BEFORE THE
WORLD TRADE ORGANIZATION

Brazil – Certain Measures Concerning Taxation and Charges
(WT/DS472, WT/DS497)

SECOND WRITTEN SUBMISSION OF

BRAZIL

15 April 2016

TABLE OF CONTENTS

TABLE OF EXHIBITS **9**

1. INTRODUCTION **10**

2. FACTUAL ISSUES **12**

2.1 The operation of Brazil's indirect taxation system 12

2.2 The reduction of prior stage indirect tax rates is neutral with regard to the tax burden 15

3. HORIZONTAL LEGAL ISSUES **19**

3.1 The term "domestic" in Article 3.1(b) of the SCM Agreement and in Article III of the GATT 1994 19

3.2 The legal standard for subsidies paid to domestic producers through indirect tax reductions 22

3.3 The legal standard for *de jure* and *de facto* claims in WTO dispute settlement 25

4. MEASURES RELATING TO THE ICT, AUTOMATION AND RELATED SECTORS **27**

4.1 Brazil has demonstrated that the Informatics Programme is consistent with the Covered Agreements 27

4.1.1 The Informatics Programme does not accord more favourable treatment to domestic products 28

4.1.2 Tax reductions under the Informatics Programme fall under Article III:8(b) of the GATT 1884 31

4.2 Brazil has demonstrated that PADIS is consistent with the Covered Agreements 34

4.2.1 There is No Tax Impact on Intermediate Products 35

4.2.2 There Is No Cash Flow Advantage 39

4.2.3 The reduction of direct taxes and of tariffs under PADIS 42

4.3 Brazil has demonstrated that the PATVD is consistent with the Covered Agreements 44

4.3.1 Brazil has demonstrated that the PATVD programme is justified under Article XX(a) of GATT of 1994 45

4.3.1.1 Factual aspects regarding the objectives of PATVD 45

4.3.1.2 The complainants have not put forth any less trade restrictive alternatives available to Brazil 48

4.4 Brazil has demonstrated that the Digital Inclusion Programme is consistent with the Covered Agreements 52

5. MEASURES IN THE AUTOMOTIVE SECTOR 53

5.1 Brazil has demonstrated that INOVAR-AUTO is consistent with the Covered Agreements 53

5.1.1 Brazil has established that INOVAR-AUTO is necessary to protect human life and health and is thus justified by Article XX(b) of GATT 54

5.1.1.1 The complainants have not identified an alternative that would allow Brazil to achieve its chosen level of protection 57

5.1.2 Brazil has established that INOVAR-AUTO is a measure relating to the conservation of gasoline and petroleum and is thus justified by Article XX(g) of the GATT 59

5.1.3 The treatment given to certain LAIA countries falls under the purview of the Enabling Clause 60

5.1.3.1 Brazil has demonstrated that internal taxes are non-tariff measures under the Enabling Clause 60

5.1.3.2 The measures at issue are non-tariff measures governed by the "provisions of instruments multilaterally negotiated under the auspices of the GATT" 61

5.1.3.3 Developing Countries are free to adopt Non-Tariff measures under Article 2(c) of the Enabling Clause 62

5.1.3.4 The Measure at issue falls under the purview of Article 2(c) of the Enabling Clause and has been duly notified. 64

6. PROGRAMS ADDRESSING TAX CREDIT ACCUMULATION 65

6.1 Introduction 65

6.2 Brazil has demonstrated that the suspension of taxes on purchases of raw materials, intermediary products and packaging materials ("PEC") is consistent with the Covered Agreements 71

6.2.1 Brazil has demonstrated that "PEC" does not provide a subsidy 71

6.2.1.1 Brazil has demonstrated that "PEC" does not provide a financial contribution 72

6.2.1.2 Brazil has demonstrated that "PEC" does not confer a benefit 78

6.2.1.3 Brazil has demonstrated that "PEC" is not contingent upon export performance: the 50% export requirement is an objective threshold relating to tax credit accumulation 80

6.3. Brazil has demonstrated that RECAP is consistent with the Covered Agreements 84

7. CONCLUSION 85

TABLE OF CASES

Australia – Automotive Leather II	Panel Report, *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather*, WT/DS126/R, adopted 16 June 1999, DSR 1999:III, p. 951
Canada – Aircraft	Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, adopted 20 August 1999, DSR 1999:III, p. 1377
Canada – Periodicals	Appellate Body Report, *Canada – Certain Measures Concerning Periodicals*, WT/DS31/AB/R, adopted 30 July 1997, DSR 1997:I, p. 449
EC – Asbestos	Appellate Body Report, *European Communities – Measures Affecting Asbestos and Asbestos-Containing Products*, WT/DS135/AB/R, adopted 5 April 2001, DSR 2001:VII, 3243
EC – Commercial Vessels	Panel Report, *European Communities – Measures Affecting Trade in Commercial Vessels*, WT/DS301/R, adopted 20 June 2005, DSR 2005:XV, p. 7713
EC – Salmon (Norway)	Panel Report, *European Communities – Anti-Dumping Measure on Farmed Salmon from Norway*, WT/DS337/R, adopted 15 January 2008, and Corr.1, DSR 2008:I, p. 3
Indonesia – Autos	Panel Report, Indonesia – *Certain Measures Affecting the Automobile Industry*, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, Corr.1 and Corr.2, adopted 23 July 1998, and Corr.3 and Corr.4, DSR 1998:VI, p. 2201
Korea – Various Measures on Beef	Appellate Body Report, Korea – Measures Affecting Imports of Fresh, Chilled and Frozen Beef, WT/DS161/AB/R, WT/DS169/AB/R, adopted 10 January 2001, DSR 2001:I, 5
Mexico – Taxes on Soft Drinks	Panel Report, *Mexico – Tax Measures on Soft Drinks and Other Beverages*, WT/DS308/R, adopted 7 October 2005
Thailand – H-Beams	Panel Report, Thailand – *Anti-Dumping Duties on Angles, Shapes and Sections of Iron or Non-Alloy Steel and H-Beams from Poland,* WT/DS122/R, adopted 5 April 2001, as modified by Appellate Body Report WT/DS122/AB/R, DSR 2001:VII, p. 2741
US – 1916 Act (Japan)	Panel Report, *United States – Anti-Dumping Act of 1916, Complaint by Japan*, WT/DS162/R and Add.1, adopted 26 September 2000, upheld by Appellate Body Report WT/DS136/AB/R, WT/DS162/AB/R, DSR 2000:X, p. 4831

US – Clove Cigarettes	Panel Report, *United States – Measures Affecting the Production and Sale of Clove Cigarettes*, WT/DS406/R, adopted 24 April 2012, as modified by Appellate Body Report WT/DS406/AB/R, DSR 2012: XI, p. 5865
US – FSC (Article 21.5 – EC)	Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations" – Recourse to Article 21.5 of the DSU by the European Communities*, WT/DS108/AB/RW, adopted 29 January 2002, DSR 2002:I, p. 55
US – Gambling	Appellate Body Report, *United States – Measures Affecting the Cross-Border Supply of Gambling and Betting Services*, WT/DS285/AB/R, adopted 20 April 2005
US – Large Civil Aircraft (2nd complaint)	Appellate Body Report, *United States – Measures Affecting Trade in Large Civil Aircraft (Second Complaint)*, WT/DS353/AB/R, adopted 23 March 2012, DSR 2012:I, p. 7
US – Upland Cotton	Panel Report, *United States – Subsidies on Upland Cotton*, WT/DS267/R, Add.1 to Add.3 and Corr.1, adopted 21 March 2005, as modified by Appellate Body Report WT/DS267/AB/R, DSR 2005:II, p. 299

GLOSSARY

Abbreviation	Description
ABINE	Brazilian Association of Electrical and Electronics Industry
ANFAVEA	Brazilian Association of Vehicle Manufacturers
ATSC	Advanced Television Standard Committee (American system)
BVD	Digital Video Broadcasting (European system)
CETAD	Revenue Service Tax and Customs Study Center
CIDE	Contribution on the Intervention in the Economic Domain
COFINS	Contribution to Social Security Financing
ECAs	Economic Complementation Agreements
EU	European Union
GDP	Gross Domestic Product
HDTV	High Definition Digital Television
IBAMA	Brazilian Environment and Renewable Natural Resources Institute
ICMS	State Value-added Tax
ICT	Information and Communications Technology
INOVAR-AUTO	Program of Incentive to the Technological Enhancement and Densification of the Automobile Production Chain
IOF	Tax on Financial Transactions
IPI	Tax on Industrialized Products

ISDB	Japanese Standard for Digital Television
IT	Information Technology
LAIA	Latin American Integration Association
LPDRAM	Low-power Dynamic Random Access Memory
NTMs	Non-tariff Measures
PADIS	Support Program for Technological Development of the Semiconductor Industry
PASEP	Program for Generation of Assets of the Civil Servants
PATVD	Support Program for Technological Development of the Equipment Industry for Digital TV
PEC	Regime for Preponderantly Exporting Company
PIS	Program for Social Integration
PPB	Basic Productive Process
PROCONVE	Motor Vehicle Air Pollution Control Program
RECAP	Special Regime for the Purchase of Capital Goods for Exporting Enterprises
R&D	Research and Development
REPES	Special Tax Regime for the Exportation Platform of Information Technology
RETAERO	Special Regime for the Brazilian Aerospace Industry
RETID	Special Regime for the Defense Industry
SDTV	Standard Definition Digital Television

SELIC	Special Settlement and Custody System
S-VHS	Super-VHS (Video Home System)
TIPI	IPI Table
TV	Television
VAT	Value-added Taxes

TABLE OF EXHIBITS

Exhibit Number	Title
BRA-110	Table with the indirect tax rates of certain intermediate and final goods produced in Brazil
BRA-111	New Translation of Inter-Ministerial Explanatory Memorandum (EM) no. 00008/2007 - MF/MCT/MDIC
BRA-112	Implementing Order 378 of January 22, 2016
BRA-113	Examples of “PEC” and RECAP functioning in tandem

Brazil – Certain Measures Concerning Taxation and Charges
(WT/DS472, WT/DS497)

1. INTRODUCTION

1. In its previous submissions, Brazil has established that the measures challenged by the European Union and Japan are not only consistent with the Covered Agreements, but are designed, structured and applied in a way to promote some of the main objectives of the WTO. The Informatics Programme, PADIS, PATVD and the Digital Inclusion Programme do not result in discrimination against imports as prohibited by the GATT 1994, the TRIMS Agreement and the SCM Agreement. Likewise, INOVAR-AUTO is a WTO-consistent subsidy programme on the production of vehicles in Brazil that is also justified under paragraphs (b) and (g) of Article XX of the GATT 1994. Finally, PEC and RECAP are tax administration measures that do not even constitute a financial contribution, that provide no benefit within the meaning of the SCM Agreement, and are tied to the accumulation of tax credits, rather than export performance, and, therefore these measures are not export subsidies as argued by the complainants.

2. Thus far in the proceedings, it has also been possible to establish that the parties seem to agree that the provision of incentives aiming at the development of productive sectors, technological capabilities and workforce skills is not in itself prohibited under the WTO.

3. The parties however still hold distinct views on how these incentives may be granted. Brazil is convinced that a large measure of the remaining disagreement between the Parties stems from certain fundamental misconceptions that seem to inform the complainants' assessment of the Brazilian measures. In its Second Written Submission, Brazil will strive to undo these misconceptions and will develop in further detail its arguments on certain horizontal aspects of the case that are relevant to most, or all, of the challenged programmes.

4. Two of these issues are essentially factual in nature: the operation of Brazil's indirect taxation system in general and the specific fact that the reduction of prior stage indirect tax rates does not necessarily result in discrimination of tax burden. The other three aspects are more

conceptual and, in this sense, key to the legal discussion in this dispute: (a) the permissible interpretations for the term "domestic" under Article 3.1(b) of the SCM Agreement and III of the GATT; (b) the legal standard for the assessment of subsidies paid to domestic producers by means of indirect tax rate reductions and (c) the proper standard for the analysis of *de jure* and *de facto* claims in WTO dispute settlement.

5. Once concluded these horizontal sections, Brazil will rebut arguments made by the complainants with regard to each of the challenged programmes, beginning with the ICT-programmes, then moving forward to INOVAR-AUTO and finally concluding with PEC and RECAP.

6. Brazil is confident that this additional layer of factual clarifications and legal analysis will reinforce the conclusion that the complainants' case is flawed and that the Panel should find the challenged measures to be fully consistent with Brazil's WTO obligations.

2. FACTUAL ISSUES

7. Before delving into the legal arguments at issue, Brazil will briefly comment on certain factual aspects of the functioning of its tax system with regard to value added taxes (VATs) and the suspension of such taxes along the production chain.

2.1 The operation of Brazil's indirect taxation system

8. Brazil has already explained at length the functioning of its value added tax system of taxation. It has stated that, as in any VAT system, the fiscal impact cannot be assessed by focusing on the "photograph" of an individual operation, as the complainants insist to do, but should be done by evaluating the "whole movie" and its impact along the whole production chain.

9. In order to clarify certain misunderstandings in the arguments presented thus far by the complainants, Brazil would like to elucidate certain points of the functioning of its tax system with regard to indirect taxation on intermediate goods and its impact along the production chain.

