Brazil

Brazil's REINTEGRA in Light of World Trade Organization Rules: A Wrong Way to Incentivize Development?

Leonardo Aguirra de Andrade[*]

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This article considers the nature of the Brazilian Special Regime for the Reintegration of Tax Values for Exporting Companies ("REINTEGRA"), and its non-conformity with World Trade Organization rules, especially in relation to the concepts of subsidy and most-favoured nation and national treatment.

1. Introduction

The recent decision of the World Trade Organization (WTO) Dispute Settlement Body, in the panel established at the request of Japan (DS 497)[1] and further joined by the panel as required by the European Union (DS 472),[2] is of great significance. Briefly, it requests the examination of some tax measures adopted by the Brazilian government to encourage the development of the domestic industry. In particular, the decision emphasizes the relationship between: (1) international trade regulation; (2) international taxation; and (3) the limits to the tax sovereignty of WTO member countries.

As a non-developed country, Brazil sought, through programmes for the development of the domestic industry, to attract investment and increase the competitiveness of Brazilian entities with regard to competition between rich and poor countries in respect of foreign trade. In principle, according to that WTO decision, which is still subject to appeal, the measures in question contravene the rules of the General Agreement on Tariffs and Trade (GATT) and the Agreement on Subsidies and Countervailing Measures (ASCM), both of which have been signed by Brazil.

In view of this, it is not clear whether the other measures adopted by the Brazilian government to increase the competitiveness of Brazilian industry and which the WTO panel has not yet examined also do not conform with the GATT and the ASCM. In this context, this article considers the compatibility between the WTO rules and one of the Brazilian regimes not yet examined by the WTO Dispute Settlement Body, i.e. the Special Regime for the Reintegration of Tax Values for Exporting Companies ("REINTEGRA"), which, according to the reasons stated in the Brazilian ruling that established it:

> seeks to circumvent the difficulties encountered by the Brazilian exporters to compete on equal conditions in an increasingly fierce competitive environment.[3]

REINTEGRA was chosen as the subject of this article because of some of its peculiarities and, inter alia, the fact that it is a programme to refund "tax residues", i.e. taxes paid in the entire productive chain that are not offset, relating to taxes not expressly specified in its rules but which are quantified on undisclosed criteria. If, according to the WTO, the characterization of a prohibited subsidy is contingent on its tax nature (e.g. tax incentives related to direct taxes granted exclusively to exporters are prohibited), it is important to establish which taxes are considered tax residues.

The premise for a tax liability to be refunded is the concept that some tax amount has been paid unduly. However, REINTEGRA does not define the parameters for the assessment of taxes that remain in the production chain. Why, in 2011, would 3% of an exporter's revenue be sufficient for tax residues to be refunded when, currently, 0.1% is enough? What has changed in the Brazilian tax system to justify such a reduction in tax residues? Without knowing the assessment criterion, it is impossible to confirm that it is a refund of tax residues and not a refund of a direct subsidy that is not linked to any past fact. With regard to this specific aspect, it is proper to consider whether the control of the amounts returned on account of a tax liability is a relevant element for the authorization to grant an indirect tax subsidy.

In addition, currently, REINTEGRA credits are exempt from the *imposto de renda das pessoas jurídicas* (corporate income tax, IRPJ) and the *contribuição social sobre o lucro líquido* (social contribution on net profit, CSLL) under *Lei* (Law) No. 13,043/2014.[4] This could reinforce the characterization of REINTEGRA as a prohibited subsidy because these are direct taxes.

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* **Master's degree and PhD candidate in Tax Law at University of Sao Paulo, Brazil. The author can be contacted at leonardo.andrade@usp.br.**

1. BR: WTO, DS 497, 22 Oct. 2015, *Brazil – Taxation*. (Japan).
2. BR: WTO, DS 472, 22 Oct. 2015, *Brazil – Taxation*. (European Union).
3. BR: *Medida Provisória* (Provisional Measure, PM) 540/2011 of 2 August 2011. This and all other translations from Portuguese into English are the author's unofficial translations.
4. BR: *Lei* (Law) 13,043/2014 of 13 November 2014.

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REINTEGRA applies exclusively to Brazilian manufactured products with, in general, an imported content of less than 40%. Excluding the export of imported goods could raise questions regarding violation of the national treatment rule.[5] On the other hand, imports from MERCUSOR member countries are considered to be domestic imports for the purposes of REINTEGRA, which may represent a violation of the most-favoured nation (MFN) principle.[6] These characteristics justify an examination of REINTEGRA in light of WTO rules, whether from the perspective of the understanding of the limits of such rules or from the viewpoint of the correction of the domestic industrial incentive policies of Brazil.

2. The Legal Nature of REINTEGRA Credits

By enacting *Medida Provisória* (Provisional Measure, PM) No. 540/2011,[7] which became Law No. 12,546/2011,[8] the Brazilian Federal Government initiated a tax incentive policy benefiting exporters of Brazilian goods by way of the refund of tax residues. According to the Brazilian Federal Government, this measure related directly to the worldwide economic crisis, which intensified from 2008 onwards and reduced demand in developed countries and increased capital flows to developing countries. This, in turn, generated an appreciation of exchange rates of developing countries. Upon appreciation of the Brazilian real and greater competition regarding products originating in emerging countries, Brazilian exporters found themselves in a position in which the Brazilian tax burden became even more relevant with regard to their competitiveness in respect of foreign trade.

