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In this article, the author considers how the U.S. Tax Cuts and Jobs Act may affect Brazilian subsidiaries of U.S. multinationals, the questionable efficacy of income stripping as a response, and other ways that companies may use international tax planning to preserve their wealth. Ultimately, he concludes that multinationals, particularly those with controlled foreign corporations in Brazil, may respond to the TCJA in ways that circumvent the act's primary goals.

Situated in a federal income tax system conveniently protected by the high-tax exception of subpart F, Brazilian subsidiaries of U.S. multinationals have historically had little incentive to avoid income taxation. The Tax Cuts and Jobs Act dramatically changed that. The combination of the new 21 percent corporate rate with new rules for global intangible low-taxed income, foreign-derived intangible income, and the foreign dividends received deduction (DRD) produces an almost irresistible incentive for U.S. parents to press their Brazilian subsidiaries to strip income and reduce their effective corporate income tax rates to less than Brazil's nominal 34 percent on net profits.

I say almost irresistible, because the Brazilian Federal Revenue (Receita Federal do Brasil, or RFB), which fiercely protects its taxable base, limits taxpayers' use of the more commonly known income-stripping strategies and will likely oppose efforts that lack a bona fide business purpose.

Should the RFB's resistance prevail, U.S. parents are likely to employ alternative strategies to close the gap between U.S. and Brazilian income taxation, including:

- checking the box on Brazilian subsidiaries and treating them as branches of the U.S. parent, thus opting out of controlled foreign corporation treatment altogether;
- converting non-subpart F income into subpart F income to benefit from the high-tax exception; or
- implementing or strengthening a CFC's tangible manufacturing structure in Brazil to increase that CFC's qualified business asset investment.

Notably, the third alternative is precisely the result the TCJA was created to prevent.

This article is divided into four sections. Section I describes the major modifications that the TCJA made to the U.S. outbound tax system (putting aside the base erosion and antiabuse tax) and explains why these modifications put pressure on U.S. parents to strip income from CFCs in high-tax countries like Brazil. Section II presents the weapons that the RFB can use to fight multinationals' most common income-stripping strategies. Section III suggests alternative ways to reduce the impact of the GILTI regime if the RFB's resistance successfully limits the use of the more common income-stripping initiatives. In Section IV, I offer my conclusions.

I. The TCJA and Its Pressure Points

A. The New Corporate Rate

The TCJA modified IRC section 11(b) to reduce the corporate income tax rate from 35 percent to 21 percent. Brazil, on the other hand, does not have a specific income tax for corporations. Instead, Brazil has two income taxes for legal entities in general:

- the legal entity income tax (Imposto de Renda Pessoa Jurídica, or IRPJ), which is generally levied at a 25 percent rate — that is, 15 percent plus 10 percent additional for

monthly income higher than BRL 20,000 (approximately $5,000); and
- the social contribution on net profits (Contribuição Social sobre o Lucro Líquido, or CSLL), which is typically levied at 9 percent (although different rates apply to some economic sectors).

Both taxes can be calculated using two different tax systems, both of which apply to entities with non-Brazilian shareholders:
- the Lucro Real system, under which taxable profit is the entity's accounting profit with modifications (additions and exclusions) in accordance with the tax law; and
- the Lucro Presumido system, under which a percentage of the entity's gross income is legally presumed to be its net profit and taxed accordingly.

Therefore, Brazilian CFCs generally pay a total 34 percent in income taxes, which was fine when the U.S. corporate rate was 35 percent because, at least under the Lucro Real system,[1] any subpart F inclusion would generate no income inclusion to the U.S. shareholder because of the high-tax exception in IRC section 954(b)(4). This rule provides that income otherwise taxable under subpart F may be excluded if the taxpayer establishes that such income was "subject to an effective rate of income tax imposed by a foreign country greater than 90 percent" of the U.S. tax rate. Now that the U.S. corporate rate is 21 percent, 34 percent suddenly seems too high — especially because the TCJA also repealed section 902, which had granted the U.S. parent an indirect foreign tax credit for the foreign income taxes previously paid by a CFC whenever it remitted dividends (which are exempt from tax in Brazil).

There are talks in Brazil about reducing the entity income taxes and resuscitating dividend taxation to align both to international standards.[2] Still, even if entity income taxation drops — for example, to 20 percent — the U.S. shareholder pressure for CFC income stripping will remain, now that the paradigm is 21 percent and not 35 percent and as a result of other changes made by the TCJA.

B. GILTI: A Minimum Tax and a Paradigm Shift

New section 951A gives birth to the GILTI tax. The TCJA inserted it into subpart F as an addition to the CFC rules that works in parallel with that regime and the U.S. transfer pricing rules. The GILTI tax reaches a CFC's foreign income that is not:
- effectively connected to a U.S. trade or business;
- subpart F income;
- excluded from foreign base company income (FBCI) or from insurance income because of the high-tax exception;
- a dividend received from a related person; or
- foreign oil and gas extraction income.

The GILTI regime taxes income currently (that is, without deferral) to the extent that the relevant income minus deductions properly allocable to it (the tested income) and minus tested losses[3] (thus, the net tested income) exceeds a 10 percent notional return (the CFC's net deemed tangible return) on the CFC's aggregate adjusted basis in depreciable tangible property used in the production of the tested income (QBAI) minus specified interest expenses.

Basically, section 951A taxes, on a current basis, all of a CFC's foreign active income that escapes subpart F (unless it qualifies for the high-tax exception[4]) to the extent that the income exceeds 10 percent of the value of the CFC's tangible, depreciable, and productive assets. If a CFC's income would not originally be FBCI or

[1] The high-tax exception applies only to foreign base company income (FBCI) and insurance income if Brazilian income taxes are paid under the Lucro Real system. Because Lucro Presumido does not allow any deductions, taxes paid under that regime fail the net income test of reg. section 1.901-2(b)(4) and are unprotected by section 954(b)(4).