10. At the outset Brazil would like to make clear the concept of "intermediate product" within the logic of the challenged programmes. It is a fiscal concept. Any product that is purchased by someone who is not the final consumer*, i. e.,* who will add a certain amount of value and pass it along the production chain, may be considered an "intermediate product" with regard to added value taxation. Thus, the main criterion for an intermediate product is its place in the production chain, not its specific uses.

11. That said, it is also important to recall that the three indirect taxes relevant to this dispute that are levied on intermediate goods, IPI[1], PIS/PASEP[2] and COFINS[3], are not payable by the taxpayer when the specific purchase of those goods occur and the corresponding invoice is issued. The taxes are calculated monthly by companies, accounting for debits and credits related

[1] According to Article 52, I item 'c' of Law 8.383/91.
[2] According to Article 10 of Law 10.637/2002
[3] According to Article 11 of Law 10.833/2003.

to all taxable transactions carried out in the previous month. The federal tax credits[4] and debits of the previous month are tallied, the credits are offset with the debits, and the remainder is the amount due to the tax authorities. Payment of the amount is due on the 25th of every month. Therefore, the tax debits occurring on a given month are offset with tax credits generated in that month.

12. Contrary to what the complainants seem to believe, there is no obligation that the tax credits generated by the purchase of a particular input be used solely when that input is incorporated in a particular final product and that final product is sold Credits accrued in a certain month are wholly used to offset debits in that same month regardless whether the specific input that generated the credit was used by the company in its monthly taxable transactions. In the rare event that there is a month where credits are higher than debits, they may be used in the following month.

13. For instance, Company A produces product X. Company B sells product Y, an input to product X. Supposing an IPI rate of 10% for both products, on March 15th, Company A's purchased R$ 500 of product Y from B. This operation generated R$ 50 in credit for A, written in A's accounting books. A's sales of product X are, on March 1st, R$ 1,000, on the 10th, R$ 500, and on the 31st R$ 100. IPI tax debits for the three sales are, respectively, R$ 100, R$50 and R$10, totaling R$ 160. Both credits and debits were registered in the order in which they occurred. In April, company A analyzed its IPI accounting books and accrued a debit of R$ 110. On April 25th it then paid this amount to tax authorities.

14. Below is an example of a simplified accounting book for IPI:

Month M	**IPI**			
Day	**Inputs**	**Credits**	**Products**	**Debit**
1	Input A	0	Product W	10
3	Input B	5	Product X	15
10	Input C	10		
14	Input D	5	Product Z	5
19	Input A	0	Product Y	20

[4] The term "tax credit" is used throughout this submission to refer to the "input tax" paid by the taxpayer when purchasing goods or services the term is not used in the sense of Article 1.1(a)(1)(ii) of the SCM Agreement.

27	Input C	10		
30	Input C	10	Product X	15
	Total	**40**		**65**
	Credit-debit			-25

15. As the table above shows, every time an input is purchased by the company in that month it is registered in the book, as is the tax credit obtained with the purchase. It does not matter if the input is used during that month or if it will be used in the future, it will be registered and credited in the month of purchase. The credits stemming from that operation will be used to offset debits in that month. At the end of the month all the credits will be added up. The total of credits obtained in the example above is R$ 40.

16. Simultaneously, all transactions involving sales of products will also be registered, along with the accrued debits. In the end of the month all debits will be added. In the example above the total tax debit is R$ 65. When the month ends, credits accrued in that month will be offset with debits in that month. In the example above, debits are larger than credits by R$25, which will be the final amount due to the tax authorities.

17. Thus a company that does not accumulate tax credits structurally (as will be explained later) will have, in the normal course of business, a tax credit for a maximum of 56 days; considering when taxpayer generates a tax credit on the first day of a month of 31 days and will only use the credit on the 25th of the following month. This is the longest the credit will last.

18. This system ensures that the entire production chain is taxed proportionately. When an input is subject to a suspension, reduction or exemption of an indirect tax, the corresponding value does not generate a tax credit to be accounted for in the calculation of a company's monthly tax liability. Therefore, each of these operations is always neutral as regard the total tax burden along the production chain.

2.2 The reduction of prior stage indirect tax rates is neutral with regard to the tax burden

19. The complainants seem to agree with Brazil that the suspension or exemption of indirect value-added taxes in the beginning or in the middle of the production chain do not affect the final amount of tax collected by the tax authorities under the challenged Programs or, at least, they seem to have decided not to belabour the point in some of their original arguments on this issue. Nevertheless, they seem to contend that even so, there would be some sort of advantage related to this suspension or exemption that would be inconsistent with the Covered Agreements. Brazil fails to see how.

20. As already explained, the credit-debit system in a value added tax ensures that the amount collected at each step of production is equivalent to the value added at that step, with no double counting[5]. This amounts to the tax rate of the final product, so that once all the credits and debits are used, the tax collected will be equal to the tax rate of the final product over the price of the final product.

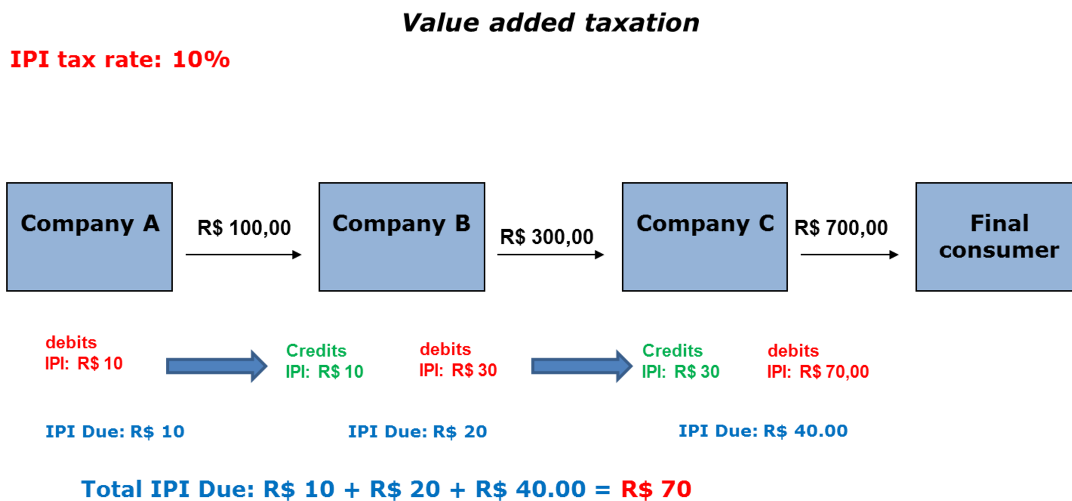
21. The actual rates of the taxes charged in the stages prior to the final products are indifferent to the tax burden, because of the functioning of the mechanism. All indirect taxes paid on inputs by a company placed in the middle of the chain will be converted to tax credits for the next step of the chain. The relevant rate is that of the final product. Even assuming, for the sake of argument, that taxes in the middle of the production chain are higher, the excess amounts collected generate correspondingly higher credits, which can be used to offset other debits. Non-credit-accumulating companies do not have problems with occasional extra credit, as debits will, in the normal course of business, be higher.

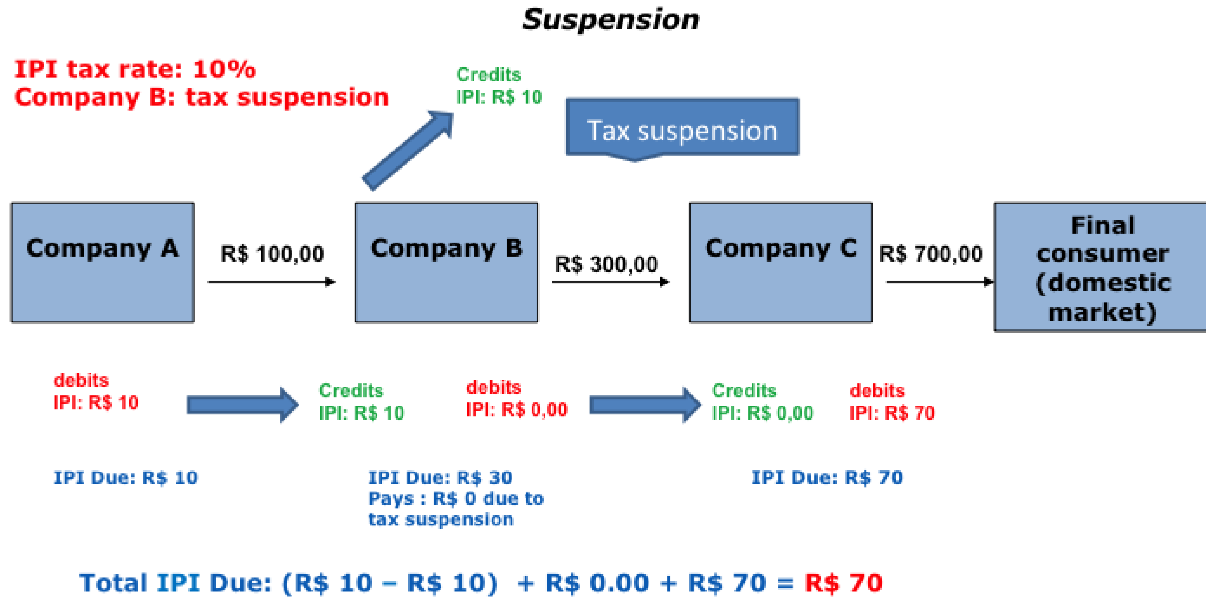
22. A suspension, exemption or zero rate of an indirect tax for a prior-stage has no effect on the final tax burden because there are no tax credits generated in that operation. The tax regarding the value added at that step of the chain is not collected and it is not computed towards the final tax burden. The next step of the chain will have no credits to offset their debits. Once

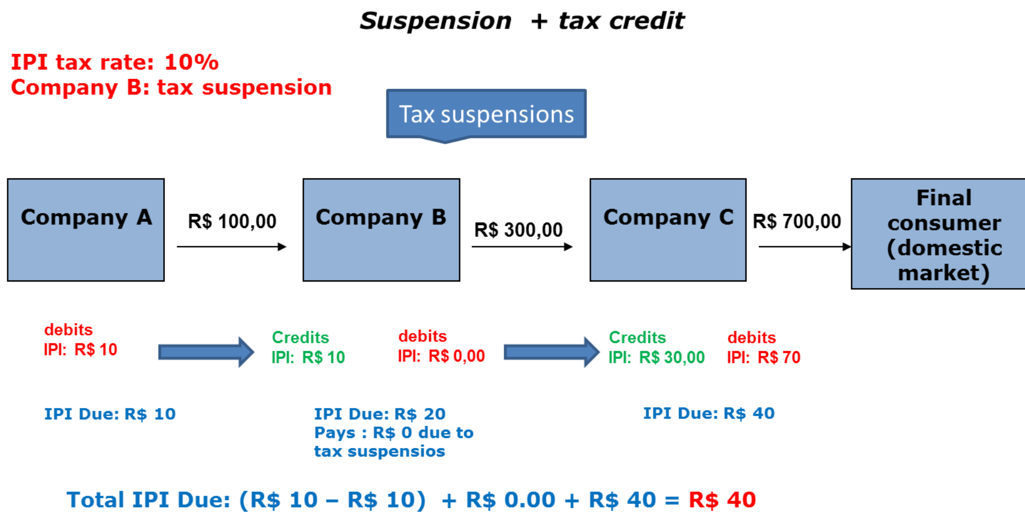
[5] If there were no credit generated at each of the steps, there would be a double counting of inputs used at prior stages and the tax would operate in cascade, compounding the base at each step further. In this situation, the longer the production chain, the higher the tax due for the final product.

again, the final tax burden is equal to the tax on the final product; therefore there is no effective difference of the moment when the tax is collected.

23. The only manner by which a suspension or exemption of an indirect VAT in the middle of the chain could affect the tax burden and generate an actual benefit would be to not charge the tax, but nevertheless generate the tax credit. In such a scenario, the value added at that stage of production would effectively not be charged and the overall tax burden would be lower. None of the challenged programmes suspend taxes while still generating credits. The examples below demonstrate that the tax burden of both production chains remain the same regardless of the tax suspension.







24. As Brazil explained, none of the tax suspensions or exemptions under the challenged program results in a higher tax burden or a disadvantage to imported products along the production chain. Also these suspensions cannot be considered revenue foregone otherwise due, since they do not affect the final amount of tax collected by the tax authorities. This mechanism simply operates as an accounting system so as ensure that tax debits remain higher than credits, by preventing accumulation of prior-stage tax credits.

25. Brazil understands that, nevertheless, the complainants believe that the exemptions and suspensions for intermediate products granted under the programs would necessarily generate a cash flow gain inconsistent with WTO rules. Brazil disagrees. As previously explained, under the Brazilian tax system, PIS, COFINS, and IPI are not paid up-front, but levied monthly on the whole of the previous month's activities. No cash flow gains can be presumed to stem from the functioning of the programmes. Nor there is any particular advantage or benefit for a company to purchase intermediate goods that flows from the structure, the design or application of the programs. Brazil will address the particular claims in each of the specific sectors.