In this regard, the following reasons given in PM No. 540/2011 for its enactment should be emphasized:

> 2. Since the international financial crisis of 2008, the global economy has experienced a series of disturbances that bring into doubt the capacity of developed countries to recover and develop robust and sustainable growth. This framework has made it possible for emerging countries to carry more weight in, and has also permitted them to act as a driver of, the world economy.
>
> 3. However, this new alignment poses a series of challenges to the practice of the economic policy. One of these is to safeguard external competitiveness. Indeed, the reduction in external demand on the part of the developed countries is discouraging our exports. This effect, together with the strong cycle of the commodity prices and the redirecting of the capital flows towards emerging countries, has given rise to a significant appreciation of the exchange rate, as it reduces the competitiveness of the domestic industry and worsens Brazil's commercial balance.
>
> 4. This context is the basis for the creation of the *Brasil Maior Plan* (Greater Brazil Plan), which are a set of measures that includes, among others, the one proposed in this Provisional Measure.
>
> 5. One of the major difficulties for the domestic companies in accessing the international market is the tax *burden* that increases the production cost in the domestic market and penalizes jobs and production. The reduction to tax costs in production is one of the major mechanisms to ensure the competitiveness of the domestic industry and the generation of jobs and income.
>
> 6. The proposed implementation of REINTEGRA, to be effective until December 31, 2012, is intended to reintegrate amounts related to costs of tax residues – *taxes paid along the entire productive chain and that were not offset* – existing in their production chains. Upon the implementation of REINTEGRA, it will be possible for the companies to offset tax residues against their own debts or even to request refunds in cash, on terms to be established by the Brazilian Federal Revenue Department.
>
> 7. The measure attributes to the Executive Branch, upon a decree, the prerogative to increase or reduce the reintegration up to a limit of 3% of the revenue from industrial goods exported by the companies as well as to set different percentages to be applied per economic sector and type of activity developed.
>
> 8. *Therefore, REINTREGA seeks to circumvent the difficulties encountered by Brazilian exporters to compete on equal conditions in an increasingly fierce competitive environment, which justifies its urgency and relevance.* (Emphasis added)

The nature of reimbursement, by the Federal Government, for the credits deriving from REINTEGRA is expressly stated in Law 12,546/2011 and in *Decreto* (Decree) No. 7,633/2011,[9] which governed this special regime. Law No. 12,546/2011 reads as follows:

> Art. 1 The Special Regime for Reintegration of Tax Values for Exporting Companies (REINTEGRA) is implemented to reintegrate values related to residual cost of federal taxes in their production chains.
>
> Art. 2 Within the ambit of REINTEGRA, any producer legal entity that exports goods manufactured in Brazil may assess a value *for the purposes of partial or full reimbursement for the federal tax residue* existing in its production chain. (Emphasis added)

Originally, under Law No. 12,546/2011,[10] REINTEGRA was only applicable to products exported up to 31 December 2012. However, Law No. 12,844/2013[11] amended REINTEGRA and extended its application to products exported up to 31 December 2013.

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5. Art. III GATT and art. 3.1.(b) ASCM.
6. Art. I GATT.
7. BR: *Medida Provisória* (Provisional Measure, PM) 540/2011 of 2 August 2011.
8. BR: Law 12,546/2011 of 14 December 2011.
9. BR: *Decreto* (Decree) No. 7,633/2011 of 1 December 2011.
10. BR: Law No. 12,546/2011, Art. 3.
11. BR: Law No. 12,844/2013 of 19 July 2013.

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In this period, REINTEGRA credit corresponded to 3% of the revenue derived from the export of certain products manufactured in Brazil as specified in Decree No. 7,633/2011. In other words, REINTEGRA did not apply, and still does not apply, to all goods that are exported, but only to those selected by the Brazilian government.

Later, in order to restore the confidence of the owners of businesses, the Federal Government implemented REINTEGRA on a permanent basis by way of PM No. 651/2014,[12] which was converted into law by Law No. 13,043/2014. The list of reasons set out in PM No. 651/2014 provides the background for this:

> 43. In order to circumvent the difficulties encountered by the Brazilian exporters, so that they will be able to operate on equal conditions in an increasingly fierce competitive environment, Provisional Measure No. 540, published on August 2, 2011 and converted into Law No. 12,546 on December 14, 2011, implemented REINTEGRA.
>
> 44. REINTEGRA permitted the recovery of amounts related to residual tax costs existing in their production chains as the exporters were able to offset tax residues against their own debts or even to apply for reimbursement in cash.
>
> 45. Two years after its implementation, REINTEGRA was extinguished, as provided for in Law No. 12,546 of 2011. However, the adverse scenario for exporters persists, and may cause the regime to be resumed.
>
> 46. The urgency and relevance of the re-establishment of REINTEGRA are justified on the need to *give the exports equal conditions in an increasingly fierce competition environment in a scenario of world economic crisis*. (Emphasis added)

Decree No. 8,543/2015,[13] which amended Decree No. 8,415/2015,[14] regulated this new phase of REINTEGRA and stated that the credit percentage to be reimbursed or offset would vary with time:

> Art. 2
>
> Par. 7...
>
> I – one per cent (1%) from March 1, 2015 to November 30, 2015;
>
> II – zero point one per cent (0.1%) from December 1, 2015 to December 31, 2016;
>
> III – two per cent (2%) from January 1, 2017 to December 31, 2017; and
>
> IV – three per cent (3%) from January 1, 2018 to December 31, 2018.

The Brazilian government, however, did not explain what factors were considered to justify the reduction, and then the future increase, in the amount of tax residues over time. In the author's opinion, the quantification of REINTEGRA does not relate to the amount of tax residues, given that the tax system was not subject to significant changes between 2011 and 2016 that could justify a change in the tax values that remain in Brazilian production chains. Should this assumption be correct, the reason for introduction of REINTEGRA is questionable to the extent that, by way of this regime, the Brazilian government intends to "reimburse" tax residues the quantification of which is not linked to the value of the "residual" taxes in the production chains of the exported goods.