[2] There are three constitutional amendment bills (Propostas de Emenda Constitucional, or PECs) pending in Congress: PEC 45/2019, PEC 110/2019, and PEC 128/2019 (in Portuguese). Although they have the common goal of simplifying the indirect tax system, only PEC 128/2019 also reinstates dividend taxation, while reducing the corporate income tax rate accordingly. It is too early to determine which, if any, PEC may be approved by Congress.

[3] Tested losses, the inverse of tested income, are the excess of deductions properly allocable to gross income — determined without regard to effectively connected income, subpart F income, items excluded from FBCI or from insurance income under section 954(b)(4), dividends received from related persons, and foreign oil and gas extraction income — over gross income.

[4] If it is excludable under section 954(b)(4) from what would otherwise be FBCI or insurance income, high-taxed income escapes the GILTI tax as well. *See* Carrie Brandon Elliot, "How the TCJA Has Changed Subpart F," *Tax Notes Int'l*, July 30, 2018, p. 439.

insurance income then it cannot escape the GILTI tax because it faces a high tax in the other country. For example, a Brazilian CFC that imports products from a controlling U.S. parent and sells them to unrelated customers in Brazil does not perceive foreign base company sales income and thus cannot use Brazil's 34 percent net profits taxation to claim the high-tax exception to the GILTI tax.

The broad formula for the GILTI regime encompasses more than just low-taxed intangible income. For example, it reaches a typically commercial CFC that keeps inventory in a space leased from third parties. That CFC would have virtually no QBAI and, therefore, would generate full 951A inclusions to its U.S. shareholders every year, despite generating income from active, tangible operations in the foreign country and even if it is taxed by a high-tax foreign jurisdiction.

The GILTI tax is a global tax that goes where subpart F and section 482 (transfer pricing's arm's-length standard) cannot go. It is built on different principles and thus represents a paradigmatic shift in international tax law. Much remains to be said and argued about the GILTI tax and only time will tell whether it will subsist, but for now it is very important for — and can make a great difference to — a U.S. multinational's tax planning strategy. To start, GILTI inclusions represent ordinary income for a U.S. shareholder. For unincorporated U.S. shareholders, this means the ultimate individual owner is subject to ordinary taxation, which may reach as high as 37 percent. U.S. corporate shareholders, however, not only benefit from the newly reduced 21 percent rate, but also receive a 50 percent deduction, resulting in an effective income tax rate of 10.5 percent for GILTI inclusions. Moreover, section 960(d) gives U.S. corporate shareholders with GILTI inclusions a deemed FTC equal to 80 percent of the foreign income taxes paid or accrued on the amount included. FTCs for the U.S. shareholders' GILTI are calculated separately from FTCs on other income.

While the high-tax exception of section 954(b)(4) partly immunizes a Brazilian CFC against subpart F inclusions, it does not protect it against GILTI inclusions. It is true that GILTI's tested income does not include income that is subpart F nor income that, but for the high-tax exception, would be subpart F. However, that is all that section 951A and reg. section 1.951A-2(c)(iii) say about section 954(b)(4).[5] A CFC's income that would not be subpart F regardless of the high-tax exception is sure to be included in GILTI's net tested income calculation, if it does not qualify for the other exceptions in section 951A. Therefore, profitable Brazilian CFCs with active, non-subpart F income are likely to generate GILTI inclusions for their U.S. shareholders. If the GILTI inclusion was subject to income taxation in Brazil under the Lucro Real system, then 80 percent of that tax is generally creditable as an FTC under section 960(d) and can be offset against the GILTI tax, which is as low as 10.5 percent for U.S. corporate shareholders. Therefore, potential GILTI inclusions will likely lead to U.S. parents pressuring their Brazilian CFCs to lower their effective, creditable income tax rates to as low as 13.125 percent (80 percent of which is 10.5 percent).

C. Foreign Dividends Exemption

What happens to a CFC's income that generated either a GILTI or a subpart F inclusion and is later distributed to the U.S. shareholder? The prior inclusion is now previously taxed income, and it escapes a second round of U.S. taxation in accordance with section 959.

More broadly, however, all dividend distributions from a CFC to its corporate U.S. shareholders are now free from additional taxation under the foreign DRD in new section 245A. This new code section strongly reduces the historic economic incentive for deferral. Aside from subpart F and GILTI inclusions, the only case in which a U.S. shareholder would owe U.S. tax is if shares of the CFC are disposed of in a taxable sale and the proceeds do not qualify as dividends.[6]

U.S. multinationals know that, whether or not taxed by subpart F or GILTI, their subsidiaries' profits may flow upstream with no additional

[5] Proposed regulations issued on June 6, if approved, will expand the GILTI high-tax exclusion to high-taxed income other than FBCI or insurance income. Prop. reg. section 1.951A-2(c)(iii) and (c)(6). But until that happens, GILTI includes otherwise high-taxed income.

[6] Jasper L. Cummings, Jr., "The Foreign Dividends Received Deduction," *Tax Notes*, Mar. 12, 2018, p. 1487.

U.S. federal income tax. Dividend distributions are also exempt in Brazil. However, tax reform may occur during the current Brazilian presidency.[7] If it does, experts expect that dividend distribution will be no longer exempt. The underlying idea is that taxation of dividends would help the government recover some of the revenue lost from a decrease in corporate income tax rates. Dividend taxation in Brazil would increase the pressure on U.S. multinationals to strip income from Brazilian CFCs.

D. FDII: A Direct Incentive

1. The FDII Deduction

Thus far, we have examined indirect incentives to strip income from Brazilian CFCs that arise from the decrease in the U.S. parent company's effective corporate income tax rate, which in turn tempts the U.S. parent to avoid "wasting" resources on foreign taxes that cannot be used as FTCs in the United States.