26. As it will be seen, in the few scenarios that one could conceive that a cash flow gain is likely to occur due to the specific nature of the commercial operation, the period between the assessment of the tax to be levied and its payment will be of at most 56 days. As a result, such gain would be minor amounting at most to 1.16% of the taxes due rather than the full annual SELIC rate (14.25%) as suggested by the complainants. As Brazil will further explain, any potential cash flow benefit would be more than offset by the production step and R&D investment requirements of those programmes. This cannot be considered a *de jure* violation of Article III of GATT 1994 or of a subsidy with regard to the SCM Agreement.

3. HORIZONTAL LEGAL ISSUES

27. As in its First Written Submission, before addressing some specific issues related to each of the challenged measures, Brazil would like to address certain systemic legal issues it believes should guide the analysis of the panel and the interpretation of the provisions raised by the complainants. Firstly, Brazil will address the term "domestic" in light of the provisions relevant to the dispute at hand. Secondly, it will further elaborate on the payment of subsidies to domestic producers by means of indirect taxation. In third place, Brazil will discuss the legal standard put forth by the complainants in the analysis of the dispute.

3.1 The term "domestic" in Article 3.1(b) of the SCM Agreement and in Article III of the GATT 1994

28. In Brazil´s view, the proper interpretation of the term "domestic" in the relevant Covered Agreements is critical to the Panel's assessment of the consistency of the challenged measures with Brazil's WTO obligations.

29. The complainants have proposed a sweeping theory that a "domestic product" is any product that "comes into existence within the territory of the country concerned"[6] and, as a consequence, any subsidy related to the *locus* of the productive activity or designed to promote local production would result in a subsidy contingent on the use of domestic products inconsistent with WTO rules. Under this assumption, the complainants have characterized the production step and the R&D requirements under five of the seven challenged programs as a *de jure* violation of both Article III of the GATT 1994 and Article 3.1(b) of the SCM Agreement.

30. The sweeping notions raised by the complainants find no ground in WTO rules[7]. Although the term "domestic" is not defined in the Covered Agreements, it follows from the

[6] EU - Oral Statement, para. 50. The complainants also seem to understand the term "domestic" as strictly juxtaposed to "imported". While the meaning of "imported" may be much easier to tangibly grasp and define (something brought from abroad; that crosses the border, etc.); the term "domestic" for purposes of the SCM Agreement and the GATT 1994 is not. Brazil understands that a superficial interpretation of the term "domestic" as "anything that is not imported" may reduce and distort the very concept and spirit of these Agreements.

[7] Brazil's First Closing Statement, para. 5.

structure and logic of the legal text that the proper interpretation of what is domestic for the purposes of the disciplines contained in Article 3.1(b) of the SCM Agreement and Article III of the GATT 1994 cannot be determined in abstract. It has to be established on a case-by-case basis, in light of the object and scope of those provisions and in the context of the total configuration of the facts of each situation.

31. Based on this premise, Brazil understands that the term domestic cannot be interpreted in a manner that would prevent members to confer subsidies to producers contingent upon the performance of production steps of goods in their territory, including those that are meant to be integrated into a local production chain. Indeed, as WTO Agreements do not prohibit a Member from conditioning a subsidy to a production requirement or other localization requirements, such as the level of employment or investments in R&D, it would be incongruous to interpret the term "domestic product" as encompassing domestic production requirements.

32. It must follow therefore that the term "domestic product" has to have an economic sense. In this connection, the definition of a domestic product is a factual question that must be determined by looking at the characteristics of the specific product/sector. While it may not be possible to determine precisely the exact percentage of value added required to characterize, in each case, a product as domestic, the economic dimension must be taken into account. It is not merely because a product is made or brought into existence within the territory of a Member[8] that the product is necessarily or automatically a "domestic product" within the meaning of the relevant provisions, as the European Union contended.

33. Brazil has provided arguments and examples regarding the absurd conclusions that these notions would create, such as the situation of a product with only 1% of its value added in a Member's territory and that would have to be considered a domestic product[9]. Should this notion prevail, a Member's ability to grant subsidies to its producers and to foster the integration of a

[8] European Union Responses to the Panel para 41
[9] The World Bank defines added value as:
"*Manufacturing refers to industries belonging to ISIC divisions 15-37.* ***Value added is the net output of a sector after adding up all outputs and subtracting intermediate inputs****. It is calculated without making deductions for depreciation of fabricated assets or depletion and degradation of natural resources. The origin of value added is determined by the International Standard Industrial Classification (ISIC), revision (Emphasis added).* "The added value as a net output of all outputs minus all inputs demonstrates the particular relevance of added value in the definition of a product. Available at: *http://data.worldbank.org/indicator/NV.IND.MANF.ZS*

production chain in its territory would be severely curtailed, effectively rendering moot Article III:8(b) of the GATT.

34. Turning to the facts before the panel in the present dispute, Brazil would like to emphasize once again that the fact that the challenged programmes encompass the performance of production steps in Brazil, through PPBs or other production requirements, does not imply a *de jure* violation of Article 3.1(b) of the SCM Agreement or of Article III of the GATT. As Brazil has already explained, a product produced according to a PPB cannot be equated with a domestic product within the meaning of WTO Law. A product produced according to a PPB is simply a product produced according to specific production step requirements, deemed necessary to promote the objectives of these programmes: i.e., workforce skills development, industrial capabilities and technological development.

35. This is the case for all PPBs, including the minority of them that make reference to other PPBs[10]. As Brazil has previously explained, PPBs with provisions requiring that an input or part should also comply with its own PPB simply refers to the additional production steps that must be complied with in the production process of the final product. It is nothing more than a production requirement.

36. In sum, PPBs cannot be confused either with a rule of origin nor with the notion of a domestic product. As Brazil argued in its closing statement at the first hearing with the Panel, there may be cases where these three concepts – or any pair of them – apply equally to a same product. There are many cases, however, where these concepts do not overlap. Therefore, it is not possible to establish *a priori* that in all cases products produced according to a PPB are domestic within the meaning of Article 3.1(b) of the SCM Agreement or Article III of the GATT 1994.

37. Therefore, they cannot be presumed to be in violation of the Covered Agreements Agreements. Article 3.1 (b) of the SCM Agreement does not prohibit subsidies contingent upon the performance of production steps. The same applies in the case of Article III of the GATT 1994. This provision explicitly applies to differences in treatment between domestic and

[10] Brazil's DS472 FWS, para. 145.

imported products. They do not relate to the notion of productive steps requirements, which are not *per se* prohibited by the WTO. Therefore Brazil contends that it cannot be inferred from the existence of a subsidy contingent on the localization requirements that there is a *de jure* contingency upon the use of domestic products or a discriminatory treatment *vis-à-vis* the imported product. Once again, whether a subsidy contingent upon localisation or production requirements amounts to a violation of WTO rules can only be assessed on a case-by-case basis in the context of the totality of facts surrounding the measure at issue.

3.2 The legal standard for subsidies paid to domestic producers through indirect tax reductions

38. In its previous submissions, Brazil explained at length that the Covered Agreements cannot be read as precluding a Member from using indirect tax reductions to finance its public spending, including the granting of subsidies to domestic producers, as long as the tax incentive does not introduce discrimination between foreign and domestic ***products***.

39. Based on the ruling of the Appellate Body in *Canada – Periodicals,* Brazil recalls that the types of subsidies listed under Article III:8(b) do not constitute an exhaustive list of possibilities to subsidize domestic producers.[11] In fact, in *EC – Vessels* the Panel recognized that a regulatory measure not involving actual outlay of funds could fall under the scope of Article III:8(b).[12] Accordingly, if a measure does not have any component that introduces discrimination between imported and domestic products, it may fall under Article III:8(b) of GATT 1994.[13] While payments derived from the proceeds of internal taxes or charges must be collected in accordance with Article III, this clause does not preclude the possibility of other types of subsidies being paid to domestic producers, whose specific impact and consistency with WTO has to be examined in light of the specific factual circumstances surrounding the grant of the subsidy.

40. As Brazil highlighted in the hearing, from a WTO perspective, the relevant legal issue in assessing the impact of a subsidy granted to domestic producer is not whether it was granted

[11] Appellate Body Report, *Canada – Periodicals,* para. 108, which reads:
[12] Panel Report, EC – Vessels, para. 7.771 et seg.
[13] Panel Report, *Indonesia-Autos*, para. 14.43.

through a specific means, but rather whether the subsidy entails an illegitimate trade distortive advantage. Therefore, the possibility of a Member granting a subsidy to its domestic producer through indirect tax reductions, an instrument increasingly used by governments – especially those of developing countries – as an effective substitute of direct payments, cannot be provisionally excluded. There is an intrinsic rationality in saving the government from the task of collecting taxes and then using the money derived from those taxes to pay back the same persons. Assuming *ex ante* that indirect tax reductions cannot legitimately qualify as a subsidy to domestic producers within the meaning of Article III:8(b) would deprive Members of an important tool to pursue its developmental goals and policies.

41. Indirect tax reductions, as any other type of subsidy, may have, of course, adverse effects in the marketplace, but this has to be assessed on a case-by-case basis. The complainants, however, seem to believe that "by definition" a subsidy granted through indirect tax reductions is WTO-inconsistent since it would necessarily discriminate against imported products and adversely affect the conditions of competition on the marketplace. As Brazil has demonstrated, this assumption is flawed.

42. In the specific circumstances of the present case, this presumption is particularly misguided. Brazil has demonstrated that the structure, design and operation of the challenged programmes do not lead to discrimination between products. The requirements for accreditation offset the tax reductions given to producers during production, and there is no effect on price. A proper analysis of the challenged measure clearly reveals that the tax reduction at issue does not have any of the adverse consequences foreseen by Article III:8(b): they do not discriminate against origin, they do not alter the conditions of competition between domestic and imported products in the market place, and they do not distort trade.

43. By means of the measures at issue, Brazil provides certain indirect tax reductions for producers to comply with a series of R&D and production step requirements. These requirements relate to development and production, activities prior to the marketing of the goods they produce. The tax reductions are used to offset the costs incurred in fulfilling these specific pre-market requirements, thus severing the connection between the tax reduction and the price of the product and compromising the ability of the producer to automatically transfer the lower tax burden to

the price of the product or to increase profits. As a consequence they do not affect the competition in the marketplace.

44. Moreover, in the case of a system of indirect non-cumulative taxation, because of the offsetting mechanism of tax credits and debits, the effective tax burden on the overall production chain is not affected by suspensions or reductions on intermediate stages of the production. Therefore, the tax reduction provided by the challenged programmes in these circumstances cannot possibly have any adverse impact on imports.

45. The complainants' presumption that an indirect tax reduction is necessarily inconsistent with the WTO rules relies on the wrong assumption that the reduction applies to a product once it is put on the market and as such automatically passes through to its price. As Brazil has already clarified, this is not the case in general and is certainly not an issue in the present dispute since the tax reduction under the challenged programs apply to the production process, not to products.

46. Brazil would like to reiterate that restricting the analysis to products does not properly address the proper functioning of the measures at issue; they must be seen through the lenses of the producers.

47. Brazil recognizes the uniqueness of this situation and the specificities of the arguments raised. The case at hand is significantly different from previous disputes and these specificities must be taken into account. This dispute is singular in many ways. There has never been a case where indirect tax reductions were established in tandem with pre-market requirements. It is also the first time production step requirements with no direct bearing on products are being put into question. None of the previous disputes has dealt with the impact of tax schemes related to pre-market R&D and production step requirements that are offset through reductions in indirect taxation.

48. There are significant changes between promoting domestic producers and not domestic products. Consequently, one cannot address this issue based on groundless presumptions and generalizations.

3.3 The legal standard for *de jure* and *de facto* claims in WTO dispute settlement

49. Finally, before addressing the specific programmes at issue, Brazil would like to remind the Panel the manner in which the current dispute has been presented and framed by the complainants and how it, therefore, should be assessed by the panel. The complainants made their claims as *de jure* claims. They have clearly submitted that the Panel should analyze the challenged programmes at their face value, according to their structure and design, as evidenced by their legal text. Brazil understands that, for the complainants, the programmes discriminate between domestic and imported products and are contingent upon the use of domestic over imported products or contingent upon export performance by their very nature as they have not put forth evidence to substantiate their claims that these measures are inconsistent with WTO rules *de facto*.

50. The jurisprudence of the Appellate Body has distinguished two manners in which an inconsistency may be assessed in a measure: *de iure* and *de facto*. In the present case, the discussion is essentially on discrimination, with regard to Article III of the GATT, or to contingency, with regard to Article 3.1(a) and 3.1(b) of the SCM Agreement. Brazil shall address, therefore, the distinctions between *de jure* and *de facto* discrimination and contingency.

51. Brazil would like to recall that a *de jure* discrimination or contingency is one discerned from the text and structure of the challenged measure as "[…] necessary implication from the words actually used in the measure." For the measures at issue to be found either discriminatory or import substitution or export contingent in law, these conclusions must stem from the reading of their legal text. The difference to a *de facto* claim would not be one of substance, but of proof. As it is well established, the legal standard for discrimination or contingency is the same whether it is in law or in fact; the distinction lies in demonstrating one or the other.

52. Based upon the legal standard applied to assess both *de jure* and *de facto* cases, Brazil submits that the complainants clearly have not been able to establish a *prima facie* case with regard to their *de jure* claims and have not argued, much less proven that the measures at issue violate *de facto* the relevant provisions.

