered.

Further, the prospect of Brazil following the U.S. steps to reduce its corporate income tax and reintroduce withholding tax on dividends cannot be discarded.[39] Having a tax treaty in place would provide a cap on source taxation on dividends payable to U.S. resident investors.

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34. Braz.-Spain Treaty, *supra* note 8; Decreto No. 76.975, de 2 de Janeiro de 1976, Diário Oficial da União [D.O.U.] de 5.1.1976 (promulgating the Braz.-Spain Tax Treaty).

35. Convention Between the Government of the Federative Republic of Brazil and the Government of the State of Israel for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Braz.-Isr., Dec. 12, 2002, Tax Analysts Doc. 2005-15217; Decreto No. 5.576, de 8 de Novembro de 2005, Diário Oficial da União [D.O.U.] de 9.11.2005 (promulgating the Braz.-Isr. Tax Treaty).

36. Switz.-Braz. Treaty, *supra* note 1.

37. Sing.-Braz. Treaty, *supra* note 2.

38. Protocol Amending the Convention Between Brazil and Sweden for the Avoidance of Double Taxation with Respect to Taxes on Income, Mar. 19, 2019, Tax Analysts Doc. 2019-30068.

39. Maria Regina Silva, *Ministério da Economia Estud Reduzir Impostosde Empresas, Anuncia Bolsonaro*, Estadão (Mar. 30, 2019), https://economia.estadao.com.br/noticias/geral,ministerio-da-economia-estuda-reduzir-impostos-de-empresas-anuncia-bolsonaro,70002773491; Rodrigo Tolotti

For U.S. corporations, lower source taxes has become more relevant since the TCJA that adopted a territorial (or partially territorial) regime on active foreign source income.[40] In cases where taxation on foreign source income still applies, the rate has been reduced to historically low levels—a general rate of 21% or 13.125% for certain foreign source income on intangibles, the so-called Global Intangible Low-Taxed Income (GILTI).[41]

These lower rates combined with complex mechanisms of foreign tax credit limitations create the potential for tax leakages (and transaction costs) if the source country (like Brazil) applies high rates of withholding tax. Any reduction of such rates is potentially a reduction in the cost of investment in the source country, therefore benefiting the U.S. investor.

III. Possible Technical Obstacles and Conditions to Overcome Them

The United States uses its own model treaty (U.S. Model) as a starting point of negotiations and is considered to be more aligned with the OECD Model Convention (OECD Model) than with the U.N. Model Convention (U.N. Model),[42] and its last version dates from 2016.[43] Despite Yariv Brauner's note that the United States has become a net importer

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Umpieres, *Bolsonaro e Guedes Falam de Novo sobre Tributar Dividendos: Quais Ações Seriam Mais Impactadas*, InfoMoney, (Apr. 1, 2019), https://www.infomoney.com.br/mercados/acoes-e-indices/noticia/8080641/bolsonaro-e-guedes-falam-de-novo-sobre-tributar-dividendos-quais-acoes-seriam-mais-impactadas.

40. *What Is a Territorial Tax and Does the United States Have One Now?*, Tax Pol'y Ctr. Briefing Book, https://www.taxpolicycenter.org/briefing-book/what-territorial-tax-and-does-united-states-have-one-now (last updated May 2020).

41. *What Is Global Intangible Low-Taxed Income and How Is It Taxed Under the TCJA?*, Tax Pol'y Ctr. Briefing Book, https://www.taxpolicycenter.org/briefing-book/what-global-intangible-low-taxed-income-and-how-it-taxed-under-tcja (last updated May 2020).

42. Brauner, *supra* note 12, at 114–16.

43. U.S. Treas. Dep't, United States Model Income Tax Convention (2016), https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US%20Model-2016.pdf [hereinafter U.S. Model Income Tax Convention].

of capital,[44] the U.S. Model favors residence taxation over source taxation in line with the position of a developed country and exporter of capital. As such, it advocates residence taxation for royalty, interest, and capital gains and reduced source withholding tax on dividends. Further, it has no specific provision on services, which generally fall under article 7 (business profits) being taxed only in the country of residence.

Brazil does not have a model treaty. It has historically used the OECD Model as a starting point for its treaty negotiations,[45] but with some very significant divergences evolving around retaining source taxation of interest, royalties, dividends, technical services, and capital gains.