The TCJA also created a direct incentive to strip income in the FDII deduction (new section 250(a)(1)(A)). FDII explicitly allows a U.S. corporation to deduct 37.5 percent of its gross income that is not attributable to a CFC, a foreign branch, financial services, or domestic oil and gas extraction, but that is related to the sale of property (including licenses and leases) to foreign persons for use outside the United States or to the performance of services for foreign persons or with respect to property outside the United States. The eligible gross income is reduced by related deductions (including taxes) and by a 10 percent notional return on the U.S. corporation's QBAI (the deemed tangible income return). In a GILTI-like calculation, FDII grants the U.S. corporation a 37.5 percent deduction on the excess of its net income from exports of goods and services over a 10 percent return on its QBAI, thus resulting in an effective federal income tax rate of only 13.125 percent (instead of 21 percent) for that excess income.

FDII also applies in foreign related-party transactions, but only if the property sold or leased, the service rendered, or the license granted is either resold to an unrelated party or used by the related party in connection with sales, leases, licenses, or services provided to unrelated parties for use outside the United States. This is essentially what a foreign subsidiary that imports products or uses the parent's equipment, patent, trademark, or services does. Therefore, section 250(b)(5)(C) directly incentivizes a U.S. parent to strip income from its foreign subsidiaries by selling or leasing products, licensing intangibles, or rendering services to the CFC at a lower income tax rate, thanks to the FDII deduction. As counterintuitive as it may be, the deduction adds pressure toward stripping income in Brazil.

There is some controversy around the FDII deduction. J. Clifton Fleming Jr. and others have suggested that FDII may violate WTO law; likewise, part of the reason that Daniel Shaviro suggests that a true intellectual property box would be preferable to FDII is that the WTO has never repealed those regimes.[8] Another potentially controversial issue is that, because it is based on the excess of the U.S. corporation's income over its QBAI, the FDII deduction not only encourages the beneficiary to increase its intangible income, but also to decrease its QBAI. One way a multinational could do this would be to transfer tangible assets to CFCs that generate GILTI, thus increase the CFCs' QBAI, while decreasing that of the U.S. parent. In this sense, both GILTI and FDII fall short on their promise to encourage multinationals to bring back factories to the United States.

2. An Example

To demonstrate how the TCJA encourages stripping Brazilian income,[9] consider a corporate U.S. parent (USP) with a commercial Brazilian CFC (BRSub). USP exports products to BRSub, which resells them locally. BRSub houses its local team in a leased office and holds its inventory

[7] *See supra* note 2.

[8] Fleming, Robert J. Peroni, and Stephen E. Shay, "Expanded Worldwide Versus Territorial Taxation After the TCJA," *Tax Notes*, Dec. 3, 2018, p. 1173; and Shaviro, "The New Non-Territorial U.S. International Tax System, Part 2," *Tax Notes Int'l*, July 9, 2018, p. 125.

[9] This example focuses on the new incentives created by the TCJA to strip income from CFCs. Section III adds other layers of complexity to the example and examines Brazilian taxes that may apply to the income-stripping payment.

through a third-party logistics provider; thus, BRSub holds no relevant tangible or depreciable assets. BRSub's net income of $100 from inventory sales to local consumers is subject to Brazilian income tax at a combined 34 percent rate under the Lucro Real system. That income is not FBCI and therefore escapes subpart F. All after-tax dividends from BRSub (here, $66) are distributed to USP free from tax in Brazil.

Before the TCJA, USP took an indirect FTC of the $34 for taxes paid on BRSub's profits and paid an additional 1 percent (here, $1) to the U.S. Treasury. Now, while the additional $1 of U.S. tax disappears because of the rate reduction and the section 245 exemption on foreign dividends, BRSub's inventory resale net income is subject to an immediate 10.5 percent GILTI tax (assume that BRSub's net income for Brazilian tax purposes equals its net tested income for GILTI purposes). Even with no QBAI to reduce its taxable basis, the GILTI tax owed is still zero because the $10.50 GILTI tax is completely offset by the $27.20 FTC (80 percent of the Brazilian corporate income tax). This leaves not only an excess credit of $16.70 — which, if not cross-credited against GILTI inclusions from other countries in the same tax year, will be forever lost — but also $6.80 of Brazilian taxes that can no longer be used as FTCs because of the combined effect of the GILTI FTC limitation to 80 percent and the section 902 revocation (referred to hereinafter as Brazilian non-FTC taxes). These become a relevant cost of doing business in Brazil, not because they produce a lower after-tax income (in fact, post-TCJA, USP gains $1), but because they are left on the table. Table 1 illustrates the example.

Table 1. Comparing Taxes and Income Pre- and Post-TCJA

Comparative Chart	Pre-TCJA	Post-TCJA
Brazil FTC taxes	$34.00	$27.20
Brazil non-FTC taxes	-	$6.80
BRSub after-tax income	$66.00	$66.00
Residual U.S. tax	$1.00	-
GILTI basket excess credit	-	$16.70
Non-GILTI excess credit	-	-
USP after-tax income	$65.00	$66.00

The U.S. parent's incentive to strip income[10] from the Brazilian CFC will thus derive from the desire to reduce the amount of potentially unused GILTI excess credits and non-FTC Brazilian taxes.

In our example, to reduce BRSub's income, USP may decide to charge BRSub $20 for a license to exploit USP's intangibles embedded on the imported products, which would — assuming, for now, that no Brazilian taxes are levied on the royalty payment (which would clearly change the numbers, as we will see in Section II.F) — reduce the Brazilian taxes to $27.20 (that is 34 percent of the new net income of $80, a $6.80 saving), reduce the GILTI excess credit to $13.36 (a $3.34 saving), and reduce the Brazilian non-FTC taxes to $5.44 (a $1.36 saving). It would also trigger a $2.62 U.S. FDII tax (assuming USP has no QBAI and applying the reduced U.S. tax rate of 13.125 percent), thus generating net tax savings of $8.88. This leaves $18.80 (that is, $13.36 GILTI excess credit plus $5.44 Brazil non-FTC taxes) on the table.

E. New Source Rule for Inventory Sales

The TCJA made a small but significant modification to the flush language of section 863(b) that changes the source rule for sales of inventory property manufactured in one jurisdiction and sold in another.