53. While not having to do so, Brazil brought extensive evidence that breaks any presumption of a *de jure* violation or contingency in the challenged programmes. Brazil particularly demonstrated the overwhelming amount of imports in the composition of the products made by companies accredited to the programmes and that the costs associated with the programme may more than offset the benefits intermediate and for final products. The complainants have not brought evidence proving otherwise.

54. This was not done by accident. The evidence simply is not there. The challenged programmes have not restricted trade or discriminated against imported products. The numbers, as Brazil extensively pointed out, do not add up.

4. MEASURES RELATING TO THE ICT, AUTOMATION AND RELATED SECTORS

4.1 Brazil has demonstrated that the Informatics Programme is consistent with the Covered Agreements

55. The Informatics Programme is a subsidy paid to domestic producers within the meaning of Article III:8(b) of the GATT 1994 to offset costs with R&D and production step requirements with which they must comply. The indirect tax reductions for the production of final products are wholly absorbed by the costs associated with the compliance with the programme's requirement and do not result in a taxation of imported products "in excess of" domestic products in the sense of Article III:2; the requirements do not affect the internal sale, offering for sale, purchase, transportation, distribution or use of imported products and do not confer less favourable treatment to those products, in the sense of Article III:4, and the requirements are not quantitative regulations relating to the mixture processing or use of products "quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions" and do not require directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources, in the sense of Article III:5 of the GATT.

56. With regard to intermediate products, there is no effective difference in taxation and, as will be further explained in section 4.2.1, domestic production of intermediate products is in fact more onerous than importing like products because of the requirements the programme imposes. Brazil argues *mutatis mutandis* for intermediate products in the Informatics Law the arguments put forth under PADIS in this submission.

57. Furthermore, the Informatics Programme does not constitute a trade-related investment measure in violation of Article III:4 of the GATT and, thus, does not violate Article 2.1 of the TRIMs Agreement and is not a subsidy contingent upon the use of domestic over imported products, under Article 3.1(b) of the SCM Agreement.

58. The complainants contend that the measures at issue were designed, structured and applied not to accomplish the objectives set out in the programs, but rather to develop the

domestic industry to the detriment of imported products.[14] There is absolutely no truth in this assertion.

59. The ICT Programs are not protectionist and do not aim to replace imports for domestic products, but to promote the development of the Brazilian ICT sector and its integration in global supply chains. Brazil has demonstrated in its First Written Submission that imports of ICT products have increased significantly between 2005 and 2014.[15] In response, the EUROPEAN UNION has simply stated that the "ICT sector grew in the same period".[16] Brazil has, in fact, provided data showing how its ICT exports have remained constant throughout time and how imports of ICT products have significantly increased, due to the impact of the Informatics Law.[17] Moreover, Brazil has shown how jobs in the Brazilian Electronic sector have increased and more so those in accredited companies, especially higher level jobs and jobs related to R&D.[18]

4.1.1 The Informatics Programme does not accord more favourable treatment to domestic products

60. Throughout these proceedings, Japan and the EUROPEAN UNION have affirmed that "what Brazil does is to make sure that the goods produced in Brazil by companies that benefit from certain incentive programmes enjoy a competitive advantage, compared to other goods (notably, imports)". According to the complainants, the tax rate difference relative to the suspension or exemption of indirect taxes to companies accredited under ICT-related programs "has normally an immediate effect on the selling price", and, thus, the measures at issue "necessarily impl[y] a detrimental effect on the competitive conditions of imported products and therefore alters the equality of competitive conditions between imported and like domestic products."

61. *Ab initio*, Brazil would like to emphasize that the tax reductions under the Informatics Programme do not relate to products, but to production processes. Accordingly it is not correct to

[14] EU Oral Statement – Para. 105; Japan Oral Statement – Paras. 6 - 8.
[15] Paras. 112, 115 and 116 of Brazil's FWS.
[16] Para. 105 of the EU's Oral Statement.
[17] Paras. 112-114 of Brazil's FWS.
[18] Paras. 112-116 of Brazil's FWS.

assume that reductions in indirect taxation will necessarily affect the selling price of the products produced by accredited companies, and will, in consequence, have a detrimental effect on the competitive conditions of imported products altering the equality of competitive conditions between imported and like domestic products. This assertion does not hold in general and is contradicted by the only evidence provided before the Panel. The complainants, who make the allegation that prices are affected by the indirect tax reduction, have not provided any evidence that this alleged negative effect indeed occurs. This fact should be duly noted by the panel.

62. The characterization of the Informatics Programme made by the complainants simply does not correspond to reality. Any subsidies granted under the programme are clearly to production rather than to products. In order to receive the tax incentives under the ICT measures companies must comply with pre-market requirements, such as the fulfilment of certain development and/or production steps in Brazil and the investment in research and development, which represent significant costs for the accredited companies. These tax incentives received under the programme are used to offset these compliance and R&D investments and costs, severing any connection between the incentive and the product and compromise the ability of the producer to automatically transfer the lower tax burden, if and when it occurs, to the price of the product or to increase profits.

63. The Informatics Programme by its design and structure does not result in advantages reflected in the price of products in the marketplace. The programme is designed to provide subsidies to domestic producers in order to offset investments made in R&D and in their production activities. It is structured so that the costs associated to these requirements are higher than the benefits stemming from the reductions of indirect taxes.

64. In its oral statement before the Panel, Japan insisted that this offsetting argument is meritless "because there is no evidence of any quantitative correspondence between the actual amount of investments made to meet the requirements of the ICT measures and the amount of tax subsidies conferred". Yet, Japan does nothing more than make a mere allegation without evidence to support this claim. Evidence Japan should have provided. Its assertion is contradicted by the facts before the Panel.

65. Although the burden of proof lies with the complainants to demonstrate that the conditions of competition have been affected by the Informatics Programmes (and the challenged programmes in general) and that there is no quantitative correspondence between investment costs incurred and the tax incentives received under the programs, Brazil has provided sufficient evidence that this offsetting not only supports rationale of the programme, but occurs in practice. Brazil has presented the breakdown of several examples of final products under the Informatics Law (magnetic resonance imaging equipment, X-Ray, computer tomography apparatus, ink cartridge, toner) that demonstrate the lack of effect of the tax incentives under the program, where the benefit from the Informatics Law is lower than the cost of operation within the Informatics Law and the mandatory R&D contribution.

66. The examples presented by Brazil disclose: (i) the taxation to which the product is subject to (IPI), (ii) the tax reduction received from the Informatics Law (iii) the cost of operation within the Informatics Law and the mandatory contribution/investment (investment in R&D, administrative costs, implementation and maintenance of quality system, implementation and maintenance of program of profit sharing and outcome for contributors, additional cost of performance of the PPB's steps), and iv) the net outcome between the benefit received under the Informatics Law and the cost of operation and mandatory contribution. All of the examples provided show that the tax reduction received under the programme is lower than the associated costs/investments.

67. The information presented was provided by Brazil's Ministry of Development, Industry and Foreign Trade and by ABINEE (the Industry Sector Association), using independent methodologies of calculation, and reach the same conclusion: it cannot be taken as a given that the indirect tax reductions deriving from the Informatics Programme are transferred to the price of the final product.

68. Japan further tries to mislead the Panel by bringing the Appellate Body understanding in the *US – Tobacco* case as an alleged confirmation that pre-market policies are considered as affecting final product prices and competition. The point Japan fails to make, however, is that the mentioned jurisprudence is an iconic case of quantitative local content requirement, which has not similarity to the Brazilian ITC measures.

69. The ITC measures at issue do not require that inputs, parts and components be domestically sourced, simply because they do not relate to products at all, but to productions steps. As has been stated by Brazil in its First Written Submission, those value-added requirements through processing operations are non-discriminatory and fully consistent with WTO law, as they do not affect market competition.

70. Finally, Brazil also takes issue with the complainant's argument that there is an additional advantage to domestic inputs deriving from the possibility of an accredited company to reduce R&D required investment by increasing its purchases of covered inputs. Article 11 of Law 8.248/91 establishes an investment requirement for accredited companies of 5% of the proceeds from sales of the incentivized products in research and development. The companies can offset from this amount the purchases of incentivized inputs. This is done to prevent double counting. This investment requirement works much in the same way as a value-added tax. This discount is given so that the investment requirement falls only on the added value of the incentivized product; if this were not the case, accredited companies purchasing products from other accredited companies would have to bear with the investment burden already bore by the previous company.

4.1.2 Tax reductions under the Informatics Programme fall under Article III:8(b) of the GATT 1884

71. Brazil has previously summited that it is not correct to assume that reductions in indirect taxation will by definition affect the selling price of products subject to such reductions, and will, in consequence, have a detrimental effect on the competitive conditions of imported products altering the equality of competitive conditions between imported and like domestic products. The complainants are required to demonstrate that this negative effect indeed occurs. Up to this point in the proceeding, both Japan and the EUROPEAN UNION have made solely a *de jure* case, without any concrete example or evidence regarding the alleged discrimination on final products in the market.

72. The assumption that reductions in indirect tax necessarily pass through to the prices of the final product does not apply in every case. It certainly does not apply when the recipient of the tax reduction is required to incur in additional production costs in order to be entitled to the reduction. Moreover, even if there was a price effect following the tax reduction, this fact alone would not be sufficient to disqualify the subsidy as a subsidy paid exclusively to domestic producers.

73. In this regard, Brazil recalls the Panel's conclusion in EC – Vessels that:[19]

> "7.73 (…) The Panel can find no textual support in Article III:8(b) for the view that a distinction must be made, for purposes of application of that provision, between the "formal recipient" and the "ultimate beneficiary" of a subsidy solely on the grounds that the subsidy allows the producer to sell a product at a lower price. Indeed, were such a price effect a sufficient basis to conclude that a subsidy is not a "payment of subsidies exclusively to domestic producers", Article III:8(b) would be deprived of its effectiveness as production subsidies can have such an effect in many instances.
>
> 7.74 In short, while the Panel realizes that the state aid provided for by the TDM Regulation may adversely affect the conditions of competition between domestic and Korean products, that effect is not relevant to whether Article III:8(b) applies to the aid."

74. In any event, the focus of the analysis under Article III:8(b) should be on the existence of a detrimental impact on the conditions of competition for imported products. In most cases relevant for the present dispute, there is not even a price effect. For "intermediate products", the indirect tax applied is neutral since the total tax burden will rest on the final product. The neutral tax effect on intermediate products occurs for products covered by the relevant ICT program, as well as for products outside these programs. It follows that the competitive position of imported intermediate products is not affected. With respect to intermediate products, Brazil has provided additional arguments in the Section relative to the PADIS program.

75. For "final products", the ICT Programs confer a subsidy to domestic producers against the fulfilment of technological R&D investments and/or production-step requirements in accordance with Article III:8(b) of the GATT 1994. The tax reductions under these programs are aimed at compensating producers from costs of fulfilling the requirements of these programs

19 Panel Report, EC – Vessels, paras. 7.73 e 7.74.

(R&D investment and investment in PPB compliance). Accordingly, they maintain the conditions of competition between domestic and imported goods.

76. In both cases (intermediate and final products), the tax reductions granted by the Informatics Programme, as well as by the other ITC programs, do not translate into the prices of goods and do not impact the market competition, allowing these measures to fall under the purview of Article III:8(b) and outside the scope of Article III.

77. Finally, in interpreting Article III:8(b) of GATT 1994, the Panel should not disregard the position and consideration of third parties in this dispute. Brazil recalls that Korea claims that the Panel cannot adopt an excessively narrow interpretation of Article III:8(b) that would render the provision inutile, thereby nullifying the right of Members to provide subsidies to domestic producers.[20] The US also recalled that Article III:8(b) expressly permits the payment of subsidies exclusively to domestic producers and that, by necessity, the derogation in Article III:8(b) extends to subsidies to productive activities or to manufacturing steps that make the recipient a domestic producer.[21] In its third party submission, Canada also affirmed that Article III:8(b) explicitly allows WTO Members to provide subsidies to their domestic producers and that a subsidy can be made contingent on the production of an intermediate as well as a final good.[22]

78. Brazil understands that the position of these third parties reflect a real concern as to the possible limitations and interferences that the WTO may have on how Members choose to tailor and develop their industrial and social policies.

20 Para. 6 of Korea's First Oral Statement.
21 Para. 12 of the US' First Oral Statement.
22 Para. 6 of Canada's FWS.

4.2 Brazil has demonstrated that PADIS is consistent with the Covered Agreements

79. Brazil has demonstrated that the PADIS Programme is a subsidy paid to domestic producers in order to offset R&D and production step requirements with which they must comply. In this case, however, the benefits are related to the reduction of direct taxes and customs duties accredited companies must pay. They do not stem from reductions on indirect taxes, as alleged by the complainants, as all of the relevant products are intermediate products. The programme, furthermore, is outside the scope of Article III of the GATT 1994. The indirect tax reductions in the case of PADIS were conceived as a means of preventing the accumulation of tax credits and do not result in a taxation of imported products "in excess of" domestic products in the sense of Article III:2. As it was the case under the Informatics Programme the requirements under PADIS do not affect the internal sale, offering for sale, purchase, transportation, distribution or use of imported products and do not confer less favourable treatment to those products, in the sense of Article III:4, and the requirements are not quantitative regulations relating to the mixture processing or use of products "quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions" and do not require directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources, in the sense of Article III:5 of the GATT.