These divergences reflect the historical position of a developing country and importer of capital, eager to retain its taxing powers as a source country. In this respect, the Brazilian treaty practice, despite having the OCED Model as the starting point, adopts principles pursued by the U.N. Model.

More recently, one feature unique to the U.N. Model has been included in Brazilian treaties—a specific provision allowing for source of technical services defined very broadly. This is present in the new protocol to the treaty with Argentina[46] and the yet to be ratified signed treaties with Switzerland,[47] Singapore,[48] and the United Arab Emirates.[49]

Examining the treaty practice of both Brazil and the United States, one can identify some key areas of divergence that would need to be addressed in negotiations for a tax treaty:

- Provisions of the U.S. Model not present in Brazilian treaties.
- Tax sparing.

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44. Brauner, *supra* note 12, at 115–16.

45. Rocha, *supra* note 25, at 155; Schoueri, *supra* note 12, at 271–73.

46. Protocol Amending the Convention Between the Argentine Republic and the Federative Republic of Brazil for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income art. 20, July 21, 2017, Tax Analysts Doc. 2017-4658; Decreto No. 9.482, de 27 de Agosto de 2018, http://receita.economia.gov.br/acesso-rapido/legislacao/acordos-internacionais/acordos-para-evitar-a-dupla-tributacao/argentina/decreto-no-9-482-de-27-de-agosto-de-2018 (promulgating the Arg.-Braz. Protocol).

47. Switz.-Braz. Treaty, *supra* note 1, art. 13.

48. Sing.-Braz. Treaty, *supra* note 2, art. 13.

49. Braz.-U.A.E. Treaty, *supra* note 3, art. 13.

- Source taxation on passive income.
- Source taxation on technical services.

In addition to these, the Brazilian transfer pricing practice is often mentioned as an area of divergence with developed economies, but we will refrain from commenting on it as this has already been extensively discussed elsewhere[50] and might become less of an issue as Brazil makes progress in its efforts to join the OECD.[51]

A. Provisions of the U.S. Model Not Present in Brazilian Treaties

The U.S. Model has a number of specificities in certain clauses addressing particular concerns resulting from the U.S. tax system. There are several of them, and they will not be exhaustively addressed in this item, which will focus on two that are completely unseen in Brazilian treaties.

The first is the so-called *saving clause* in Article 1, paragraph 4 of the U.S. Model, according to which the treaty does not affect the taxation of citizens of any country and a former citizen or long-term resident of a Contracting State may be taxed in accordance with the laws of that Contracting State. The role of the *saving clause* is to allow the United States to hold its right to tax its citizens even if they are resident of the other Contracting State under the treaty, and it is consistent with the historical position of the country to use nationality as nexus to attract worldwide taxation.[52]

This does not seem to be a significant obstacle for Brazil in case a tax treaty is concluded with the United States. In case a U.S. citizen is a tax resident of Brazil, he or she will be taxed in the country on his/her worldwide income (including income from Brazilian sources) and

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50. Luís Eduardo Schoueri, *Arm's Length: Beyond the Guidelines of the OECD*, 69 Bull. Int'l Tax'n 690–716 (2015).

51. Press Release, OECD, OECD and Brazil Share Outcomes of Project to Align Brazil's Transfer Pricing Rules to OECD Standard (July 11, 2019), http://www.oecd.org/tax/oecd-and-brazil-share-outcomes-of-project-to-align-brazil-s-transfer-pricing-rules-to-oecd-standard.htm.

52. U.S. Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, at 3, https://www.irs.gov/pub/irs-trty/temod006.pdf (last visited June 28, 2020).

will be allowed to credit the Brazilian tax paid against any U.S. tax due as per article 23, paragraph 4 of the U.S. Model.[53] To avoid having Brazilian residence taxation unfairly reduced, this provision should be carefully reviewed by Brazilian negotiators to make sure the Brazilian tax paid is credited against the U.S. tax due by the U.S. citizen that is a resident of Brazil under the treaty, and not the other way around. A second feature worth mentioning is the right of the source country to impose an additional tax on profits of a permanent establishment of a

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53. U.S. Model Income Tax Convention, supra note 43, art. 23, ¶ 4, states:

> Where a United States citizen is a resident of __________:
>
> a) with respect to items of income, profit or gain that under the provisions of this Convention are exempt from United States tax or that are subject to a reduced rate of United States tax when derived by a resident of __________ who is not a United States citizen, __________ shall allow as a credit against __________ tax only the tax paid, if any, that the United States may impose under the provisions of this Convention other than taxes that may be imposed solely by reason of citizenship under paragraph 4 of Article 1 (General Scope);
>
> b) for purposes of applying paragraph 2 to compute United States tax on those items of income, profit or gain referred to in subparagraph (a) of this paragraph, the United States shall allow as a credit against United States tax the income tax paid to __________ after the credit referred to in subparagraph (a) of this paragraph; the credit so allowed shall not reduce the portion of the United States tax that is creditable against the __________ tax in accordance with subparagraph (a) of this paragraph; and
>
> c) for the exclusive purpose of relieving double taxation in the United States under subparagraph (b) of this paragraph, items of income, profit or gain referred to in subparagraph (a) of this paragraph shall be deemed to arise in __________ to the extent necessary to avoid double taxation of such income under subparagraph (b) of this paragraph.

resident of the other country (article 10, paragraph 10 of the U.S. Model[54]), limited to a certain maximum rate.

With certain limitations, this mirrors the so-called *branch profits tax* imposed by the United States on profits of permanent establishments in lieu of a withholding tax on dividends of resident legal entities. It is hard to see how this would face opposition by Brazilian negotiators.

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54. U.S. Model Income Tax Convention, supra note 43, art. 10, ¶ 10, provides:

> a) A company that is a resident of one of the Contracting States and that has a permanent establishment in the other Contracting State or that is subject to tax in the other Contracting State on a net basis on its income that may be taxed in the other Contracting State under Article 6 (Income from Real Property (Immovable Property)) or under paragraph 1 of Article 13 (Gains) may be subject in that other Contracting State to a tax in addition to the tax allowable under the other provisions of this Convention.
>
> b) Such tax, however, may be imposed:
>
> i) on only the portion of the business profits of the company attributable to the permanent establishment and the portion of the income referred to in subparagraph (a) of this paragraph that is subject to tax under Article 6 (Income from Real Property (Immovable Property)) or under paragraph 1 of Article 13 (Gains) that, in the case of the United States, represents the dividend equivalent amount of such profits or income and, in the case of __________, is an amount that is analogous to the dividend equivalent amount; and
>
> ii) at a rate not in excess of the rate specified in subparagraph (a) of paragraph 2 or paragraph 6 of this Article, but only if for the twelve-month period ending on the date on which the entitlement to the dividend equivalent amount is determined, the company has been a resident of the other Contracting State or of a qualifying third state. The term "qualifying third state" has the same meaning as in clause (i) of subparagraph (a) of paragraph 2 of this Article.

Brazil currently does not impose withholding tax on dividends.[55] However, if one day it reintroduces such tax, it would be in its best interest to also charge withholding tax on the dividend equivalent of profits of Brazilian based branches of U.S. resident corporations, and this provision would allow it to do so, achieving tax neutrality as regarding the legal form of the business operation in the country (subsidiary or branch).

Other features of the U.S. Model that in the past were not common in Brazilian treaties have become so in recent years, including a Limitation on Benefits clause to combat treaty shopping and an extensive Exchange of Information clause. Recent Brazilian treaties with Switzerland,[56] Singapore,[57] and the United Arab Emirates[58] include them, and one would not expect difficulties for them to be considered in a treaty with the United States. In sum, for the reasons explained above there do not seem to be technical reasons for Brazil to have a problem in accepting the concept behind these specific features of the U.S. Model commented on herein.

B. Tax Sparing

This is the most commonly mentioned obstacle for the conclusion of a treaty between the two countries. There has been some imprecision in the terminology used to explain the phenomena, but the majority of scholars identify two types of tax sparing clauses in tax treaties:

> (i) a tax sparing *sensu stricto*, under which the residence country allows a credit for the source tax that has been exempted in the source country as if such exemption did not exist; and,
> (ii) a matching credit, under which the residence country allows for a tax credit regarding source taxation to be computed at a fixed rate, regardless of the actual rate of tax (usually lower) applied by the source country.[59]

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55. Lei No. 9.249, de 26 de Dezembro de 1995, art. 10, http://www.planalto.gov.br/ccivil_03/leis/L9249.htm (last visited June 28, 2020).