These rules do not make clear the nature of the tax residues or which taxes give rise to such residues. The rules simply indicate that it is the residues "remaining in the production chain of exported goods" that relate to "taxes paid throughout the production chain that were not offset".

In order to clarify the scope of REINTEGRA, the Brazilian government published on its website[15] information which stated that the tax residues in question are related to:

> contribution for the Intervention on the economic domain [*contribuição de intervenção no domínio economic*] – CIDE, tax on financial tansactions [*imposto sobre operações financeiras*] – IOF, the social integration program [*programa de integração social*] – PIS, contribution for financing social security [*contribuição para financiamento da seguridade social*] – COFINS, etc.

However, such information is not provided in any rule. In an article on this topic, Tôrres (2016) states that REINTEGRA contemplates the refund of credits of "ICMS [*imposto sobre circulação de mercadorias e serviços de transporte interestadual e intermunicipal e de comunicação* (tax on the sale of goods and on the provision of interstate and intermunicipal transportation services and communication services)], IPI [*imposto sobre produtos industrializados* (tax on manufactured products)], PIS/COFINS and contributions, in addition to ISS [*imposto sobre serviços de qualquer natureza (municipal tax on services*)] or IOF", but does not indicate the legal grounds for such an understanding.[16] The fact is that there is no legal provision indicating the taxes covered by this tax regime, and there is no information provided in this respect in the list of reasons for the promulgation of the PM referred to previously in this section.

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12. BR: PM No. 651/2014 of 9 July 2014.
13. BR: Decree No. 8,543/2015 of 21 October 2015.
14. BR: Decree No. 8,415/2015 of 27 February 2015.
15. *See* www2.planalto.gov.br/acompanhe-o-planalto/brasil-em-pauta/brasil-em-pauta/resultado-da-balanca-comercial-2011-e-tema-do-programa-brasil-em-pauta (accessed 19 Nov. 2016).
16. H.T Tôrres. Revisão de incentivos à exportação não pode afetar competitividade, Revista Consultor Jurídico (16 Nov. 2016), available at www.conjur.com.br/2016-nov-16/revisao-incentivos-exportacao-nao-afetar-competitividade (accessed 19 Nov. 2016).

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Consequently, there is uncertainty regarding the definition of the taxes relating to the tax residues reimbursed under REINTEGRA. However, the definition of the taxes contemplated by REINTEGRA is relevant in an analysis of whether the regime conforms to WTO rules.

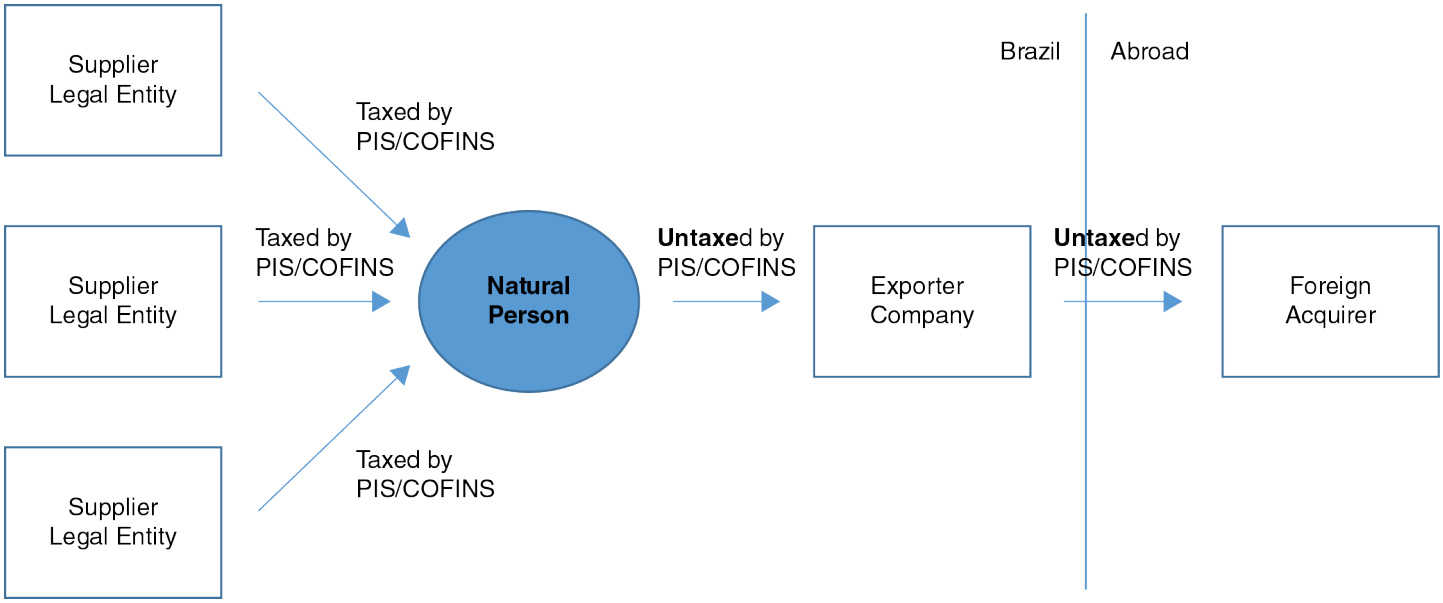
Given this relevance, some academic speculations are pertinent. Due to the limitation of the taxing power of the Federal Government, many have speculated that only federal taxes give rise to the tax residues in question. This is all the more so because it does not appear to be reasonable to believe that the Federal Government would reimburse, for example, values relating to the ICMS and the ISS, which are collected by other federative entities. If REINTEGRA had been considered to relate to state and municipal taxes, reimbursement would not have been possible.