Before the TCJA, the income from these sales was sourced 50 percent to the country where the inventory was produced and 50 percent to the country where title to the property changed hands. If title to U.S.-manufactured inventory passed from seller to buyer within the United States, 100 percent of the income from that sale would be sourced in the United States. If, however, title to the same U.S.-manufactured inventory passed outside the United States, 50 percent of the income would be U.S.-source, and the other 50 percent would be foreign-source. This particularity made the taxation of income from U.S.-manufactured inventory sales subject to contractual manipulation.

[10] USP may rely on the freedom of contract, the arm's-length standard for intragroup arrangements, or the ambiguities of returns on intangibles to create one or more intragroup deductions or income inclusions (for example, interests, rents, or royalties). *See, e.g.*, Edward D. Kleinbard, "Stateless Income," 11 *Fla. Tax Rev.* 699 (2011).

Post-TCJA, section 863(b) flush language provides that the sole basis for sourcing the income from the sale of inventory property produced in one jurisdiction and sold in another is "the production activities with respect to the property" — that is, 100 percent of inventory sales income will be sourced to the jurisdiction of production regardless of where title passes.

By providing a clear, tangible standard, amended section 863(b) has closed the door on entities contractually altering the source of international inventory sales. However, as will be discussed in Section III.C, it may have left a window open for U.S. groups that are willing to move their factories abroad.

F. Incentives for U.S. Shareholders to Incorporate

The lower 21 percent rate, the 50 percent GILTI deduction, the foreign DRD, and the FDII deduction are corporate privileges. They are not available to unincorporated U.S. entities that have subsidiaries abroad, and there are no similar benefits available to unincorporated taxpayers doing business abroad.

Indeed, the new section 199A — which provides a 20 percent deduction for partnerships and other noncorporate businesses (other than those engaged in excluded types of business) — does not apply to trades or businesses carried on outside the United States and thus cannot be used in the international subsidiary context. Section 199A(c)(3)(A)(i) specifically limits the definition of qualified business income for purposes of the deduction to items of income, gain, deduction, and loss effectively connected with the conduct of a trade or business within the United States.

Taking our previous example, suppose USP is a noncorporate entity. Post-TCJA, USP (or, more accurately, its partners or members) will be immediately taxed on the GILTI from BRSub's net sales income at a rate of 21 percent rather than 10.5 percent because the 50 percent deduction does not apply. In the example, there would still be zero GILTI tax because the $21 tentative GILTI tax would be completely offset by the $27.20 FTC. USP will also be taxed at the applicable noncorporate rate on non-PTI dividends flowing from BRSub because the foreign DRD does not apply. In the example, this would also lead to a zero tax, because the entire GILTI inclusion and the distributed amount coincide. USP will not be able to use the discounted 13.125 percent rate for income from licensed U.S. intangibles because the FDII deduction does not apply. In the example, there would be no alternative to leaving $13 of unusable Brazilian taxes on the table.

Individual U.S. shareholders can still make a section 962(b) election and get corporate treatment for purposes of applying the 21 percent corporate rate on their income inclusions under section 962(a)(1) and qualifying for section 960's deemed FTC in accordance with section 962(a)(2). It is not yet clear, however, whether a section 962(b) election would enable an individual U.S. shareholder to benefit from the FDII and GILTI[11] deductions under section 250, or from the DRD in section 245A.

Moreover, section 962(d) taxes prior section 951(a) inclusions (that is, section 951(a) PTI) upon actual distribution of earnings and profits to the opting individual U.S. shareholder, except to the extent the amount of E&P distributed equals the amount of U.S. income tax the opting U.S. individual previously paid. Were it not for the section 962 election, actual distribution of E&P pertaining to PTI would be nontaxable under section 959(a)(1). This harsh rule — which largely annihilates the advantage of a section 962 election — was recently upheld by the Tax Court in *Smith v. Commissioner*, 151 T.C. No. 5 (Sept. 18, 2018). Although Congress's clear intent in issuing section 962 was to prevent an individual U.S. shareholder from suffering hardship and guarantee he incurred no heavier taxation than he would have suffered if he invested in a U.S. corporation doing business abroad, the Tax Court found that this intent related solely to undistributed earnings.

Therefore, in addition to encouraging CFCs to strip income, the post-TCJA international tax framework strongly incentivizes U.S. shareholders to incorporate, which is a far cry from, and in no way facilitates, attracting jobs or investments back into the United States.

[11] *See, e.g.*, Libin Zhang, "Direct Foreign Tax Credit and GILTI: The Curious Incidence of the Credit That Was Not Cut," 47 *Tax Mgmt. Int. J.* 257 (2018).

II. The RFB's Response to Income Stripping

A. Brazil's Federal Income Taxes

Brazil's federal income taxes not only include the previously mentioned IRPJ and CSLL, which are levied at a combined rate of 34 percent on an entity's net profits under the Lucro Real system, but also two social contributions — Programa de Integração Social (PIS) and Contribuição para Financiamento da Seguridade Social (COFINS) — that are levied on the entity's gross income. While the PIS and COFINS rates vary according to the economic activity of the taxpayer, the general rate is 9.25 percent (1.65 percent for PIS and 7.6 percent for COFINS) under the Lucro Real and 3.65 percent (0.65 percent for PIS and 3 percent for COFINS) under the Lucro Presumido.

Only the IRPJ and CSLL under the Lucro Real are creditable taxes in the United States under sections 901 and 960. The PIS and COFINS taxes, either under the Lucro Real or under the Lucro Presumido, are costs to the taxpayer.

B. General Antiavoidance Rule

Article 116, sole paragraph, of Brazil's National Tax Code (Código Tributário Nacional, or CTN)[12] contains a general anti-tax-avoidance provision, as follows:

> The administrative authority may disregard legal acts or transactions performed with the purpose of dissimulating the occurrence of the taxable fact or the nature of the elements of the tax obligation, according to procedures to be established by law.