56. Switz.-Braz. Treaty, *supra* note 1, arts. 26–27.

57. Sing.-Braz. Treaty, *supra* note 2, arts. 27–28.

58. Braz.-U.A.E. Treaty, *supra* note 3, arts. 28–29.

59. Bruno Gouthière, Les impôts dans les Affaires Internationales 124 (5th ed. 2001).

Brazil had historically taken the view that tax sparing provisions were a necessary feature of its treaties with developed countries to ensure that the reduction in Brazilian source taxation does result in actual benefits for the resident investor (and would otherwise increase the tax collection of the residence country through a reduction of the tax credit to avoid double taxation).[60] As such, it was viewed as a necessary incentive or subsidy of developed countries to developing or underdeveloped economies. The U.S. Senate never agreed with that and therefore refused to accept any tax treaties that include such a clause. The United States even went to the point in its negotiations with China to state that if one day the United States would sign a treaty with any country including a tax sparing provision such provision would be automatically extended to the China treaty, in a kind of most favorable nation clause.[61] This never happened.

In 1998, the OECD published a report[62] advocating that tax sparing provisions should be excluded from tax treaties as in the view of the majority of the members they were not an effective mechanism to promote FDI and would open the door to treaty shopping and aggressive tax planning. Accordingly, tax sparing provisions as a way to foster FDI in developing economies would be an example of good intentions producing bad results.[63]

The authors have serious reservations about the view of the OECD.[64] For purposes of this Article, it suffices to say that tax sparing, and matching credit in particular, should not be seen as an incentive provided by developed/residence countries to developing/source countries, but rather as a mechanism to preserve the allocation between the source and the residence country of the right to tax certain items of income.

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60. *See supra* note 13.

61. Agreement Between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with Respect to Taxes on Income, U.S.-China, Apr. 30, 1984, Treaty Doc. 98-30 [hereinafter U.S.-China Treaty].

62. OECD, *Tax Sparing*, *supra* note 19.

63. Deborah Toaze, *Tax Sparing: Good Intentions, Unintended Results*, 49 Can. Tax J. 879 (2001).

64. Schoueri, *supra* note 20.

Accordingly, the matching credit rate would be the "portion" of such right attributed to the source country that accepted reducing its rates under the treaty, avoiding that this decision would represent a transfer of such portion of the right to tax to the residence country.[65] As such, tax sparing provisions should be encouraged as "two way streets" to be granted to both treaty partners, be they developed, developing, or underdeveloped economies.[66] Having said that, one should recognize that, if Brazil and the United States decide to engage in treaty negotiations, the lack of a tax sparing provision should no longer *per se* be an irremovable obstacle.

Brazil seems to silently have altered its once fierce resolve to have tax sparing provisions in all treaties with so called developed economies. There are at least five examples of treaties with developed economies (four of which are members of the OECD) in which Brazilian negotiators have accepted either removing or not having a tax sparing provision.

The first one dates from 2007 in an amendment to the treaty with Belgium (an OECD member). Brazil accepted gradually reducing the rate of tax sparing until its extinction in 2011. In exchange, it included a provision in the treaty extending the treatment of royalties to technical assistance and technical service.[67]

The second dates from 2011 in a new protocol to the treaty with Denmark (an OECD member). The matching credit clause that existed in favor of a Denmark resident that received dividends, royalties, and interest from Brazilian sources was eliminated and replaced with a tax credit for the tax actually withheld in Brazil. The amendment was recently ratified by the Brazilian Congress and made effective by a presidential decree.[68] There is no official confirmation as to the reasons that

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65. *Id.* at 118–23.

66. *Id.* at 124.

67. Supplementary Agreement Amending the Convention Between the Kingdom of Belgium and the Federative Republic of Brazil for the Avoidance of Double Taxation and the Regulation of Certain Other Matters with Respect to Taxes on Income, and the Final Protocol, Signed in Brasília on June 23, 1972, at art. 12, Nov. 20, 2002, Tax Analysts Doc 2008-1038; Decreto No. 6.332, de 28 de Dezembro de 2007, Diário Oficial da União [D.O.U.] de 31.12.2007 (promulgating Belg.-Braz. Supplementary Agreement).