On the adoption of this methodological cut-off, i.e. that REINTEGRA only relates to federal taxes, it is proper to ask whether the reference to "taxes" in the statement of reasons set out in PM 540/2011 can be aligned with the list of those taxes provided for in article 145 of the Brazilian Federal Constitution, under which taxes and contributions are species of the tax genus. If this is so, tax residues do not relate to, for example, social contributions, such as the PIS and the COFINS.[17] It appears to the author that the reference to "taxes" relates to such terminology, such that, in the author's opinion, the intention of the legislator was to include social contributions within the concept of tax residues.

Others have speculated that tax residues relate to the effect of taxes on the cost of exported goods. This is because it is known that some of the inputs acquired by exporters, despite the fact that such inputs are taxed at previous stages of the production chain, do not necessarily give rise to tax credits that can be recovered in the future by these exporters.

This is, for example, the case for a food exporter, whose suppliers are natural persons. In such circumstances, the PIS and the COFINS are levied on the inputs acquired by those suppliers, i.e. natural persons, such as in relation to suppliers of water, electricity, transport, animal food, fertilizers, etc.; however, at the next stage of the production chain, specifically on the sale of goods by these natural persons, the PIS and the COFINS are not levied, which precludes the purchaser of such goods from acquiring tax credits. In such cases, the PIS and the COFINS are part of the costs of the goods, and it is not possible for the exporters to recover the relevant tax residues. The Table illustrates this scenario.

Figure 1. Tax residues scenario in relation to the PIS and the COFINS



In this case, the fact that the supplier is a natural person and cannot be subject to tax in relation to the PIS and the COFINS precludes exporters from acquiring credits in respect of these contributions in the non-cumulative regime.[18] Consequently, in such an event, the tax is part of the cost of the goods and cannot be recovered by an exporter from a legal perspective. The exporter may recover the tax value by reducing its profit margin. However, in those markets in which the profit margin is reduced too much, irrecoverable tax, in general, only increases the price of the Brazilian goods and, as a result, reduces the competitiveness of the Brazilian entity in question.

The premise of these considerations is the concept that the taxes in question would originally be recoverable, but that such taxes became irrecoverable due to some peculiarity of the Brazilian tax system. With regard to this issue, it should be noted that the tax residues, i.e.

17. The PIS is a regime that collects contributions to fund insurance for the employees of private companies and the COFINS is a contribution to finance social security financing.
18. BR: Law No. 10,833/2003 of 29 December 2003, art. 2, II.

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the subject matter of REINTEGRA, should not relate to all federal taxes, but only those taxes that, given their nature, should be passed on to the foreign purchaser but are not because of the principle of destination.[19] This point is examined in detail in section 3.

In other words, tax residues in respect of REINTEGRA should only encompass those taxes that, given their nature, should not be considered in relation to export. In this respect, the concept that tax residues should relate to the taxes that unjustly remain in the production chain is based on the assumption that these taxes should not remain in the production chain. However, such taxes should only be those taxes that are subject to border tax adjustments,[20] but, by reason of the peculiarities of the Brazilian tax system, they are a cost to the exporter.

Based on those premises, it is possible to conclude that it is likely that the nature of reimbursable credits, within the scope of REINTEGRA, is related to tax cost. This, in theory and in light of the principle of destination, should not be included in the price of exported goods. Assuming that these premises are correct, the author now considers the compatibility, or not, of REINTEGRA with WTO rules.

3. WTO Rules

3.1. In general

The three main WTO rules affect the tax issues relating to the subject matter of this article. These are: (1) the MFN rule (*see* section 3.2.); (2) the national treatment rule (*see* section 3.3.); and (3) the prohibited subsidies rules (*see* section 3.4.).[21]

3.2. The MFN rule

The core of the MFN rule is to ensure that the commercial advantages granted to a country are also granted to other countries that are in the same position. In practice, the MFN rule seeks to ensure that foreign products or services are subject to similar treatment irrespective of their country of origin. In other words, this is a rule for the non-discriminatory treatment for countries. The MFN principle is defined in article I of the GATT as follows:

> ... any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.

3.3. The national treatment rule

Under the national treatment rule, a WTO member country must treat imported products and services in a no less favourable manner than national products and services, such that foreign and local products and services may compete on an equal basis in the same market. In other words, this is a rule regarding the non-discriminatory treatment of foreign products and services in relation to national products and services.[22] National treatment is defined in article 3 of the GATT as follows:

> 3.1 The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.
>
> 3.2 The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.
>
> ...
>
> 3.4 The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use. The provisions of this paragraph shall not prevent the application of differential internal transportation charges which are based exclusively on the economic operation of the means of transport and not on the nationality of the product".

Proof of the violation of the national treatment rule requires the provisions of evidence of similarity between the relevant foreign product and the domestic product, which, according to the WTO, must take into consideration: (1) the essential properties, the nature and the quality

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19. I. Lejeune, J. Daou-Azzi & M. Powell, *The Balance has Shifted to Consumption Taxes – Lessons Learned and Best Practices for VAT*, in *Value Added Tax and Direct Taxation: Similarities and Differences*, p. 86 (M. Lang, P. Melz & E. Kristoffersson eds., IBFD 2009), Online Books IBFD.
20. G.G. Vetori, *Contribuição ao estudo sobre as influências recíprocas entre a tributação da renda e o comércio internacional*, Doctoral Thesis, University of São Paulo, pp. 139-145 (2011).
21. Lu Lingbo, *WTO – Compatibility of Harmful Tax Practices*, in *The Relevance of WTO for Tax Matters* p. 397 (J. Herdin-Winter & I. Hofbauer eds., Linde 2006).
22. V. Thorstensen, *OMC – Organização Mundial do Comércio: as regras do comércio internacional e a nova rodada de negociações multilaterais* 2nd edn., p. 33 (Aduaneiras 2001).