This provision thus empowers the tax authority to investigate and disregard arrangements that lack a bona fide business purpose or that the taxpayer entered into solely to avoid or reduce taxes. Therefore, to be on the safe side, an income-stripping strategy needs to be something beyond an income-stripping strategy. It needs an autonomous, valid business purpose, regarded independently of tax reasons. If it lacks such purpose, the RFB will likely disallow the respective deduction at the Brazilian entity level.

The "business purpose" condition has been hotly debated by Brazilian scholars and practitioners since Supplementary Law 104/2001 inserted the paragraph into the CTN. In the absence of statutory guidance on its implementation, the definition has been progressively shaped by the Administrative Council of Tax Appeals (CARF). According to Plinio J. Marafon,[13] CARF has interpreted the business purpose condition as a surrogate for simulation. That surrogate argument has a valid basis in the text of the sole paragraph of article 116 of the CTN, but CARF has historically imposed, more often than not, the business purpose condition as a requirement to validate tax planning.[14]

C. Product Imports

Regardless of the underlying legal transaction or where title passes, anything that physically enters the Brazilian territory is subject to a bundle of taxes at varying rates depending on the product: import tax (Imposto sobre a Importação, or II), excise tax (Imposto sobre Produtos Industrializados, or IPI), sales tax (Imposto sobre Operações Relativas à Circulação de Mercadorias e Serviços de Transporte Interestadual e Intermunicipal e de Comunicações, or ICMS), PIS, and COFINS. Rates vary according to each product's tax code under the Mercosur (a customs union and free trade bloc in which Argentina, Brazil, Paraguay, and Uruguay are full members).

[12] Author's translation.

[13] Marafon, "Propósito Negocial na Visão Fiscal," *Valor Econômico*, July 11, 2018.

[14] *See, e.g.*, CARF opinions in Administrative Procedures 10880.721826/2010-81, Session of May 9, 2013 (if a transaction lacked economic substance and business purpose, and an expense was incurred only to reduce the taxable base, then the expense must be disregarded and the taxable base restored); 16327.720417/2012-91, Session of Oct. 17, 2017 (a corporate reorganization with no other purpose than obtaining tax advantages is ineffective against the Federal Treasury); and 16561.720167/2013-06, Session of Feb. 19, 2019 (concluding that a transaction without business purpose, aimed exclusively at reaching tax purposes, is ineffective against Federal Treasury). *But see* CARF's opinions in Administrative Procedures 10680.726772/2011-88, Session of Feb. 20, 2013 (accepting business transactions performed solely for tax reasons); and 16327.721148/2015-23, Session of Aug. 15, 2018 (finding there is no federal or national rule that regards a legal transaction as nonexistent or without legal effect if the only reason for it was tax savings, and stating that the idea that tax authorities must disregard transactions that are motivated by tax savings and have no economic content or business purpose lacks legal support).

Although some of these taxes may be creditable by the importer, these taxes are generally levied on top of each other and its total economic burden may create a disincentive, especially if the importer cannot use the entirety of its import tax credits. Specifically, while the import tax is never credited to the importer, the IPI and the ICMS generally are and can be offset with later levies of the same taxes, and the PIS and COFINS are creditable if the importer opted for the Lucro Real system. An example of the importer being unable to use all of its credits would occur if an 18 percent ICMS import levy was followed by an interstate sale of the imported product, taxed at 4 percent. Moreover, deductibility of the respective product cost is subject to transfer pricing controls under one of the applicable, non-OECD, Brazilian methods of Law 9.430/1996.[15]

Therefore, Brazil is not a country that companies tend to use to triangulate imports or structure round-trip transactions. Usually, multinational groups ship products to Brazil only when they actually intend to sell them there, and it may be even cheaper to manufacture those products in Brazil.

D. Dividend Distributions

Dividends are neither deductible nor taxable in Brazil. They cannot be deducted because they are an after-tax payment. Further, they have been exempt from income taxation at both the source and beneficiary levels since 1996.[16] As noted, a future tax reform (possibly focused on matching the new U.S. corporate rate) may change this.

Notably, however, if the Brazilian entity pays dividends to a shareholder in a tax haven,[17] then the exemption does not apply and the dividends are fully taxable by a 25 percent income withholding tax.[18]

Therefore, dividend distribution does not amount to an income-stripping strategy in Brazil.

E. Interest Payments

When paying interest to its U.S. parent, a Brazilian subsidiary has to withhold a 15 percent income tax, creditable to the U.S. parent under section 901. The U.S. parent may use the income withholding tax credit regardless of the tax regime selected by the Brazilian subsidiary, because it is a tax withheld from (and thus suffered by) the U.S. parent. This can be a good deal, once the corresponding deduction at the Brazilian entity level reaches 34 percent to Lucro Real taxpayers. Lucro Presumido taxpayers cannot take any deductions because they are taxed on gross revenue at a much lower combined rate. Because of that, only income taxes paid under Lucro Real may be credited (when appropriate) in the United States, while income taxes paid under Lucro Presumido may not.

The RFB usually allows the deduction of interest payments from a Brazilian CFC to its U.S. parent[19] as long as:

- they are necessary and ordinary expenses in the course of the Brazilian entity's trade or business;[20]
- the applicable interest rate is among those established by legislation and regulations, plus a spread determined by the Ministry of Finance;[21]

[15] IRC section 482 prohibits a taxpayer from adopting differential reporting methods, that is, reporting one transfer price in the United States and another in a foreign country. Stanley I. Langbein, "The Unitary Method and the Myth of Arm's Length," *Tax Notes*, Feb. 17, 1986, p. 625. Langbein admits that, were he in the position to do so, he would be reluctant to penalize a taxpayer that reported differentially if its transfer pricing conformed to the regulations because the "applicable substantive standards flatly reward" the practice. To avoid this problem, I prefer that a taxpayer find a common ground for its intragroup transfer price, so that the rules of both jurisdictions are satisfied. However, there could be a situation in which a U.S. multinational group finds it impossible to comply with both the Brazilian standards (which often mandate fixed percentages of profit margins for the Brazilian entity) and section 482.

[16] Law 9.249/1995, article 10. *See also* Ruling (Solução de Consulta) 257/2005.