68. Protocol Amending the Convention Between the Government of the Kingdom of Denmark and the Government of the Federative Republic of Brazil for the Avoidance of Double Taxation and the Prevention of Fiscal

drove Brazilian negotiators to accept that. However, a closer look at other changes in the treaty implemented through the same protocol and at the justification for the protocol prepared by the Executive Branch when asking Congress for its approval provide a strong indication. The protocol eliminated an anti-CFC provision and an exemption for distribution of stock in kind that existed in the original wording of the treaty[69] and that in the view of the Brazilian tax administration were being used for treaty shopping purposes by Brazilian multinationals investing abroad through Denmark.[70]

In 2018, two new treaties were signed by Brazil with two developed economies—Switzerland (also an OECD member) and Singapore.[71] In both treaties, no tax sparing provision was included. In exchange, source taxation was preserved for dividends, interest, and royalties capped at 10% (a reduction compared to most Brazilian treaties, which provide for a 15% rate, equal to the current domestic rate) and capital gains.

In addition, a new provision inspired in the U.N. Model was included to preserve source taxation of fees for technical services, defined broadly as "any payment in consideration for any service of a managerial, technical or consultancy nature," also subject to a maximum rate of 10%. This distributive rule avoids the exclusive right of the residence country to tax this income under article 7 (business profits) and follows the tradition of Brazilian treaty practice of preserving the right of the source country to tax technical services, but through a different mechanism. While before, the approach was to extend the royalty treatment to these services, Brazil has chosen to introduce a new provision, separate from royalties, with a broader and more clear definition.

Finally, in March 2019, Brazil and Sweden (also an OECD member) signed a new protocol amending the existing tax treaty between

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Evastion with Respect to Taxes on Income, Signed at Copenhagen the 27th Day of August 1974, Mar. 23, 2011, Tax Analysts Doc. 2011-8906; Decreto No. 9.851, de 25 de Junho de 2019, http://www.planalto.gov.br/ccivil_03/_ato2019-2022/2019/Decreto/D9851.htm (promulgating the Braz.-Den. Protocol).

69. Braz.-Den. Treaty, *supra* note 14, art. 23, ¶¶ 5–6.

70. Mensagem nº 545 de 18 de Dezembro de 2015 do Congresso Nacional, at item 5, https://www.camara.leg.br/proposicoesWeb/prop_mostrarintegra;jsessionid=14BDAE109C21DEFB3B187C7631B0F1A8.proposicoesWebExterno1?codteor=1426709&filename=Tramitacao-MSC+545/2015 (last visited July 1, 2020).

71. *See supra* notes 1 & 2.

the two countries.[72] The amendment excludes the tax sparing provision that existed before, but in exchange includes the right of the source country to tax technical services and technical assistance not involving transfer of technology as royalties. The treaty with Sweden is still one of the very few that do not have such a provision and where article 7 preserves the right of the residence country to tax this type of income (the others being those with Austria, Finland, France, and Japan[73]).

It is clear from these five recent cases that Brazil no longer seems to insist on having tax sparing provisions in its treaties with developed economies, including four members of the OECD. Instead, it appeared to prefer to insist on preserving source taxation to the maximum extent, expanding it to technical services without transfer of technology, a relevant item of income in the digital economy.[74] It will be hard for Brazil to insist on a tax sparing provision in a possible treaty with the United States after these five cases.

Further, tax sparing may have marginal or no effect at all on U.S. investors after the TCJA. Indeed with the move to a territorial or partially territorial system, U.S. corporations will either not tax the profits of Brazilian subsidiaries engaged in active business or tax it at a maximum rate of 13.125% in case of GILTI income.[75] At this stage, it seems difficult to imagine the Brazilian corporate income tax rate (currently at 34%) going below such level, in which case a direct tax credit will already be sufficient to avoid double taxation on dividends, and a matching credit would not provide any additional relief for the U.S. resident investor.

Even for interest and royalty income earned directly by U.S. corporations from Brazilian sources, where in some cases the regular 21% corporate income tax rate could apply, limitations on the computation of foreign credit could make it very difficult for tax sparing to provide an actual incentive for investment. It would not be consistent and effective for Brazil to insist on tax sparing in negotiations for a future tax

72. *See supra* note 38.