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of the product; (2) the purposes of the product; (3) the tastes and preferences of the consumer; and, finally, (4) the tariff classification.[23] In other words, the product in question should be compared with what is comparable. If the product is different, there is no justification for applying the national treatment rule.

3.4. The prohibited subsidies rules

Finally, the WTO prohibits the granting of a subsidy linked to the export activity, which, according to article XVI.4 of the GATT, reads as follows:

> ... contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.

A subsidy is defined in article I of the ASCM as being:

> 1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:
>
> (a) (1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:
>
> (i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);
>
> (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits) (1);
>
> (iii) a government provides goods or services other than general infrastructure, or purchases goods;
>
> (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments; or
>
> (b) (2) there is any form of income or price support in the sense of Article XVI of GATT 1994;
>
> (c) any benefit is thereby conferred.
>
> 1.2 A subsidy as defined in paragraph 1 shall be subject to the provisions of Part II or shall be subject to the provisions of Part III or V only if such a subsidy is specific in accordance with the provisions of Article 2.

With regard to the characterization of a subsidy, the governmental measure in question must be specific, i.e. according to article 2 of the ASCM:

> Where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises...

Given the foregoing, it is possible to conclude that a subsidy, under WTO rules, is a financial contribution granted, directly or indirectly, by commission or not, by a governmental entity and which benefits certain companies with regard to the production sector of the entity's country in a specific manner so as to reduce the competitive advantage of the foreign products competing with the products of the domestic companies, thereby damaging the production sector of another WTO member country.[24]

There are two types of subsidies. These are: (1) prohibited, or red, subsidies; and (2) actionable, or yellow, subsidies.[25]

Prohibited, or red, subsidies are those defined in article III of the ASCM as subsidies contingent, in law or in fact:

(i) whether solely or as one of several other conditions; upon export performance, and

(ii) whether solely or as one of several other conditions, upon the use of domestic over imported goods.

With regard to a prohibited subsidy, the affected WTO member country is not required to prove that damage has been caused by the measure in dispute. This is the primary difference in relation to an actionable subsidy, which requires proof of damage to be so characterized. In other words, damage is not a requirement for a claim that the subsidy is not prohibited, but is an indispensable requirement for a claim relating to an actionable subsidy. If an adverse effect cannot be demonstrated, an actionable subsidy is considered to be permitted.[26]

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23. European Communities – Measures Affecting Asbestos and Asbestos – Containing Products, WT/DS132 (2001).
24. A.C. Bliancheriene, *Subsídios: efeitos, contramedidas e regulamentação – uma análise das normas nacionais e das normas da OMC*, in *Direito Tributário Internacional* p. 305 (H.T. Tôrres & H. Taveira eds., Quartier Latin 2003).
25. The category of non-actionable subsidy ceased to exist in 1999, as it had a valid term, of five years, and was not renewed by the WTO.
26. F.N. Reis, *Subsídios na OMC: as limitações impostas aos governos na sua política industrial pelas regras do ASCM e pela jurisprudência da OMC* p. 83 (Juruá 2008).

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Annex I to the ASCM contains an illustrative list of the circumstances in which prohibited subsidies are so characterized. Among such events, for the purposes of this article, items (e), (g) and (h) should be noted:

> (e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.
>
> ...
>
> (g) The exemption or remission, in respect of the production and distribution of exported products, of indirect taxes in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.
>
> (h) The exemption, remission or deferral of prior-stage cumulative indirect taxes on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior-stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior-stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior-stage cumulative indirect taxes are levied on inputs that are consumed in the production of the exported product (making normal allowance for waste). This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II.

It should be noted that Annex I to the ASCM has adopted the criterion of dichotomy between direct taxes and indirect taxes as being relevant in characterizing a prohibited subsidy. In this context, the granting of tax benefits specifically to exporters in relation to direct taxes gives rise to the characterization as a prohibited subsidy. On the other hand, the joint reading of footnote 5 and item 2 of Annex II to the ASCM gives rise to the conclusion that the granting of benefits specifically to exporters in relation to indirect taxes does not give rise to characterization as a prohibited subsidy.

In order to make this distinction clearer, footnote 58, which inserted the term “taxes” into items (e), (g) and (h) noted previously in this section, defines the concept of direct taxes and indirect taxes for the purposes of the ASCM as follows:

> 1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if
>
> The term “direct taxes” shall mean taxes on wages, profits, interests, rents, royalties, and all other forms of income, and taxes on the ownership of real property;
>
> ...
>
> The term “indirect taxes” shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;
>
> “Prior-stage” indirect taxes are those levied on goods or services used directly or indirectly in making the product;
>
> “Cumulative” indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production;

The traditional distinction between indirect taxes and direct taxes can be criticized. This is so because such a distinction assumes the premise that, with regard to indirect taxes, the tax burden is borne by consumers but, with regard to direct taxes, the burden lies with the producers. However, according to modern economic theory, such a distinction is justifiable only to the extent that, economically, the tax burden is shared by consumers, producers and employees, depending on the circumstances and the market.[27]

From the foregoing, it is evident that, economically, all taxes, including the income tax, are levied on consumption to the extent that they affect the price of the goods and services consumed. This means that, irrespective of the tax in question, consumers bear at least part of the tax burden in the production chain as a whole, which varies according to the profit margin of the economic sector in question.