80. Furthermore, the PADIS Programme does not constitute a trade related investment measure in violation of Article III:4 of the GATT, thus, does not violate Article 2.1 of the TRIMs Agreement and is not a subsidy contingent upon the use of domestic over imported products, under Article 3.1(b) of the SCM Agreement.

81. Brazil has demonstrated that PADIS is a subsidy paid to domestic producers in order to offset costs associated with R&D investments and production-step requirements with which they must comply. In this case, however, the benefits that exist are related to the reduction of direct taxes and customs duties accredited companies must pay. They do not stem from reductions on indirect taxes, as alleged by the complainants, as all of the relevant products are intermediate products. The programme is outside the scope of Article III of GATT 1994. The indirect tax

reductions in the case of PADIS do not result in a taxation of imported products "in excess of" domestic products in the sense of Article III:2; it simply prevents the accumulation of tax credits. As it was the case under the Informatics Programme the requirements under PADIS do not affect the internal sale, offering for sale, purchase, transportation, distribution or use of imported products and do not confer less favourable treatment to those products, in the sense of Article III:4, and the requirements are not quantitative regulations relating to the mixture processing or use of products "quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions" and do not require directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources, in the sense of Article III:5 of the GATT 1994.

82. Furthermore, the PADIS Programme does not constitute a trade related investment measure in violation of Article III:4 of the GATT, thus, does not violate Article 2.1 of the TRIMs Agreement and is not a subsidy contingent upon the use of domestic over imported products, under Article 3.1(b) of the SCM Agreement

83. With regard to the tax burden on the products covered by PADIS, there is no effective difference in taxation or regulation and domestic intermediate products are in fact more onerous than their imported counterparts as explained below.

4.2.1 There is No Tax Impact on Intermediate Products

84. Brazil understands that, despite all the evidence in contrary, the complainants insist that PADIS would impose a higher tax burden on imported products related to indirect taxation adversely affecting the conditions of competition of imported products. As Brazil has demonstrated throughout this proceeding the PADIS program aims at fostering knowledge, innovation and the development of the Brazilian sector of semiconductors and displays by promoting investments in R&D. Its objective is to promote development and assembly of semiconductors and displays in Brazil in a holistic manner without any discrimination towards the origin of inputs used in the process. To be eligible to benefit from the tax exemption granted under PADIS, companies must invest in R&D and perform certain activities related to the

development and assembly of semiconductors and displays in Brazil.[23] PADIS was not conceived for and is not aimed at replacing imported by domestic products or undermining market competition. In order to illustrate that, Brazil prepared Exhibit BRA-109 and explained during the first substantive meeting with the Panel that the exemptions of indirect taxes granted under PADIS do not have any impact on the total tax burden of the production chain. In other words, the total tax paid throughout the production chain is the same with or without the exemptions granted under PADIS[24]

85. In its response to the questions posed by the Panel, the European Union affirmed, however, that such result is not the rule and can only be obtained when the tax rate applied on the intermediate product is identical or lower than the rate applied on the final product.[25] Without presenting examples or support information, the European Union alleges that the tax rates are much diversified and that there are no legal requirements that mandate the Brazilian government to apply the same rate to intermediate and final products, suggesting that, in practice, intermediate products can be subject to higher taxes than final products.

86. As a consequence, the total IPI tax incurred by the production chain would be affected by the benefit granted under PADIS.[26] According to the EU, such effect is even more pronounced when PADIS is operated together with the Informatics Law, resulting in a much lower tax burden than when only PADIS is applied.[27]

87. At the outset, Brazil would like to mention, as a matter of factual clarification that there are no intermediate ITC products produced and sold in Brazil with IPI, PIS/PASEP and COFINS rates higher than the ones applied on final ITC products. Such instances simply do not exist. Secondly, as Brazil has already explained, even if this situation could have occurred, the extra tax collected would be converted into credits to be offset against other tax debits, ensuring the tax neutrality along the production chain.

[23] Para. 317-323 of Brazil's FWS.
[24] Para. 185 of Brazil's FWS
[25] Para. 172 of the EU's Responses to the Panel's Questions.
[26] Para. 173 of the EU's Responses to the Panel's Questions.
[27] Para. 176 of the EU's Responses to the Panel's Questions.

88. Although it is upon the EUROPEAN UNION to prove what it alleges, in order to further illustrate this Brazil has prepared Exhibit BRA-110 to demonstrate that semiconductors and displays (intermediate products) produced by accredited companies to PADIS are never subject to IPI, PIS/PASEP and COFINS rates higher than the rates applied to the final products that use such intermediate products. The IPI, PIS/PASEP and COFINS rates of intermediate products are always identical or lower than the rates of final products.

89. For example, USB Flash drives are subject to an IPI rate of 15% and are used in the production of pen drives, which are also subject to IPI rates of 15%. Another example is the memory modules LPDRAM subject to an IPI rate of 5%. Such modules are used on desktops, which are subject to an IPI rate of 15%.

90. In certain circumstances, the tax rate may not increase and remains the same as in the previous production stage. However, since final products are always more expensive than intermediate products due to their higher added value, the amount of tax collected by the government increases accordingly.

91. Specifically regarding IPI, the rate applicable on intermediate products can never be higher than the IPI rate of final products for a very simple reason: the IPI operates similarly to a value-added tax, as recognized by the EUROPEAN UNION itself in its FWS.[28] As such, the tax rate is levied over the value-added during certain production step and it progressively increases throughout the production chain.

92. Therefore, the EU’s arguments have no factual and legal grounds. A scenario in which the amount of tax paid on the sale of the intermediate product is higher than the amount of tax paid on the sale of the final product, and in which PADIS could have some effect in terms of tax burden, is simply not possible in practice or in theory.

93. There is only one possible scenario, which was presented by Brazil in Exhibit BRA-109: the amount of tax due gradually and necessarily increases throughout the production chain. As previously explained, the tax amount paid in each stage may be accrued as credit to offset tax liabilities due in the next stage of the production chain. Consequently, the sum of all taxes

effectively paid throughout the production chain will match exactly the total tax levied on the sale of the final product to the customer before the deduction of the tax credits accrued.

94. When the producer of the intermediate product is accredited under PADIS, the sale of intermediate products to the producer of the final product is exempted from the payment of IPI, PIS/PASEP and COFINS. This means that those taxes will not be charged at that stage of the production chain. They will only be charged over the sale of the final product.

95. However, as demonstrated in Exhibit BRA-109, zero tax rates in the middle of the production chain do not change the total final tax burden, because the taxation on the final product remains the same.[29] Therefore, there are no scenarios in which the total tax burden levied on a production chain is affected by PADIS, as claimed by the EU. In sum, the European Union's argument has no factual or legal ground, and should be disregarded as unsupported allegation by the Panel.

96. Brazil further points out that the EUROPEAN UNION errs in stating that the tax burden reduction is significantly higher when PADIS and the Informatics Law or the Digital Inclusion Programme are applied together. Brazil showed in Exhibit BRA-109 that the reduction of the tax burden in those scenarios are linked to the tax regime under the Informatics Law or the Digital Inclusion Programme and not to the incentives granted to intermediate products under PADIS. The tax exemption granted under PADIS is irrelevant to the amount of tax collected in the end of the production chain.[30]

97. The neutral tax effect of the PADIS tax incentives on intermediate products is further evidenced by the Explanatory Memorandum of the Provisional Measure relative to the PADIS and PATVD programmes.[31] The language in the Explanatory Memorandum relative to PADIS is quite telling. Relevant part states that:[32]

[28] Para. 59 of the EU FWS.
[29] Slides 7 and 8 of Exhibit BRA-109.
[30] Slides 9 and 10 of Exhibit BRA-109.
[31] European Union's opening statement at the first meeting of the Panel, paras. 71 and 163; Japan's opening statement at the first meeting of the Panel, para. 24.
[32] Although the Explanatory Memorandum was presented as by the EU as Exhibit EU-109, the EU failed to provide a translation of that document from Portuguese to English, French or Spanish. Brazil provides an English translation of that document as Exhibit BRA-111.

> "14. It is important to highlight that **the reduction to zero of PIS/PASEP and COFINS rates levied on the purchase or import of capital goods or inputs or on the sale of semiconductors, displays and equipment <u>does not result, in economic terms, in revenue foregone since it only triggers a temporary change in the collection flow, since these taxes, when applied on imports or sale of products, entitle taxpayer credits that are offset against contributions to be paid</u>. Thus, <u>such reduction does not produce financial or budgetary impact and consequently there is no need for any compensation measure</u>**.
> (…)
> 16. Finally, it is important to note that by increasing the economic efficiency and by stimulating investment on production, **<u>the measures adopted create the conditions necessary for a more expedited growth of the economy in the next years, with a positive impact on the tax collection in the long term,</u>** even if the proportion of tax burden on the GDP becomes lower than the proportion currently observed. In that context, the country's own long term tax sustainability is reinforced by the set of measures that we submit, at this moment, for your appreciation.
> (...); (Emphasis added)

98. As for the Japanese claim that the credit/debit offsetting would not occur in the case of companies subject to the cumulative regime of PIS/PASEP and COFINS,[33] Brazil would like to clarify that this specific regime is not the regime adopted by producers of semiconductors in Brazil. As explained in Brazil's First Written Submission, the cumulative regime of PIS/PASEP and COFINS is not compulsory under Brazilian law, but rather a simplified option given to small and medium sized Brazilian companies, which comprises *inter alia* of different tax rates for PIS/PASEP (0,65%) and COFINS (3%) that cannot be offset and, thus, is not suitable for producers of complex intermediate goods, such as those covered by PADIS.

4.2.2 There Is No Cash Flow Advantage

99. Brazil would like to address the argument that the tax deferral in PADIS would amount to a government revenue foregone or not collected that is otherwise due in the sense of Article 1.1(a)(1)(ii) of the SCM Agreement. The EUROPEAN UNION alleges that without the suspension or exemption of the tax on the inputs that PADIS provides, a company would have to

bear the "financial cost" of having to pay an amount of tax upfront, even though it may be offset later in time, forfeiting the possibility of freely employing those financial resources.[34]

100. The following clarifications and explanations are in order regarding this "cost of money" argument relative to the PADIS tax incentive and its qualification as a "tax deferral". In the first place, as submitted to the Panel in the first hearing Brazil would like to recall the IPI, PIS/PASEP and COFINS are not collected upfront at the moment of each operation, but are levied monthly on the total amount corresponding to the previous month's activities. The operations are accounted in a ledger, debits from sales are offset with credits from purchases and the remainder is collected by the tax authority.

101. Secondly, it is important to bear in mind, that the credits and debits offset are neither product nor tax specific. In other words, credits from purchases of inputs do not have to be offset with debits of the exact same tax, neither with debits incurred from the sale of the product produced from the input that generated the credit.

102. For example, Company A produces notebooks and tablets. Accordingly, Company A purchases the memory module X, used in the production of notebooks, and the memory module Y, used in production of tablets. When Company A purchases such memory modules, it accrues IPI credit. The IPI credits accrued with the purchase of memory module X (for notebooks) can be offset with the IPI debits from the sales of tablets or even with some other tax debit incurred by Company A.

103. This possibility has been established by article 74 of Law n. 9,430/1996 that states as follows:[35]

> Art. 74. **The taxpayer accruing any credit**, including any credit from a res judicata decision, **concerning any tax or contribution administered by the Federal Revenue Office**, liable to be returned or recovered, **may use said credit to offset own debits related to <u>any</u> taxes or contributions administered by said Office.** (Wording under Law no. 10637 of 2002) (Emphasis added)

[34] Para. 187 of the EU's Responses to the Panel's Questions.; Japan – Responses to the first set of questions from the Panel, para. 64.
[35] Exhibit BRA-99.

104. Therefore, there are no factual or legal grounds that support the European Union's claim that credits are offset only when incorporated into a more complex product and sold with the latter, with expressive gains in terms of cash flow.[36] The credits and debits under Brazilian tax legislation do not need to be compensated only when they have been generated from purchases/sales of products within the same production chain.

105. Consequently, it is incorrect to affirm that by definition the cash flow effect that follows the exemption of taxation on intermediate products is relevant due to the amount of time that elapses between the acquisition of the intermediate product and the sale of the product that incorporates that intermediate product. Since the credits accrued from the purchase of inputs do not have to be necessarily compensated with debits of the same tax, they do not have necessarily to wait for the sale of the final product to be used. Such credits may be compensated even before the debit from the sale of the final product is generated.

106. In third place, even if Brazil were to accept, for the sake of argument, the EU's "cost of money" argument and that PADIS confers a financial contribution within the meaning of Article 1.1(a)1(ii) of the SCM Agreement, which it does not, it still does not confer a benefit within the meaning of Article 1.1(b) of the SCM Agreement.