73. *See* Braz.-Austria Treaty, *supra* note 14; Agreement Between the Republic of Finland and the Federative Republic of Brazil for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, Fin.-Braz., Apr. 2, 1996, 2021 U.N.T.S. 119; Fr.-Braz. Treaty, *supra* note 7; Japan-Braz. Treaty, *supra* note 6.

74. *See infra* Part III.D.

75. *See supra* note 41 and accompanying text.

treaty with the United States. It makes sense for Brazil to focus on preserving source taxation, which has been the cornerstone of its regime of taxation of non-residents for decades. The United States, on the other hand, could use its position as one of the major sources of FDI and trade partner with Brazil to negotiate lower rates of source taxation.

C. Source Taxation on Passive Income

Although the treaty practice of Brazil and the United States in relation to source taxation of passive income seem divergent in several respects, there have been instances where both countries conceded their respective positions on the matter in other treaty negotiations. This signals that, instead of deal breakers, these are points that negotiators will factor in when deciding what to request and what not to request from the counterparty during negotiations.

For dividends, the U.S. Model does preserve the right of the source country to impose withholding tax, at rates of 5% and 10%. Brazil has already accepted a 10% maximum rate in the case of shareholding participations exceeding a minimum threshold in several treaties currently in force[76] and in others yet to be ratified (like those with Switzerland and Singapore).

For royalty and interest income, even though the starting point in the U.S. Model is exclusive residence taxation, there have been instances where the United States accepted source taxation in treaties with emerging and developing countries. See in Table 2, for example, the rates applicable for interest and royalty income in the treaties with China, India, and Mexico:[77]

Finally, Brazil's treaty position on taxation of capital gains involving assets other than real estate contradicts U.S. sourcing rules. While the U.S. Model generally reserves the right to tax exclusively to the residence country,[78] Brazil defends cumulative taxation by source and residence countries, with relief from double taxation through a tax credit by the residence country (this is the position in all Brazilian treaties with the exception of Japan).

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76. *See supra* note 33 and accompanying text.

77. *Tax Treaty Tables*, IRS, https://www.irs.gov/individuals/international-taxpayers/tax-treaty-tables (last updated Jan. 14, 2020).

78. U.S. Model Income Tax Convention, *supra* note 43, art. 13, ¶ 6.

Table 2

Country	Interest	Royalties
China	10%	10%
India	15%	10–15%
Mexico	15%	10%

This may be a point of contention, but it is worth noting that the United States has accepted source taxation for capital gains in the treaties with China (article 12)[79] and India (article 13),[80] countries that similarly to Brazil impose source taxation on this type of income.[81] A possible middle ground, even though uncommon in treaty practice, would be to allow source taxation but with a limitation on the applicable rate.

D. Source Taxation on Technical Services

Unlike items of passive income, fees for technical services are active income by nature. Under the U.S. Model and the OECD Model, such type of income falls within the concept of business profits covered by article 7, with a distributive rule for exclusive right to tax by the residence country. The only exception admitted by the OECD Commentaries to Article 12 of the OECD Model is technical assistance ancillary to a know-how agreement, which is arguably covered by the royalty provision.[82]

This has been the standard treatment in U.S. treaty practice with no exceptions. The maximum concession made by the United States was the acceptance of a so-called *included services* clause in Article 12 of the treaty with India to extend the royalty treatment to certain services

79. U.S.-China Treaty, *supra* note 61, art. 12.

80. Convention Between the Government of the United States of America and the Government of the Republic of India for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-India, Sept. 12, 1989, Tax Convention with the Republic of India, art. 13, Jan. 1, 1991, Treaty Doc. 101-5 [hereinafter U.S.-India Treaty].

81. Tax Treaties and Domestic Law (Guglielmo Maisto ed., 2006).

82. OECD, Model Tax Convention on Income and on Capital: Full Version, at C(12)-11 (2017), https://doi.org/10.1787/g2g972ee-en.

connected with royalties or that make technology available to the service hirer. Paragraph 4 of Article 12 of the U.S. treaty with India reads as follows:

> 4. For purposes of this Article, "fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of services of technical or other personnel) if such services:
>
> a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or
>
> b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.[83]

The U.S. treaty with India is accompanied by a Memorandum of Understanding that provides a general definition of the meaning of "made available technology"—the person acquiring the service is enabled to apply the technology—and a list of examples of the application of the clause.[84] Andrés Báez Moreno points out that despite the different terminology, the approach of the *included services* clause as drafted in the treaty with India is not that different from the current status of Article 12 in the OECD Model, in the sense that in both cases there is a subsidiary or ancillary character of the services in relation to the know-how or technology. The service is just a means for the service hirer (or licensee) to acquire the knowledge to apply the technology.[85] This provides a much narrower scope for source taxation of technical

83. U.S.-India Treaty, *supra* note 80, art. 12, ¶ 4.

84. *Id.* at Memorandum of Understanding Concerning Fees for Included Services in Article 12 (May 15, 1989).