Although this criticism is valid, the fact is that the criterion adopted by the WTO to characterize a prohibited subsidy takes into account such a distinction. Consequently, whether or not it is desired, it is necessary to deal with this distinction.

Here, reference should be made to the fact that the criterion adopted by the WTO does not apply in several countries and this gives rise to numerous issues in the application of this rule. The reason is that, although based on the principle of destination, i.e. applying to taxes on consumption, the definition of indirect taxes, adopted in footnote 58, is not fully compatible with the concept of taxes on consumption. The WTO’s concept of indirect tax contemplates, for example, value added tax (VAT), which in turn can be characterized as: (1) VAT on domestic consumption, which permits the offsetting of credits in respect of inputs consumed in the production process; (2) revenue VAT, where a credit is permitted with regard to inputs consumed during the production and in respect of goods depreciated in such a process to the extent of the depreciation; and (3) consumption VAT, which is relevant where a credit is permitted in respect of consumed inputs and for depreciated goods on the date of acquisition of the asset, and not to the extent of its depreciation. Only the third type of VAT can be considered a tax on consumption, but the other two types of VAT are also included in the WTO’s definition of indirect tax, thereby contradicting the logic of exemption of the tax on consumption according to the principle of destination.

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27. Vetori, *supra* n. 20, at p. 142.

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This conceptual difference is relevant to the Brazilian tax system because the ICMS, the PIS and the COFINS do not authorize an integral credit in respect of a fixed asset at the time of the acquisition of such an asset. Consequently, it would be VAT revenue according to the definition of the Musgraves and not VAT consumption.[28] However, the breadth of the WTO's concept of indirect tax encompasses all types of VAT.[29] The breadth of the concept of indirect tax is even more evident given its residual nature because, according to footnote 58, indirect taxes encompass "all taxes other than direct taxes and import charges". In addition to the lack of correspondence with regard to VAT, it should be noted the WTO's concept of indirect tax does not precisely match the notion of an indirect tax as settled under Brazilian indirect tax law.

In order to define indirect tax, footnote 58 lists possible materialities that may be subject to indirect taxes, i.e. "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes". In this context, it could be said that there is no conceptualization of indirect tax, but rather only its exemplification.

On the other hand, in Brazil, the focal point regarding the distinction between direct and indirect tax, in spite of the criticism noted previously in this section, is the transfer of the tax burden to the consumer. However, this is not any transfer; it is only a legal transfer.

The criterion that should be adopted to establish that it is a legal transfer is the indication of the pass-through in the law that introduces the tax. This means that it is the law that introduced the tax that must define whether the tax burden causes legal repercussions. This is the lesson of Machado (2007), who states that:[30]

> In our view, taxes that, by their nature, involve transfer of the respective financial charge are only those taxes in relation to which *the law itself prescribes such transfer*. The rule of art. 166 of the Brazilian Tax Code applies to such events only, as the nature to which such provision relates can only be a legal nature, *which is determined by the corresponding law, and not by mere economic circumstances* that may or may not exist if we do not have a safe criterion to know when the transfer occurred or when it did not occur. (Emphasis added)

According to the *Superior Tribunal de Justiça* (Superior Court of Justice, STJ)", it is incumbent on the law to define if a certain tax gives rise to or does not give rise to legal repercussions for the purpose of application of article 166 of the Brazilian *Código Tributário Nacional* (National Tax Code, CTN):[31]

> ...
>
> 2. Concerning the repercussion, the 1st Section of that Court (Appeal against a Divergent Decision in Special Appeal EREsp No. 168469/SP) settled that repercussion cannot be required in cases of repetition or offsetting of contributions, tax considered direct, especially where the law imposing its collection was considered unconstitutional under a court decision. Said Section of this Court, on Appeal against a Divergent Decision, settled that the understanding to accept the argument that art. 66 of Law No. 8,383/91, according to its systemic interpretation, authorizes the taxpayer to offset, via self-assessment, paid taxes whose payment were unduly or unconstitutionally required. *Taxes that allow, by their nature, transfer of the respective financial charge are only those in relation to which the law itself provides for said transfer*.
>
> 3. The rule of art. 166 of the CTN applies to such events only, *as the nature to which such provision relates can only be a legal nature, which is determined by the corresponding law, and not by mere economic circumstances that may or may not exist if we do not have a safe criterion to know when the transfer occurred or when it did not occur*.
>
> 4. Art. 166 of CTN clearly asserts the fact that, in the event of repetition of undue payment, the interpreter must always identify whether that tax, by its nature, permits or does not permit transfer of the respective financial charge to a third party where the law does not expressly establish that the payment of the exaction be made by a third party, as is the case with the ICMS and the IPI. The proof to be required in the first case is the possible one and must be convincing in order not to allow unjust enrichment of the taxing entity. Where the law expressly determines that the third party assumed the charge, it is absolutely necessary that the third party authorize the repetition of undue payment. (Emphasis added)[32]

Following this rationale, the author notes that the PIS and the COFINS do not permit the legal transfer of the relevant tax burdens. According to Laws Nos. 9,718/1998,[33] 10,637/2002[34] and 10,833/2003, the PIS and the COFINS are payable by the legal entity that derives the taxable revenue arising from a sale of goods or the provision of services, such that these are "indirect taxes", in light of the legal repercussions of the tax.