107. The Appellate Body in *Canada – Aircraft* understood that "benefit" must be established by determining whether the financial contribution makes the recipient better-off *vis-à-vis* the market than it would have been absent that financial contribution.[37] According to the European Union, a company that cannot defer taxes on its inputs would have higher costs than a company that is able to defer those taxes (even if it is just for one month)[38], having to pass those higher costs to the price of the product it sells.[39]

108. The European Union fails to realize that, in the case at hand, PADIS imposes certain requirements for companies to be eligible to receive the tax incentives under the program, such as carrying out investments of at least 5% of the beneficiary's gross revenue in R&D and the

[36] Para. 128 of the EU's Responses to the Panel's Questions.
[37] Appellate Body Report, *Canada — Aircraft*, paras. 157 and 158.
[38] Para. 121 of the EU's Responses to the Panel's Questions.
[39] Para. 121 of the EU's Responses to the Panel's Questions.

performance of specific development and/or manufacturing steps, which require that investments be made. The investments in R&D and in the development and/or manufacture of intermediate products is a major investment incurred by companies, which offsets any possible financial contribution that may derive from a company not bearing the "cost of money" of the payment of the relevant indirect tax in that stage of production. Accordingly, the alleged financial contribution received under PADIS does not have an impact on the competitive position of goods on the market.

4.2.3 The reduction of direct taxes and of tariffs under PADIS

109. As a final comment, Brazil would like to address the European Union's argument relative to the exemption from CIDE and import duties under PADIS regarding the purchase of machinery, input and software for the production of the covered products in the sense that there is no credit mechanism for these taxes and duties and, thus, there is no solid defense relative to the neutrality of the impact of the tax incentive.[40]

110. At the outset, Brazil recalls that at the moment there is no company accredited under this specific provision of PADIS. More importantly, Brazil points out that the EUROPEAN UNION recognizes that the CIDE is a direct tax[41]. According to the European Union:[42]

> "Many WTO Members, including the European Union, have put in place systems of incentives to innovation and the technological improvement of industrial production. There is nothing in the WTO rulebook that prevents WTO Members from applying such support measures, provided that they are crafted in a way that do not restrict or distort international trade by embodying discrimination against foreign goods and/or prohibited support to domestic goods. Oftentimes, admissible support schemes for innovation involve tax advantages for companies. That is, for instance, **companies that invest in R&D may often benefit from reductions in the direct taxes that they have to pay** (e.g. corporate income tax)." (Emphasis added)

[40] Para. 194 of the EU's Responses to the Panel's Questions.
[41] EU – FWS, para. 51 and fn14.
[42] EU – FWS, para. 4.

111. Brazil understands that the complainants' challenge in this dispute relates to indirect taxes and does not involve the CIDE contribution with regard to that claim. As Brazil has argued, this provision could only be challenged as an actionable production subsidy and not as a prohibited subsidy, as it does not entail the use of domestic over imported products.

4.3 Brazil has demonstrated that the PATVD is consistent with the Covered Agreements

112. Brazil has demonstrated throughout these proceedings that, as a subsidy paid to domestic producers in order to offset investments in R&D and in the compliance of production step requirements, the tax reductions under the PATVD Programme are fully consistent with WTO rules. These indirect tax reductions under the programme are wholly absorbed by the costs associated with the compliance with the programme and do not result in a taxation of imported products "in excess of" domestic products in the sense of Article III:2; the requirements do not affect the internal sale, offering for sale, purchase, transportation, distribution or use of imported products and do not confer less favourable treatment to those products, in the sense of Article III:4, and the requirements are not quantitative regulations relating to the mixture processing or use of products "quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions" and do not require directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources, in the sense of Article III:5 of the GATT.

113. PATVD does not constitute a trade related investment measure in violation of Article III:4 of the GATT, thus, does not violate Article 2.1 of the TRIMs Agreement and is not a subsidy contingent upon the use of domestic over imported products, under Article 3.1(b) of the SCM Agreement.

114. Brazil has stated also that, if the Panel were to understand that the PATVD programme violates substantive provisions of the GATT 1994, it is justified as a measure necessary to protect public morals under Article XX(a) of the GATT 1994. In its second submission Brazil will explore and counter the complainants' arguments related to this latter aspect and their suggestions for less trade restrictive measures below.

4.3.1 Brazil has demonstrated that the PATVD programme is justified under Article XX(a) of GATT of 1994

4.3.1.1 Factual aspects regarding the objectives of PATVD

115. As provided in Brazil's First Written Submission, there are three main digital television standards in the world: i) the Advanced Television Standard Committee – ATSC (American system); ii) the Digital Video Broadcasting – BVD (European system); and iii) the Integrated Service Digital Broadcasting – ISDB (Japanese system). These standards were established by major developed economies and were tailored towards their needs and interests. Each standard has its own specificities that does not necessarily fit or comply with the needs of different countries.

116. Taking that into consideration, and the importance of television broadcasting in Brazil as a vector of social inclusion and cultural diversity, Brazil decided to adopt a specific and unique standard of digital television based upon the Japanese model (ISDB)[43] with added technological innovations, such as video codification H.264 and the middleware developed in Brazil. The Brazilian Digital Television System (SBTVD) preserved the characteristics of the Brazilian TV, open and free for all, but introduced the possibility of being received by portable and mobile receivers, in addition to allowing the interactivity of the viewer with the program.

117. The SBTVD was established by means of Decree No. 4,901, of 26 November 2003, and its objectives are clearly establish in the relevant legislation:[44]

- The promotion of social inclusion and cultural diversity by means of access to digital technology (information democratization);
- The creation of a universal network for distance learning;

[43] The Japanese Standard for Digital Television (ISDB) operates mainly with High Definition Digital TV (HDTV) transmission, but is also capable of operating with Standard Digital TV (SDTV) technology. Set-top-boxes may convert digital signals (HDTV and SDTV) into NTSC and S-VHS signals or tune HDTV and SDTV signals and send them to video devices similar to what happens with the American standard. The Japanese standard also implemented mobile transmissions and reception.
[44] Exhibit BRA – 40.

- The encouragement of research and development and fostering of the expansion of Brazilian technologies and of a national industry related to communication and information technology;

- The planning of the transition from the analogue to the digital system so as to guarantee the gradual accession of viewers at costs compatible with their income, making it possible for sound and image broadcasting service providers to use additional radiofrequency level;

- The enhancement of the use of radiofrequency spectrum and the quality of audio, video and services; as well as

- The promotion of the local and regional production of instruments and digital services;

118. The transition to the digital television system is considered a key element in the access to information and education for well over 90 million television viewers. The proper and timely access of the Brazilian population to information and education is a matter of highest public interest in Brazil as it ensures a better means of social inclusion. Since television remains the population's predominant source of information,[45] ensuring appropriate conditions to the implementation of the digital television system, falls squarely within the range of policies necessary to protect public morals, related to the "standard of right conduct inherent to the behaviour or costumes of people" in Brazil, justified under paragraph (a) of Article XX of GATT 1994.

119. A vital part of implementing the digital system all over the country was to ensure the supply of digital TV transmitting equipment and the capacity to develop and manufacture this equipment in Brazilian order to comply with the schedule established for the transition from analogue to digital transmission.[46] Consequently, PATVD was created in 2007 to facilitate the

[45] Exhibit BRA-38
[46] Article 10 of Decree no. 5,820/2006 and Implementing Order n. 378/2016, published on 25th January 2016. Exhibit BRA-**112.**

integration and operation of the new technology in the country and therefore is justified under paragraph (a) of Article XX of GATT 1994.[47]

120. Brazil would like to highlight as well that, in light of the objectives of the Programme, from the very beginning there has been concern in fomenting the local capacity to develop and manufacture this equipment, so as to ensure that there would be no risk of discontinuity of the supply of the transmitting equipment required to carry out the transition as planned. Thus this is the "urgency" in implementing PATVD that is reflected in the Explanatory Memorandum of the Provisional Measure relative to the PATVD program, mentioned completely out of context by the European Union in its oral statement. According to the relevant provision of the EM:

> (…)
>
> 19. The urgency is justified by the need for immediate implementation of mechanisms that induce investment that favor technological development and the implementation of the contemplated industry sectors, due to:
>
> (…)
>
> **a) The time necessary to project and set up manufacturing plants for transmitting equipment, approximately 24 months, and the publication of Decree n. 5,820, of June 29, 2006, that defined the set of technological standards to be adopted for the broadcast of digital sounds and images,** if the incentives indicated in this draft are not adopted quickly, there is a risk that these products be imported to the detriment of the creation of an industrial park for the sector. (Emphasis added)

121. Letter " b" of point 19 simply states that is necessary "to induce investment that favours technological development and the implementation of the contemplated industry sectors 'before' there is a risk that these products be imported to the detriment of the creation of an industrial park in the sector" which does not convey any discriminatory treatment with regard to imported products. On the contrary, it concedes that the transition to digital television will most likely rely also on imported products. The EM only reflected that in light of this expected increase of imports and the objectives of PATVD of fostering local production, it would be urgent to adopt the proper incentives to foster the local development of these products.

[47] As a further point of clarification, Brazil notes that the objectives sought by the SBTVD go beyond the promotion of social inclusion by providing access to digital technology and include other important objectives such as fostering investments in R&D and the expansion of Brazilian technologies and industrialization.

122. Brazil would like to emphasize that at the time the decision to adopt the SBTVD was taken, although imports were expected, there was no guarantee at all that the transmitting equipment, compliant with Brazil's standards, would be produced worldwide and made available in the Brazilian market in the necessary scale. Moreover even if imports occurred as expected, there was a risk of discontinuity that could affect the transition schedule. Depending solely on the possibility of importation was accordingly not an option.

4.3.1.2 The complainants have not put forth any less trade restrictive alternatives available to Brazil

123. The European Union and Japan insist in their Oral Statements and their Responses to the Panel's Questions that there were alternative less restrictive measures that would be of equivalent contribution to Brazilian goals of ensuring the transition to a digital television system[48].

124. Brazil submits, however, that the measures suggested by the complainants do not contemplate all objectives of the program, as highlighted above, nor are they reasonably available in terms of Brazil's budget, scale and time of implementation.

125. The first alternative measure suggested by the European Union and Japan was to provide tax exemptions for both domestic and imported digital TV equipment[49]. Contrary to what was stated by the European Union, however, this alternative does not "pass with flying colors" the test of whether a measure is reasonably available within the concept developed in *EC – Asbestos*, according to which the alternative measure should consider: [50]

> (i) whether the measure proposed is WTO consistent or less inconsistent than the measure challenged;
>
> (ii) the extent to which the alternative measure contributes to the realization of the end pursued; and

[48] Paras. 77-93, EU Responses to the Panel's Questions; Para. 38 of Japan's Responses to the Panel's Questions.
[49] Para. 82, EU Responses to the Panel's Questions; Para. 38, Japan's Responses to the Panels Questions.
[50] Appellate Body Report, *EC – Asbestos*, paras. 170-172.

(iii) whether the measure proposed is less trade restrictive than the measure challenged.

126. When suggesting the first alternative measure, Japan and the European Union are considering only one of PATVD's objectives and ignoring the realization of all goals pursued by the programme. Thus, the first measure suggested does not fulfil the requirement (ii) proposed by the European Union itself.

127. The PATVD has objectives other than just providing the Brazilian population with access to digital television, and one goal should not prevail over the other. As explained above, as part of the effort to promote social inclusion by providing access to digital technology, the PATVD also aims at promoting local capability and investments in R&D of such technologies in Brazil. It is not possible to achieve this objective by simply providing tax exemptions for sales, as suggested by the complainants[51]. Therefore, the alternative measure proposed is not adequate or sufficient to meet the purpose of fostering investments in R&D in the digital television sector.

128. In this sense, the conception of the PATVD as it is, establishing annual investments in R&D activities by the accredited companies and requiring the development and manufacture of digital transmitters in Brazil, serve to encourage research and development and foster the expansion of Brazilian technologies and of a national industry related to communication and information technology, which are all goals pursued by the SBTVD. Therefore, Brazil highlights that all objectives must be taken into account when evaluating whether the proposed alternative measures are adequate or even feasible in the pursuit of the program's goals.

129. The exemption on the sale of the products (be it imported or not) would not ensure that digital TV transmitters compliant with Brazil's standards will be made available in the Brazilian market in the necessary scale and timeframe to reach well over 90 million TVs and 100 million cellular phones[52] within the schedule for the transition from analogic to digital transmission of the services of sound and image broadcasting and for retransmission of the television to SBTVD.

130. Granting tax exemptions for sales of digital transmitters would at most encourage the consumption of the equipment, but would not foster the production of digital transmitters,

[51] EU – FOS, Para. 165.
[52] BRA – FWS, para. 364 (2006 numbers).

especially within the scale and timeline necessary to ensure compliance of the schedule of transition from the analogic to the digital system.

131. Thus this particular measure proposed by the complainants is not reasonable from the point of view of the burden imposed on Brazil. The conception of the PATVD as it is, establishing annual investments in R&D activities by the accredited companies and requiring the development and manufacture of digital transmitters in Brazil, serves to encourage research and development and foster the expansion of Brazilian technologies and of a national industry related to communication and information technology, which are all goals pursued by the SBTVD. Therefore, Brazil highlights that all objectives must be taken into account when evaluating whether the proposed alternative measures are adequate or even feasible in the pursuit of the program's goals.

132. The second measure suggested by the European Union to exempt from customs duties all digital TV transmitters [53] has the same flaw. Once again, a simple tax exemption (whether for tax sales or import duties) is not an adequate measure to address all of PATVD goals and is not reasonable considering the extent of the contribution to the realization of the end pursued. By exempting the import tariffs of digital transmitters, Brazil would not be fostering other objectives of the PATVD.

133. Contrary to what has been affirmed by the European Union, this is not an alternative free of difficulties of implementation as it would likely increase the time of implementation and the reduction of the import duty would not guarantee the adequate offer of transmitters in terms of scale considering the dimension of the Brazilian consumer market.