[17] Brazil has a general concept of tax havens (jurisdictions or tax regimes that allow income taxation at a rate lower than 20 percent), a blacklist of jurisdictions, and a gray list of tax regimes. Many of its transfer pricing, withholding, and deductibility rules vary depending on whether the beneficiary is in a tax haven.

[18] Income Tax Regulations, article 744, para. 1. *See also* Decision 21/2000.

[19] *See, e.g.*, Ruling (Solução de Consulta) 382/2012.

[20] Article 47 of Law 4.506/1964, and article 311 of the Income Tax Regulations (Decree 9.580/2018).

[21] Article 22 of Law 9.430/1996.

- the total amount of debt does not exceed twice the amount of equity of the Brazilian entity;[22] and
- the total amount of debt owed to entities established in tax havens does not exceed 30 percent of the Brazilian entity's equity.[23]

Returning to our example, assume that USP decides to strip income from BRSub via interest on a previously made intercompany loan that fulfills the requirements above, and the amount of interest paid in a given year is $20. All other amounts are the same as those in the original example that led to Table 1. The $20 interest payment will reduce BRSub's income taxes to $27.20 (80 * 34 percent), generate an FTC of $21.76 (27.20 * 80 percent) and, consequently, a GILTI excess credit of $13.36 and non-FTC Brazilian tax of $5.44. USP will fully credit itself for the $3 that Brazil withholds as income tax on the interest payment (15 percent of $20) against its tentative $2.63 U.S. tax on the interest income (that is, assuming the interest income is eligible for the FDII deduction under section 250(b), the $20 royalty minus the $7.50 FDII deduction taxed at 21 percent),[24] generating a $0.38 non-GILTI excess credit. USP's after-tax income will rise from $66 to $72.80.

Table 2 compares a pure dividend distribution with an interest payment strategy.

Table 2. The Interest Payment Strategy

Comparative Chart	Dividend	Div. + Interest
Brazil FTC taxes	$27.20	$21.76
Brazil non-FTC taxes	$6.80	$5.44
BRSub after-tax income	$66.00	$52.80
Residual U.S. tax	-	-
GILTI basket excess credit	$16.70	$13.36
Non-GILTI excess credit	-	$0.38
USP after-tax income	$66.00	$72.80

[22]Article 24 of Law 12.249/2010.

[23]Article 25 of Law 12.249/2010.

[24]If it is not eligible, then residual U.S. tax would be $1.20, non-GILTI excess credits would be zero, and USP's after-tax income would be $71.60 — thus, it is still a very good result.

F. Royalty Payments

In the past, remuneration for the transfer or use of IP rights between related parties would escape Brazil's transfer pricing controls if the parties registered the respective agreement with the National Institute of Industrial Property (Instituto Nacional da Propriedade Industrial, or INPI), which, based on a 1958 rule, imposed a cap on the royalties to be paid.[25] Although the INPI ceased applying that rule in 2017 — theoretically leaving the parties free to agree upon the amount of royalties — the RFB is likely to continue applying the old rule in audits. Since the old rule has not been repealed, the fact that the INPI does not use it when registering IP agreements does not prevent the RFB from using it when auditing royalty deductibility ex post.

Royalty payments sent abroad also trigger the Contribution of Intervention on the Economic Domain (Contribuição de Intervenção no Domínio Econômico, or CIDE). The CIDE is a 10 percent social contribution levied on royalties and some service compensation remitted abroad. It was designed to prevent the erosion of the Brazilian tax base. Although not restricted to a particular universe of taxpayers, the CIDE plays a similar role to that of the BEAT. Before the CIDE's creation in Law 10.168/2000, the RFB denied the deductibility of royalties remitted abroad.[26] The payment also triggers the 15 percent income withholding tax. While the income tax may generate an FTC under section 901, the CIDE may not. Although the tax burden here may reach 25 percent, the corresponding deduction for 34 percent means it still improves the result.

Adding the income withholding tax and the CIDE to our original example, the $20 royalty payment will generate a $2 CIDE tax, which, together with the royalty, will reduce BRSub's taxable income to $78 and reduce income taxes to $26.52 (34 percent of $78). It will also generate an FTC of $21.22 (80 percent of $26.25), a GILTI

[25]Rule (Portaria) MF 436/58. The RFB strictly applied this rule when auditing or ruling on the deductible amount of royalties remitted to a related party abroad. If a specific product or economic sector was not foreseen in the rule, the RFB mandated that the taxpayer require that such product or sector be explicitly mentioned in Rule 436/58 and, in the meantime, allowed the taxpayer to deduct royalties capped at 1 percent. Ruling (Solução de Consulta) 40/2011.

[26]*See, e.g.*, Decision 133/2000.

excess credit of $13.03, and $7.30 in non-FTC Brazilian taxes (the $2 CIDE plus the $5.30 non-FTC Brazilian income taxes). USP will fully credit the $3 Brazilian income tax withheld against its tentative $2.63 U.S. tax on the interest income, generating a $0.38 non-GILTI excess credit. USP's after-tax income will rise from $66 to $71.48. Table 3 illustrates the tax impact of the royalty strategy vis-à-vis a simple dividend distribution.

Table 3. The Royalty Strategy

Comparative Chart	Dividend	Div. + Royalty
Brazil FTC taxes	$27.20	$21.22
Brazil non-FTC taxes	$6.80	$7.30
BRSub after-tax income	$66.00	$51.48
Residual U.S. tax	-	-
GILTI basket excess credit	$16.70	$13.03
Non-GILTI excess credit	-	$0.38
USP after-tax income	$66.00	$71.48

G. Cost-Sharing Agreements and Service Imports

When paying its U.S. parent for intercompany services — such as IT support, client support, customer relationship management, finance, accounting, general management, human resources, legal, corporate, and collection services, which is usually done via an intragroup cost-sharing agreement — the Brazilian CFC suffers a 10 percent non-creditable CIDE[27] and a 15 percent income withholding tax[28] that is creditable to the parent under U.S. law. Payments for services abroad also trigger the municipal service tax[29] (Imposto Sobre Serviços, or ISS) (rates vary from 2 to 5 percent) in addition to PIS (typically, 1.65 percent), and COFINS (typically, 7.6 percent).[30]

When you examine Brazilian taxes alone, importing services from a parent or related entity does not seem to be a wise strategy: The allowable deduction is 34 percent while the total tax burden may reach 39.25 percent. Plus, the deductibility of the payments is subject to one of the aforementioned transfer pricing regimes. However, when U.S. taxes are factored in, the strategy may slightly improve the U.S. parent's after-tax result.