A transfer of the financial burden does not entail the legal transfer of the tax, as is the case with regard to "indirect taxes" and, therefore, in respect of the ICMS and the IPI, as the value of the PIS and/or the COFINS at the previous stage does not determine the credit at the following stage, whether in the cumulative or in the non-cumulative regime. The primary proof is that the repetition of undue payments

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28. R.A. Musgrave & P.B. Musgrave, *Public Finance in Theory and Practice*, 4th edn., pp. 441-443 (McGraw-Hill 1984).
29. Vetori, *supra* n. 20, at p. 145.
30. H. de B. Machado, *Curso de Direito Tributário* 28th edn. (Malheiros 2007).
31. BR: *Código Tributário Nacional* (National Tax Code, CTN), art. 166 reads as follows: "The restitution of taxes that imply, by their nature, transfer of the respective financial burden will only be made to those who prove to have assumed such charge, or, in the case of having transferred it to a third party, be expressly authorized by it to receive it".
32. BR: STJ, 16 Apr. 2006, Internal Appeal in Special Appeal AgRg in REsp 819.627/SP, reported by Justice José Delgado, First Panel.
33. BR: Law No. 9,718/1998 of 27 November 1998.
34. BR: Law No. 10,637/2002 of 30 December 2002.

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related to the PIS and/or the COFINS is not contingent on compliance with the criteria set out in article 166 of the CTN. These are the parameters accepted by the majority opinion of Brazilian jurists and courts for a tax to be characterized as an indirect tax.

However, this was not the criterion adopted in footnote 58 of the ASCM, which, in contemplating:

> taxes on sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges,

encompasses the PIS and the COFINS. Yet again, there is a divergence between the Brazilian concept and the WTO's rule with regard to indirect taxes. Nevertheless, it can be affirmed that under both Brazilian rules and WTO rules, income taxes are direct taxes.

With regard to indirect taxes, the principle of destination applies, thereby permitting the exemption from a tax on exports. The exemption, remission or deferral of cumulative indirect taxes levied at previous stages on inputs consumed during the production of goods to be exported is also not considered to be a prohibited subsidy, according to item 1 of Annex II to the ASCM. Here, the issue relates to the quantification of the subsidy because, according to item 2 of Annex II to the ASCM, systems for reduction of indirect taxes may constitute an export subsidy to the extent that they result in the exemption, remission or deferral of cumulative indirect taxes levied at previous stages, in addition to the value of equivalent fees effectively applied to inputs designed for the production of the goods to be exported.

Contrary to reason, if the amounts arising from the measure exceed the amount corresponding to the simple refund of the amounts cumulated in the production chains, there is a prohibited subsidy. Consequently, the qualification of a tax as indirect is not sufficient to eliminate the characteristic of prohibited subsidy. This is so because, even if it is an indirect tax, there is still the possibility of a refund of an amount in excess of that one which would ideally be assessed according to border tax adjustment rules. In order to determine whether an amount conforms to a border tax adjustment, the measure must contain clear rules. As a result, a measure intended to refund tax that does not set out clear rules for the quantification of the indirect tax to be refunded must be considered to be a prohibited subsidy. This lack of clarity makes the control of the characterization of a subsidy impossible and, for this reason, such a measure must not be authorized. In other words, the control capacity is an essential element to permit a subsidy relating to indirect taxes.

4. REINTEGRA: Incompatibility with WTO Rules

4.1. The national treatment rule

REINTEGRA only applies to "goods manufactured in Brazil". Consequently, goods imported for re-export, which do not undergo any manufacturing process in Brazil, do not fall within the scope of the regime.

As REINTEGRA provides for a more favourable treatment of domestic goods, it is therefore open to question by other WTO member countries. In such an event, Brazil could argue that the measure is based on article III.8(b) of the GATT, according to which:

> The provisions of this Article shall not prevent the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic products.

Should this be so, the defence of Brazil would be considered valid in the event of a decision that REINTEGRA encompasses not only indirect taxes because, as it appears to the author, article III.8(b) of the GATT should be interpreted together with the characterization of a prohibited subsidy. That is, in the author's view, article III.8(b) of the GATT does not apply to direct taxes.

Refuting the allegation that local content is required is, however, more difficult. This is so because one of the differentiation criteria for the inclusion of a certain product designed for export in REINTEGRA is the national content requirement. The goods contemplated by the regime are required to have 40% and 65% of national inputs[35] and, according to article 5 of Decree No. 8,415/2015, and therefore clearly violate article III.2 of the GATT. In view of this, REINTEGRA infringes the national treatment rule because of the national content requirement.

4.2. The MFN rule

Decree No. 8,415/2015 states that inputs originated in a MERCOSUR member country are considered to be national inputs for the purposes of REINTEGRA.[36] In this regard, the local content requirement considers "local" not only to be the Brazilian territory, but also the territories of the MERCOSUR member countries.

The Brazilian practice that gives priority to the MERCOSUR member countries to the prejudice of the other countries may be questioned in light of the MFN rule. However, in its defence, Brazil could argue that among the exceptions to the MFN rule is article XXIV.5 of the GATT, under which free trade zones do not violate the MFN rule.[37]

On the other hand, MERCOSUR is not exactly a free trade zone as it has many barriers and exceptions to free trade. In this regard, the objectives of Decree No. 2,873/1998[38] would be merely in the realm of ideas. Some pronouncements of the Brazilian authorities also

35. BR: Decree No. 8,415/2015, art. 5, III.
36. BR: Decree No. 8,415/2015, art. 5, para. 3, I.
37. Thorstensen, *supra* n. 22, at p. 35.
38. BR: Decree No. 2,873/1998 of 14 December 1940.

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indicate that such objectives are not to be realized any time soon.[39] Currently, the MERCOSUR cannot enjoy the benefits granted to free trade zones. Consequently, the exception provided for in article XXIV of the GATT does not apply to MERCOSUR. As a result, REINTEGRA violates the MFN rule by giving priority to MERCOSUR member countries to the detriment of the other WTO member countries.

4.3. The prohibited subsidies rules

REINTEGRA exhibits three issues from the perspective of the subsidy rule. These issues are now considered.