134. Even considering that foreign producers/exporters would produce transmitters under the technological specifications of the Brazilian system, they would likely need to adapt their production to comply with local standards. There would be a high risk that imports of digital TV transmitters would not ensure supply to the Brazilian market in the time and scale required to meet the schedule of transition from the analogic to the digital system. Thus, eliminating tariffs

[53] Para. 85, EU Responses to the Panel's Questions.

on the importation of digital TV transmitters is also not a reasonable measure to achieve PATVD's goals.

135. With respect to the third measure proposed by the European Union and Japan[54] – that Brazil grant subsidies directly to producers of digital TV equipment – Brazil recalls that this is exactly what PATVD does. The fact that the subsidy is granted through indirect taxes does not alter the fact that the programme confers a subsidy to domestic producers within the meaning of Article III:8(b), applied in a non-discriminatory manner fully consistent with WTO rules.

136. Limiting the form of subsidies to domestic producers to direct payments would significantly hinder a Member's ability to carry out industrial policy and development, and the actual possibility of countries facing budgetary constraints subsidizing their domestic producers. In practice, it would mean that only countries that have less of a budgetary constraint would be allowed to provide subsidies to domestic producers.

137. In the case of Brazil, where 90% of the federal budget is committed to "mandatory" expenditures[55], it would be very difficult to secure the necessary resources to foment research and development and the manufacturing of the relevant equipment and, consequently, a delay in meeting the transition schedule from the analog to the digital television system in Brazil. The "direct subsidisation" alternative measure thus would impose an undue burden on Brazil due to the prohibitive costs and time involved in subsiding producers directly.

138. Having this in sight, it is clear that none of the proposed alternative measures can be consider as a proper reasonable alternative to PATDV. Brazil needed to encourage the development and production of digital TV transmitters under the Brazilian digital TV standards. In this way, Brazil transferred the required investments in R&D and development and manufacturing of transmitters to the private sector, saving time and costs that it was not able to allocate.

[54] Para. 91, EU Responses to the Panel's Questions; Para. 38, Japan's Responses to the Panel's Questions.

4.4 Brazil has demonstrated that the Digital Inclusion Programme is consistent with the Covered Agreements

139. As Brazil has explained, the Digital Inclusion Programme is a subsidy paid to domestic producers accredited under the Informatics Programme, in order to foment the production in Brazil of certain low cost ICT consumer products. The programme is fully consistent with Brazil´s WTO obligations. The indirect tax reductions are wholly absorbed by the costs associated with the compliance with the programme and do not result in a taxation of imported products "in excess of" domestic products in the sense of Article III:2; the requirements do not affect the internal sale, offering for sale, purchase, transportation, distribution or use of imported products and do not confer less favourable treatment to those products, in the sense of Article III:4, and the requirements are not quantitative regulations relating to the mixture processing or use of products "quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions" and do not require directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources, in the sense of Article III:5 of the GATT.

140. The Digital Inclusion Programme does not constitute a trade related investment measure that violates Article 2.1 of the TRIMs Agreement and is not a subsidy contingent upon the use of domestic over imported products, under Article 3.1(b) of the SCM Agreement.

141. The programme was part of the broad effort to increase the access of the Brazilian population to computers and information technology products, by ensuring the local development and production of low costs ICT products. As in the case of the Informatics programmes the producers use the additional tax reduction provided under the Digital inclusion program to offset the additional costs incurred with investments in R&D and the productive process related to those low costs ICT products that otherwise could not be met. As such the programme does not have any impact on the conditions of competition in the market.

142. As Digital Inclusion Programme provides subsidies to producers of final consumer products, the arguments submitted in section 4.1.1 about these products are applicable *mutatis mutandis* to it.

5. MEASURES IN THE AUTOMOTIVE SECTOR

5.1 Brazil has demonstrated that INOVAR-AUTO is consistent with the Covered Agreements

143. Brazil has demonstrated that the INOVAR-AUTO Programme is a subsidy paid to domestic producers and importers who undertake certain obligations to produce and commercialize safer, more environmentally friendly vehicles in Brazil, and make certain expenditures in Brazil. Accredited companies that fulfill the programme's requirements are entitled to benefit from presumed IPI credits that can be used to offset tax debits on both imported and domestic vehicles. Since the requirements are all pre-market operations, they do not affect the internal sale, offering for sale, purchase, transportation, distribution or use of imported products and do not confer less favourable treatment to those products, in the sense of Article III:4. They do not result in a taxation of imported products "in excess of" domestic products in the sense of Article III:2. The Programme also does not establish any quantitative regulations relating to the mixture processing or use of products "quantitative regulation relating to the mixture, processing or use of products in specified amounts or proportions" and do not require directly or indirectly, that any specified amount or proportion of any product which is the subject of the regulation must be supplied from domestic sources, in the sense of Article III:5 of the GATT.

144. Brazil has also contended that INOVAR-AUTO does not constitute a trade related investment measure in violation of Article 2.1 of the TRIMs Agreement and is not a subsidy contingent upon the use of domestic over imported products, under Article 3.1(b) of the SCM Agreement.

145. Brazil also submitted also that in any event the tax treatment conferred under the Program would be justified under Article XX(b) and XX(g) of the GATT as necessary measures to protect human life and health and relating to the conservation of exhaustible natural resources, and that the tax treatment given to certain LAIA countries is justified under the Enabling clause. Brazil further explores these two issues below.

5.1.1 Brazil has established that INOVAR-AUTO is necessary to protect human life and health and is thus justified by Article XX(b) of GATT

146. The complainants have argued[56] that Brazil has not demonstrated that the tax treatment under INOVAR-AUTO was "necessary" to protect human life or health. While the overall program and objective could lead to more environmentally friendly automobiles, the complainants argued, there was no clear link between the challenged aspects of the programme and the requirements of paragraph (b) of Article XX. This contention is wrong.

147. Brazil has demonstrated in its First Written Submission and Oral Statement that INOVAR-AUTO is a shift in paradigm with regard to environmental policy in the automotive sector. Brazil described at length the exhaustion of a model based solely on ever-increasing standards that turned out to be impossible for companies to meet. Brazil explained the situation regarding PROCONVE 6[57], where companies were not able to meet emission standards and had to come to a legal settlement to comply with the requirements set out by IBAMA.

148. INOVAR-AUTO is structured in an open non-discriminatory manner, allowing for the participation of both producers and importers and accommodating different situations within its framework in order to avoid any distorting effects on trade. The presumed credits on various expenditures made in Brazil were conceived and are calculated to offset the costs incurred by the accredited companies in their different capacities in fulfilling the programmes requirements. Both the requirements and the type of expenditures foreseen in INOVAR-AUTO against which presumed credits are accrued were established in order to maximize their contribution to the programmes objectives.

149. In this sense, Brazil has never raised a generic claim under the General Exception provision of GATT 1994 that INOVAR-AUTO *as a whole* is justified under Article XX(b), as the complainants seem to argue. In Brazil's understanding, the Programme as a whole is not under contention and does not require justification. Essentially, what Brazil understands the complainants seem to consider would amount to a violation of articles III:2, III:4 and III:5 of

[56] EU – Oral Stamtent, para. 69.

GATT 1994,relates to on the one hand, the R&D and production step requirements set for accreditation under the programme and, on the other, to the method of calculation and use of the presumed IPI credits the programme gives to participating companies.

150. Although Brazil fails to see how non-discriminatory investment requirements on R&D and on production steps and objective criteria for obtaining presumed IPI credit in light of the programmes objectives could amount to a violation of the WTO rules, it has submitted that theses aspects of the Programme would be, in any event, justified under Article XX of GATT 1994. Accordingly these are the two elements under scrutiny for Article XX purposes. As Brazil explained in its First Oral Statement[58], the R&D and production requirements as well as the method of calculating and using the presumed IPI credit were established in order to enhance the contribution of the programme to Brazil's safety and environmental objectives. In Brazil's experience, it is not feasible to achieve the desired level of technological advance in the auto industry without the proper incentives to R&D, productive capacity and a highly developed auto parts industry.

151. More importantly, Brazil does not make a generic argument regarding the protection of human life and health. Brazil does not contend, as the complainants also seem to believe, that INOVAR-AUTO makes an *in abstracto* contribution to the goals without actually demonstrating its necessity. Brazil has established in its First Written Submission that prior traditional approaches to energy efficiency and carbon emission reduction had run their course. Brazil could not simply require automobiles to be more efficient without any corresponding incentive. In this context the means by which the Programme´s goals are reached are just as relevant in this analysis.

152. Brazil needed to provide the conditions for its automotive industry, as well as its main strategic suppliers, to comply with global environmental standards, while also providing equivalent incentives for importers to commercialize energy efficient automobiles in Brazil. The measure seeks a sustainable development of the automotive sector as a whole in an open and effective manner.

[57] Brazil – First Written Submission, section 6.1.1.2.
[58] BR – Oral Statement, para. 74 and 75.

153. These are the two aspects to INOVAR-AUTO: the environmental and safety objectives, on the one hand, and the means for companies to comply with these objectives in a sustainable manner. The immediate goals are intrinsically tied to the means to reach them.

154. As Brazil has mentioned in its First Written Submission, INOVAR-AUTO paved the way to adequate development of safety and environmental protection in the industry as a whole. The use of special steels in car manufacturing, for instance, which are lighter and more resistant, is a consequence of compliance with INOVAR-AUTO's requirements. The incentives for the adoption of flex fuel cars also required several adjustments to the production process of parts and components. Companies must invest in new technologies – such as downsizing engines, direct fuel injection, turbocharging, more efficient camshafts, reduction of mass, reduction of friction between components, "start-stop" – which also contribute to the overall quality of the vehicles sold in Brazil.

155. INOVAR-AUTO's energy-efficiency requirements, which can only be reached by the presumed IPI credits given by the programme, are significant. The reductions surpass the 2020 voluntary commitments for energy efficiency assumed by Brazil under The United Nations Framework Convention on Climate Change. Once again, these goals can only be reached with the corresponding "carrots" given by the government.

156. The programme has wide ranging and interconnected goals in enhancing automotive engineering and technological development, building workforce capacity in the sector, which results in energy-efficient vehicles with more added value and technological content.

157. The complainants point to the fact that there are certain vehicles that are excluded from the energy efficiency requirements in order to try to dismiss the contribution of the Programme to is declared goal to promote energy efficiency and the protection of the environment, and incorrectly state that the majority of products are excluded from the obligation[59]. The statement is untrue. While there is a list of product codes that do not need to meet additional energy

[59] EU – Oral statement, para. 75.

efficiency targets, they do not represent the majority of sales of vehicles in Brazil; rather, they correspond to 11% of sales[60].

158. Indeed, this list can be divided into two main categories: heavy vehicles, such as trucks and busses, and specialty *niche* vehicles. For heavy vehicles, INOVAR-AUTO is a continuation of Brazil's efforts in improving fuel efficiency and air quality through the PROCONVE programme. INOVAR-AUTO was established to ensure that manufacturers could comply with the environmental standards currently in force and future requirements to keep up with global standards. The investment and production step requirements and the tax credits ensure that companies have a technological leap and meet the requirements governmental agencies establish. The other codes refer to racing cars – designed exclusively for performance and constituting a diminutive part of the Brazilian market.

5.1.1.1 The complainants have not identified an alternative that would allow Brazil to achieve its chosen level of protection

159. As Brazil has demonstrated, the two aspects of the INOVAR-AUTO under scrutiny are fully justified under Article XX(b). In this context, the complaining parties bear the burden of identifying an alternative measure that would be reasonably available to Brazil to achieve the same results.[61] In their written answers to the panel, the complainants have provided a bevy of suggestions in this regard[62]. These suggestions, however, either fail to reach the appropriate level of protection sought by Brazil or remain technically of financially unavailable.

160. First of all, the complainants suggest an "across-the-border" tax exemption or provision of subsidies for all vehicles that meet the fuel-efficiency standards. This measure would undermine the objectives sought by INOVAR-AUTO and effectively maintain Brazil lagging behind other countries in terms of technological development of the automotive sector, risking to suffer years of "technological dumping" which would undermine its efforts to develop a

[60] Exhibit BRA-46, p. 40 et seg.
[61] For instance, Appellate Body Report, *US – Gambling*, at para. 320.
[62] Japan's responses, para. 37; EU's responses, para. 66 et seg.

sustainable and efficient automotive industry. More than ensuring efficient and safe vehicles circulating in its territory, Brazil wishes to foster its industry to acquire the technology and know-how to manufacture these automobiles in a sustained basis. The programme provides the same benefits for importers as long as they contribute to the programme's goals in Brazil.

161. Additionally, the European Union suggests the reduction or elimination of tariffs on products meeting the environmental and safety standards. Once again, this solution does not address the fundamental issue of transforming the productive sector. If adopted, this measure would, once again, relegate Brazil as a destination for obsolete technology and maintain its technological gap with developed countries.

162. Japan suggests the adoption of vehicle safety and energy efficiency directly. As Brazil has extensively explained, it has already tried it, and it did not work. Companies could not meet the requirements without corresponding incentives to do so.