Revisiting our original example again, assume BRSub pays USP a $20 service fee that complies with both countries' transfer pricing rules. Assuming further that CIDE applies, the $20 service payment will generate a $2 CIDE (10 percent of $20), a $1 ISS (assuming a 5 percent rate), a $0.33 PIS (assuming a 1.65 percent rate), and a $1.52 COFINS (assuming a 7.6 percent rate). Those non-FTC taxes will reduce BRSub's taxable income to $75.15. That will trigger income taxes of $25.55 (34 percent of $75.15), generate an FTC of $20.44 (80 percent of $25.55), and a GILTI excess credit of $12.55. The non-FTC Brazilian taxes will total $9.96 (adding the $5.11 non-FTC Brazilian income taxes to the noncreditable taxes above). Again, USP will fully credit the $3 Brazilian income tax withheld against the tentative $2.63 U.S. tax on the interest income, leaving a $0.38 non-GILTI excess credit. USP's after-tax income will rise modestly from $66 to $69.60.

Table 4 compares the service payment strategy with a standard dividend distribution.

Table 4. The Service Payment Strategy

Comparative Chart	Dividend	Div + Service
Brazil FTC taxes	$27.20	$20.44
Brazil non-FTC taxes	$6.80	$9.96
BRSub after-tax income	$66.00	$49.60
Residual U.S. tax	-	-
GILTI basket excess credit	$16.70	$12.55
Non-GILTI excess credit	-	$0.38
USP after-tax income	$66.00	$69.60

If CIDE did not apply, the service fee expense would be subject to a higher (but creditable to USP) withholding tax of 25 percent. BRSub's taxable income would be $77.15. Brazil FTC taxes would be $20.98, Brazil non-FTC taxes would be $8.10, BRSub's after-tax income would be $50.92, the GILTI excess credit would be $12.88, and the non-GILTI excess credit would be $2.38. USP's

[27] Law 10.168/2000, article 2.

[28] Ruling (Solução de Consulta) 163/2012.

[29] Supplementary Law 116/2003, article 1, para. 1.

[30] Law 10.865/2004, article 1, para. 1.

after-tax income would be $70.92, again producing a slight increase to USP's results.

Ultimately, the discussion of income-stripping strategies[31] shows that Brazil's efforts at resistance do not do enough to disincentivize U.S. groups from undertaking these efforts. However, the limited deductions for interest, royalties, and services are unlikely to fill the gap between Brazil's 34 percent Lucro Real profit taxes and the U.S. 21 percent corporate rate. Even the most efficient income-stripping strategy may leave valuable excess credits or non-FTC Brazilian taxes — or both — on the table.

III. Possible Alternatives

If income stripping fails to get the effective income tax rate for Brazilian CFCs near the 21 percent goal, they might consider the following alternatives.

A. Checking the Box on Brazilian Subsidiaries

Unaltered by the TCJA — and at first glance less relevant thanks to the advent of section 245A DRD — the check-the-box rules actually remain a powerful tax planning tool in the GILTI context.

There is no such thing as a Brazilian passthrough entity. Because dividend distributions are tax exempt, all Brazilian entities are opaque — that is, they are taxable at the entity level. Despite that shared characteristic, only the Brazilian Sociedade Anônima (S.A.) is a per se corporation under the check-the-box regulations. A Sociedade por Quotas de Responsabilidade Limitada (Ltda.) — a much more common and easier to manage type of Brazilian entity — may elect passthrough treatment under the check-the-box regulations.

If a Brazilian Ltda. that would otherwise be a CFC elects to be treated as a passthrough for U.S. tax purposes, it will be considered a branch of the U.S. parent[32] and all of its income ceases to be foreign CFC income for GILTI purposes. Foreign branch treatment also allows full FTCs for the taxes the Ltda. pays in Brazil as if they were incurred by the U.S. parent under section 901. Foreign branches, however, cannot benefit from the FDII deduction and need to keep their FTCs segregated in their own, brand-new, foreign branch income basket.

For Brazilian CFCs that do not have subpart F income, checking the box as a foreign branch may be useful because it completely avoids GILTI inclusions. Even if Brazil's high-tax FTCs are lost because they can't be combined with other branches' income, dividend distributions will be free from tax in both countries. Converting existing, nontransparent CFCs into foreign branches demands proper planning and care, because a wrong step might result in a deemed liquidation of the CFC either under section 331 (taxable) or under section 332 (tax-free).

B. Converting GILTI Into Subpart F Income

Thanks to the TCJA, previously deferrable income is now income subject to GILTI.

As a practical matter, deferral no longer exists for a U.S. shareholder.[33] Therefore, the next best option for a Brazilian CFC is to convert what would otherwise be immediately taxable GILTI into subpart F income, protected by the section 954(b)(4) high-tax exception. Even if a future tax reform drops Brazil's income tax rate to 20 percent, it will still be sheltered by the high-tax exception, which extends to foreign income tax rates as low as 18.9 percent.

Prop. reg. section 1.951A-2(c)(1)(iii) and (c)(6) intend to allow a CFC's non-FBCI and non-insurance income to nonetheless qualify for the GILTI high-tax exception if submitted to high foreign income taxes.[34] If this proposed regulation is approved,[35] U.S. shareholders will be able to make use of Brazil's high-tax exception without having to convert GILTI income into subpart F income.