85. Andrés Báez Moreno, *The Taxation of Technical Services Under the United Nations Model Double Taxation Convention: A Rushed—Yet Appropriate—Proposal for (Developing) Countries?*, 7 World Tax J., no. 3, 2015, § 3.2.2 (2015).

services than the approach that Brazil has pursued in its past and more recent treaty practice.

With very few exceptions (Austria, Finland, France, Japan, and Sweden[86]), most Brazilian treaties have a provision in their protocols extending the royalty treatment (article 12) to fees for technical service and technical assistance. The position of the Brazilian Revenue Service is that in those cases, even if the services do not involve any transfer of technology, Brazil has the right to tax at the source, limited to the maximum rate foreseen in the treaty for royalty income.[87]

In most recent treaties, Brazil has opted to include a specific provision following the U.N. Model that preserves the source country right to tax fees for technical services, which are defined broadly (and without any connection with know-how) as any consideration for any service of a managerial, technical, or consulting nature. Brazil has accepted limiting the rate of tax to 10% in the recent treaties with Switzerland and Singapore that follow such pattern.

Despite possible difficulties in separating technical from ordinary services, it is clear that the scope of source taxation is significantly expanded under the approach followed by Brazil, which is unprecedented in U.S. tax treaty history. Consideration should be given by both countries when addressing the likely request of Brazil to include a clause following the U.N. Model in this respect. This could be a more difficult issue to address than tax sparing.

The United States could condition the acceptance of such a deviation to its common treaty practice to a more significant effort by Brazil in reducing the maximum rate—perhaps testing a minimum low below the 10% threshold. If Brazil accepts rates below such a level, it would have to consider the corresponding impact on most favorable nation clauses existing in its tax treaties.[88] By doing so, Brazil would

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86. The Brazil treaty with Sweden has been amended to also include the extension of royalty treatment to technical services but this is pending ratification. *See supra* Part III.B.

87. Ato Declaratório Interpretativo RFB Nº 5, de 16 de Junho de 2014, Diário Oficial da União [D.O.U.] de 20.06.2014.

88. E.g., in treaties with Mexico and Spain. Convention Between the Governments of the United Mexican States and the Federative Republic of Brazil for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, at Protocol item 5, Braz.-Mex., Sept. 25, 2003, Tax Analysts Doc. Doc 2007-27077; Braz.-Spain Treaty, *supra* note 8, at

reduce the transaction cost of its residents in accessing the U.S. services market, still keeping some reasonable level of source taxation (in addition to the indirect taxes that Brazil applies on the importation of services and which are not covered by tax treaties).

IV. Conclusions

In summary, the historical obstacle invoked to prevent a tax treaty between Brazil and the United States—Brazil's insistence on tax sparing—has become less relevant in recent years with Brazil giving up on it in recent treaty negotiations with some developed economies and the United States moving to a territorial or quasi-territorial system. The technical challenges for a tax treaty between Brazil and the United States remain relevant, with the most relevant evolving around the historical tension between residence and source taxation.

For passive income, the middle ground seems easier to achieve as there are precedents on concessions from both sides in past treaty negotiations. The most challenging item might be source taxation of active income represented by remuneration of technical services, which is of greater importance in the digital economy and where historical positions of both countries will need to be mediated for an agreement to be reached. This will require political resolve by the respective governments with the support of the respective business communities. Some believe that there has never been a better time for that given recent economic and political changes in both countries.[89]

Protocol items 3 & 4; *see also* Decreto nº 6.000, de 26 de Dezembro de 2006, Diário Oficial da União [D.O.U.] de 27.12.2006 (promulgating the Braz.-Mex. Tax Treaty).

89. Braz.-U.S., *Roadmap*, *supra* note 22.