The first issue relates to the taxes contemplated by the tax residues. As it is not clear whether the regime encompasses direct taxes, there is a potential violation of the subsidy rule to the extent that, should such an assumption be correct, it is a measure which grants a subsidy in relation to a direct tax specifically oriented towards certain economic segments of the Brazilian industry and linked to the volume of an exporter's revenues, i.e. relating to "export performance". Tôrres (2016) has argued that the "export performance" is a kind of "target" and, as no target is set under REINTEGRA, such a criterion should not apply.[40] It does not appear that the export performance, according to the WTO's definition, relates specifically to a target or a trigger permitting the participation of the regime, but rather that it is a tax measure the quantification of which is directly proportional to the exporter's revenue, as it is the case with the REINTEGRA. Consequently, REINTEGRA takes the export performance into account.

The second issue relates to the quantification of the volume of the refunded taxes. With regard to this issue, Tôrres (2016) contends that the return of tax residues, under REINTEGRA, do not exceed the "amount of the taxes collected and remaining in the price of the products", such that a "specific subsidy" would not be so characterized.[41]

Nevertheless, as noted, REINTEGRA has no clear rules on the quantification of the amounts of tax residues to be returned. What were the parameters considered in the initial definition that the tax residues would correspond to 3% of export revenue? The Brazilian authorities have not provided any parameter or any public explanation regarding this matter. In addition, for the sake of practicability, is it admissible to accept that different economic sectors have a same volume of tax residues? The Brazilian authorities have also failed to explain the parameter for comparison per sector contemplated by REINTEGRA. Further, what are the criteria that justified the percentage reduction to 0.1% after three years? Such a sharp reduction in the amount of the tax residue in a scenario that was not subject to any relevant changes in the Brazilian tax system is a strong indicator that the quantification of the tax residue under REINTEGRA has no parameter at all.

As noted in section 3., it is possible to argue that, based on item 2 of the Annex II to the ASCM, the capacity to control the amount of indirect tax residues returned according to border tax adjustment rules is an indispensable element in determining that a measure is a permitted subsidy. To this end, clear rules for the quantification are essential, but this is not the situation with regard to REINTEGRA. Currently, it is not known whether Brazilian exporters benefit from the receipt of amounts that exceed the amount that would correspond to the tax residues.

Finally, the third issue with regard to REINTEGRA and the prohibited subsidy rules according to the WTO relates to the exemption of credits received under the IRPJ regime and the CSLL. In this respect, Law No. 13,043/2014 establishes that the credits derived from REINTEGRA cannot be included in the base for the calculation of the IRPJ, the CSLL, the PIS and the COFINS.[42]

In the answer to Inquiry COSIT No. 88/2016, the Brazilian Federal Revenue expressed its understanding that Law No. 13,043/2014 was an innovation when it authorized the exclusion of the amounts of the credit under REINTEGRA from the base in respect of the calculation of the IRPJ, the CSLL, the PIS and the COFINS, and that, given their nature, such credits should be taxed. Consequently, according to the Brazilian Federal Revenue, REINTEGRA credits should originally be derived from the IRPJ, the CSLL, the PIS and the COFINS, but Law 13,043/2014 exempted such credits from taxation. Evidently, this is a tax measure related to direct tax, i.e. the IRPJ and the CSLL, according to the WTO's definition of a direct tax, which only applies to exporters that are included in REINTEGRA and, as such, its nature is that of prohibited subsidy. For all these reasons, REINTEGRA violates the WTO's prohibited subsidy rules.

5. Conclusions

The decision of the WTO Dispute Settlement Body, in the panel established at the request of Japan (DS 497) and further joined by the panel required by the European Union (DS 472), is a strong indicator that the Brazilian measures oriented towards the development of its local industry should fall within the focus of attention of the countries that compete with Brazil and should be questioned from the perspective of WTO rules. As REINTEGRA has not been considered by that panel and, as noted in section 4., REINTEGRA violates some WTO rules, i.e. the MFN rule, the national treatment rules and the prohibited subsidies rules, the chances of the regime being questioned in the future by WTO member countries are high.

It is evident that Brazil has the right to exercise its sovereignty to exempt exports from indirect taxes subject to border tax adjustment rules, in conformity with the principles that govern economic order.[43] Notwithstanding this, the exercise of sovereignty with regard to this issue must respect the international agreements to which Brazil is a signatory.

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39. In this regard, *see* the pronouncement of the Brazilian ambassador, Rubens Barbosa, available at www1.folha.uol.com.br/mercado/2015/11/1703397-mercosul-desistiu-de-livre-comercio-diz-ex-embaixador-do-brasil.shtml.
40. Tôrres, *supra* n. 16.
41. Tôrres, *supra* n. 16.
42. BR: Law No. 13,043/2014, Art. 22, para. 6.
43. BR: Brazilian Federal Constitution, art. 170.

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The historical argument that, previously, rich countries had adopted similar practices, which are no longer permitted within the scope of the WTO, cannot be a justification for the adoption of measures that violate the MFN rule, the national treatment rules and the prohibited subsidy rules. Should the Brazilian authorities consider that such a historical argument is reasonable, the correct action should be to leave the WTO and not to adopt a measure that contravenes agreements signed by Brazil. As it is unthinkable for Brazil to leave the WTO, the WTO rules must be respected by the country. At this point, as noted in section 2., the peculiarities of the Brazilian tax system and the need for the Brazilian government to develop local industry do not justify not observing the WTO rules.

For all of these reasons, this article defends the revision of the rules of REINTEGRA and the improvement in respect of transparency with regard to the criteria adopted to regulate the regime, including making it conform to WTO rules.

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