[31] These are all based on the absence of a double taxation treaty between the United States and Brazil. They do not consider the possibility of using a third country as an intermediary in the transaction, which could, in theory, improve USP's after-tax results.

[32] The TCJA did not change the treatment of branches as passthroughs under the check-the-box rules. *See* Fleming, Peroni, and Shay, *supra* note 8 at 1173, 1178.

[33] Deferral remains only for U.S. individuals and corporations that do not meet the 10 percent vote and value threshold for U.S. shareholder status. *Id.*

[34] Of 18.9 percent or higher. Prop. reg. section 1.951A-2(c)(6)(B).

[35] Stephen E. Shay advocates this proposed regulation should not be approved. Shay, "A GILTI High Tax Exclusion Election Would Erode the U.S. Tax Base," *Tax Notes Federal*, Nov. 18, 2019, p. 1129.

C. Transferring Tangible Structures to Brazil

Because of Brazil's high import duties, a U.S. multinational group might decide to initiate or increase a Brazilian CFC's manufacturing activities by transferring the necessary tangible production assets to the CFC, especially if the rate of return on the assets in their home country is lower than 10 percent. A higher return on QBAI for GILTI purposes incentivizes shifting assets abroad. Higher amounts of tangible assets abroad increases a CFC's QBAI, thus decreasing or even fully offsetting the resulting GILTI inclusion.

Generally, holding everything else constant, the higher a CFC's QBAI is, the lower its GILTI will be.[36] However, tangible assets transferred to a CFC must be validly used in the CFC's trade or business, under penalty of exclusion from QBAI. In this sense, reg. section 1.951A-3(h) disqualifies tangible property held temporarily for the principal purpose of reducing the GILTI inclusion amount.[37]

Still, as a general matter, this alternative conflicts with the purported goal of the TCJA: bringing factories, investments, and jobs back to the United States. The incentive to shift businesses abroad does not come exclusively from an isolated need for the timely QBAI increase that is key to this alternative. It is present in other parts of the TCJA, such as:

- The GILTI residence-based rule of section 951A(e)(2): This rule encourages multinational companies to establish their headquarters abroad to avoid U.S. shareholder status.
- The new source rule in the flush language of section 863(b), which allocates and apportions sales that are partly from within and partly from outside the United States "solely on the basis of the production activities with respect to the property" sold: As Section I.E of this article notes, this change incentivizes locating production assets abroad.
- The calculation of the FDII deduction based on the excess of the U.S. corporation's income over its QBAI: All else being equal, the lower a U.S. parent's QBAI is, the higher its FDII will be. This rule encourages U.S. groups to keep U.S. QBAI as low as possible, giving them another incentive to move their factories abroad.[38]

If all else fails and none of the foregoing alternatives is workable,[39] the Brazilian CFC will carry high-taxed income into the U.S. parent's GILTI basket that the parent can use to cross-credit low-taxed GILTI from other CFCs.

IV. Conclusion

What must taxpayers and governments do when the largest economy in the western world dramatically changes its international tax landscape? Situated somewhere between expanded worldwide taxation and territoriality,[40] the post-TCJA tax framework, whether thought of strategically or unilaterally, has provoked discussions everywhere and not only among international tax planners. As Shaviro points out, the ink on the TCJA was not even dry when other countries started planning their own income rate reductions. Brazil might follow this path — it is still too early to know.

Although Brazilian CFC income is usually not "bad" foreign-source income (as Shaviro names income from passive investments, from the use of intermediaries and aggressive transfer pricing, and from the use of tax havens) and has historically remained out of subpart F's reach, it is now subject to GILTI (unless and until prop. reg. section 1.951A-2(c)(1)(iii) and (c)(6) are approved), and the TCJA has suddenly made Brazilian income taxes too expensive. However, because U.S. multinational groups are typically in Brazil to access its market — rather than for unrelated tax planning reasons — they will need

[36] Zheli He, "Trading Tangible for Intangible: The Incentives Created by GILTI and FDII in the TCJA," Penn Wharton Budget Model Blog, Sept. 10, 2018.

[37] *See* Elizabeth Colagiovanni, "The Consequences of Being GILTI," 102 *Prac. Tax Strategies* 14 (2019).

[38] *See* He, *supra* note 36.

[39] Shaviro suggests an alternative that is not explored herein: Joining low-return businesses with high-return businesses to reap the GILTI-reducing benefits. *See* Shaviro, *supra* note 8 at 137.

[40] Fleming et al. argue that to achieve expanded worldwide taxation, the United States would need to eliminate the QBAI threshold, repeal the GILTI corporate deduction, and eliminate both GILTI cross-crediting and the 80 percent GILTI FTC limitation. *See* Fleming, Peroni, and Shay, *supra* note 8 at 1185.

to plan around an unwanted excess, uncreditable payment of foreign taxes. This is where the TCJA may have provided the means and the incentive to turn on itself, with one — but not the only — planning opportunity relying precisely on the expatriation it sought to discourage.

While the U.S. Congress apparently intended for the TCJA to incentivize multinationals to shift their intangibles to the United States from overseas, it left the door open to encouraging the exact opposite conduct regarding those multinationals' tangibles. While intangibles are easily movable, tangibles are not, which is precisely why it is harder for tax authorities to challenge the shifting of tangible structures. It takes much more credible and measurable business efforts to build a factory abroad, and many U.S. multinationals still have large enough piles of cash overseas to make that happen.

Maybe the TCJA policy decision-makers foresaw this risk but deemed it unlikely to happen, given the effort such change would demand. But then, again, maybe those who crafted the old U.S. outbound system once thought the same thing about deferral. Businesses are intelligent, dynamic, and self-preserving organisms; business plans change to adapt to internal and external circumstances, including the tax landscape. Courts have already established that there is nothing wrong with a taxpayer legitimately and honestly modifying its business decisions with the goal of paying less taxes.

Therefore, in stark contrast to the TCJA's promise to bring factories and massive numbers of jobs back to the United States, Brazilian subsidiaries are somewhat likely to see their manufacturing and other tangible activities enhanced thanks to the provisions discussed herein. ■