163. It bears recalling that an alternative measure is *not* "reasonably available" if it is merely theoretical, or if it imposes an "undue burden", or if it does not "preserve for the responding Member its right to achieve its desired level of protection with respect to the objective pursued."[63] An alternative measure is also not "reasonably available" if its result or outcome is uncertain.[64] In the context of the present dispute, this means that for an alternative measure to be considered "reasonably available," it must be capable of ensuring with a reasonable degree of certainty that it will allow Brazil to properly foster its industry in order to produce and import energy efficient and safe vehicles.

164. Last, but not least, Brazil would also like to emphasize that there is nothing arbitrary or discriminatory in the application of INOVAR-AUTO. The programme provides the same benefits for importers so long as they contribute to the programme's goals in Brazil and has no distortive impact on trade.

---

[63] Appellate Body Report, *US – Gambling*, at para. 308, citing Appellate Body Report, *EC – Asbestos*, at paras. 172-174. *See* also Appellate Body Report, *Korea –Various Measures on Beef*, at para. 180.
[64] *See* Panel Report, *Mexico – Taxes on Soft Drinks*, at para. 8.188.

5.1.2 Brazil has established that INOVAR-AUTO is a measure relating to the conservation of gasoline and petroleum and is thus justified by Article XX(g) of the GATT

165. Brazil demonstrated in its First Written Submission that INOVAR-AUTO is a measures relating to the conservation of exhaustible natural resources made effective in conjunction with restrictions on domestic production or consumption. The fuel efficiency standards, together with the investment and production step requirements, on the one hand, and the benefit structure, on the other, promote a long-lasting, structured and sustained development of cleaner, more efficient vehicles circulating in Brazil.

166. INOVAR-AUTO is part of a comprehensive strategy of petroleum conservation that dates back to the 1970s and includes several other measures such as the compulsory mixture of ethanol in gasoline sold in Brazil, the promotion of electric cars and other important related measures. INOVAR-AUTO's particular contribution is its "carrot-and-stick" structure, which allows for the overall energy efficiency improvement of the automotive sector in Brazil. As both domestic manufacturers and importers have to comply with the same energy conservation/efficiency requirements established in the programme, there is “even-handedness” in the efficiency requirements applicable to domestic manufacturers and importers alike.

167. Brazil understands that the complainants have not made suggestions of alternative measures specific to this point, therefore, it argues, *mutatis mutandis,* what it has presented in the previous section.

5.1.3 The treatment given to certain LAIA countries falls under the purview of the Enabling Clause

168. In their Oral Statement and written answers to the Panel, the complainants take issue with the arguments submitted by Brazil its First Written Submission, demonstrating that the treatment given to certain LAIA Members fell under Articles 2(b) and 2(c) of the Enabling Clause and met the requirements of Article 3 of the Enabling Clause.

5.1.3.1 Brazil has demonstrated that internal taxes are non-tariff measures under the Enabling Clause

169. In its oral statement, Japan[65] seems to imply that the treatment given to certain LAIA countries does not fall under the Enabling Clause because Brazil has not properly characterized the measures at issue as "non-tariff measures". Japan alleges that, since the "Illustrative List of Non-Tariff Measures" in the document Non-Tariff Measures Affecting Trade of Developing Countries[66] does not list internal taxes, it could not be considered a non-tariff measure within the meaning of the Enabling clause

170. In that document, paragraph 2 states:

> 2. The work in GATT in the field of non-tariff measures is based on notifications made by countries indicating specific problems faced by them. The Inventory of Non-Tariff Measures, revised in MTN/3B/1 to 5 and Addenda, summarizes the view-points expressed by the notifying countries and the countries against whom notifications were made, as regards the nature of the problems that arise in respect of each of the notified measures in trade in industrial products. On the basis of the initial examination of these notifications, a list of twenty-seven categories of non-tariff measures has been drawn up. The list is reproduced in Annex I.

171. Paragraph 78 explains the alleged "absence" of internal taxes in stating:

> 78. Among the other non-tariff measures included in the illustrative list at Annex I in which developing countries have expressed interest through notifications or during discussion, but which have not as yet been taken up for discussion by Group 3(b), would appear to be selective taxes, prior import deposits and government procurement. **In regard to selective excise taxes, however, it may be pointed out that products of interest to developing countries, which are subject to such taxes, are mainly tropical**

~~Japan, OS, para. 40.~~

[66] JE – 232.

> **products. The problems in this field are being examined in Group 3(f).** (Emphasis added).

172. Under the heading "Part 5: Charges on Imports", the "Internal tax on whiskies and brandies" is listed as an NTM, as well as "Excise tax system".

173. Brazil fails to see how this "context and negotiating history of the treaty[67]" would lead an interpreter to believe that internal taxes could not be considered NTMs. The non-tariff nature of internal taxes stem from the clear reading of the GATT. Argentina's mention of the World Trade Report[68], while non-authoritative, corroborates the understanding put forth by Brazil, in indicating that NTMs are comprised under the structure of Article III of the GATT and corresponding to those measures under Articles 2(b) and 2(c) of the Enabling Clause:

> 2. The GATT's origins were also reflected in the agreement's structure and substantive obligations. Article I sets out the most-favoured nation (MFN) obligation, whereby members agree to apply tariffs on a non-discriminatory basis. Article II covers the tariff reductions schedules to which GATT members had agreed. Together, these two articles comprised Part 1 of the agreement. Part 2 of the GATT, Articles III to XVII, contains almost all of the GATT's other substantive obligations – the most important of which is national treatment (Article III), clearly aimed at preventing NTMs, especially domestic tax and regulatory policies, from being used as protectionist measures that would defeat the purpose of tariff bindings. **In addition to national treatment, Part 2 also contains rules governing other NTMs**, such as anti-dumping and countervailing duties, customs valuation, customs administration, rules of origin, quantitative restrictions and subsidies. (Emphasis added).

5.1.3.2 The measures at issue are non-tariff measures governed by the "provisions of instruments multilaterally negotiated under the auspices of the GATT"

174. The European Union on its turn has argued that that Brazil has not proved that the tax treatment at issue correspond to "measures governed by the provisions of instruments multilaterally negotiated under the auspices of the GATT". According to the EU, Brazil limited itself to discuss the meaning of the term *non-tariff measures*[69].

[67] Japan, Answers to the Panel, para. 32.
[68] Argentina's third party submission, para. 18 (citing World Trade Report 2012, Exhibit JE-241, p. 47).
[69] EU – responses to the questions of the panel, para. 47.

175. The Enabling Clause states in its Article 2(b) the following:

> 2. The provisions of paragraph 1 apply to the following (2):
> (…)
> b) Differential and more favourable treatment with respect to the provisions of the General Agreement concerning non-tariff measures governed by the provisions of instruments multilaterally negotiated under the auspices of the GATT;
> (...)

176. Brazil understands that the GATT 1947 and its successor, GATT 1994, are the relevant, multilaterally negotiated, instruments dealing with internal taxation, as there is no specific agreement dealing with that issue. The interpretation of the provision at the time of its elaboration meant "GATT" as the Organization to which the WTO is a successor. The provision should be interpreted at present as "under the auspices" of the WTO, as an Organization[70].

177. Therefore, the current proper understanding of the scope of Article 2(b) is that the GATT 1994 is the "instrument multilaterally negotiated" that deals with this specific NTM. Furthermore, it is under the auspices of the WTO, successor to the GATT as an Organization.

5.1.3.3 Developing Countries are free to adopt Non-Tariff Measures under Article 2(c) of the Enabling Clause

178. The European Union further argues that Article 2(c) of the Enabling Clause does not permit the justification of non-tariff measures[71]. For this last argument, it cites its own opinion in another case.

179. The plain reading of the text does not warrant such an interpretation. The text reads:

> c) Regional or global arrangements entered into amongst less-developed contracting parties for the mutual reduction or elimination of tariffs and, in accordance with criteria or conditions which **may be prescribed** by the CONTRACTING PARTIES, for the mutual reduction or elimination of non-tariff measures, on products imported from one another; (emphasis added).

[70] The expression "under the auspices" appears in the Covered Agreements in the SPS Agreement, Annex A, paragraph 3, also referring to international organizations.
[71] EU, responses to the panel, para. 49.

180. The text is self-explanatory. The possibility for developing countries to enter into regional agreements for the mutual reduction or elimination of non-tariff measures is not conditioned upon the approval by the contracting parties of those criteria or conditions as the European Union argues, as there is no obligation to do so, only a possibility. The term "may" evidences such an understanding. The term "may" is also present in many of the Covered Agreements, and in all instances, has been interpreted to connote a possibility or option rather than an obligation[72]. It is unwarranted, therefore, to consider that there must be a decision by the Ministerial Conference in order for NTMs to fall under Article 2(c) of the Enabling Clause.

181. Bearing in mind the general objective of Latin American integration of mutually reducing or eliminating obstacles to trade within the region, Article 9 of the 1980 Treaty of Montevideo that creates the Latin American Integration Association (LAIA) specifically established that the partial scope regional agreements such as the ECA at issue, may include, among others, specific rules regarding non-tariff restrictions. The provision also foresees that should these specific rules not be adopted, the general provisions to be established by Members on the respective matters shall be taken into account.

182. Negotiated under the TM- 80, which was properly notified as an Agreement under Article 2(c) of the Enabling Clause in July 1982, and under Article XXIV of the GATT 1994, the ECAs at issue aimed at progressively achieving the reduction and elimination of tariff and non-tariff trade barriers in the automotive sector among its Members, in line with LAIA's objectives. The

---

[72] Panel Report, *US – 1916 Act,* para. 116, interpreting the term "may" in Article VI:2 of the GATT 1994: "[…] "[T]he verb "may" in Article VI:2 of the GATT 1994 is, in our opinion, properly understood as giving Members a choice between imposing an anti-dumping duty or not, as well as a choice between imposing an anti-dumping duty equal to the dumping margin or imposing a lower duty.
Panel Report, *Thailand – H-Beams,* para. 7.123, interpreting the term may in Article 2.2.2 of the Antidumping Agreement: "[…] , as in our view the word "may" constitutes authorization to use the methodologies in the subparagraphs where the methodology in the chapeau, which is the preferred methodology, 'cannot' be used."
Panel Report, *United States – Clove Cigarettes*, para. 7.529, interpreting the term may in Article 2.9 of the TBT Agreement: "[…] t". "May" is used to express a possibility as opposed to a certainty. 897 We therefore interpret these terms to mean that Article 2.9 of the TBT Agreement does not require proving actual trade effects. Rather, this condition encompasses situations in which a technical regulation may have a significant effect on trade of other Members."
Panel Report, *United States – Upland Cotton,* para. 1369, interpreting the term may in Article 6.3 of the SCM Agreement: "[…] The ordinary meaning of the word "may" in the chapeau of Article 6.3 of the SCM Agreement may express "possibility" or "permission"."
See also Panel Report, *EC – Salmon (Norway)*, para. 7.348 for Article 6.8 of the Antidumping Agreement

preferential treatment given to Argentina, Mexico and Uruguay under INOVAR-AUTO is inscribed under the process of internal implementation of the respective ECA and as such fall within the scope the Enabling Clause, in the same way as the TM-80 and the ECAs themselves.

5.1.3.4 The Measure at issue falls under the purview of Article 2(c) of the Enabling Clause and has been duly notified.

183. Both complainants also argue that the tax treatment conferred to Argentina, Mexico and Uruguay under INOVAR-AUTO could not be justified under the Enabling Clause because Brazil failed to properly notify the measures at issue. As Brazil has explained, the LAIA Agreement was notified as an Agreement under Article 2(c) of the Enabling Clause in July 1982. The Montevideo Treaty was established as an umbrella treaty on the basis of which its Members could negotiate specific agreements among them, including both tariff and non-tariff measures. The Economic Complementation Agreements are implementation measures of the Treaty of Montevideo and are notified to the WTO by the LAIA secretariat. INOVAR-AUTO's tax treatment to certain LAIA countries is the corollary of these ECAs and does not require further notification.

6. PROGRAMS ADDRESSING TAX CREDIT ACCUMULATION

6.1 Introduction

184. As explained previously, Brazil has a system of value-added taxation along the production chain that is composed of three different federal taxes, namely the IPI, the PIS and the COFINS. Since they are value-added taxes, the amounts of these taxes paid in prior steps of the production chain normally may be used as credits, which, as a general rule, are offset against the debits accumulated in subsequent steps of the production chain.

185. Companies that manufacture and sell goods on a regular basis calculate and pay monthly the balance of their tax debits minus their credits. This system of value-added taxation operates under the premise that debits must be higher than credits and under the general principle that companies must not structurally accumulate tax credits. In some cases, though, companies of some sectors tend to structurally accumulate credits since their sales are subject to low or no taxation at final stages of production.

186. For example, companies that manufacture and sell footwear in Brazil do not have IPI debits since such products are subject to IPI at a 0% rate. Therefore, these companies tend to accumulate IPI credits resulting from their purchases of inputs. Likewise, manufacturers of military products qualified under the Special Regime for the Defense Industry (RETID) tend to accumulate credits of IPI, PIS and COFINS because their sales to the Brazilian Government are exempt from the referred taxes. In such cases, in order to implement the above-mentioned principle, the legislation suspends taxes on purchases of inputs and capital goods made by the referred companies.

187. The rationale for this has already been fully explained in this dispute. First, the structural accumulation of tax credits leads companies to submit repeated requests for the refund or special offsetting of their accumulated tax credits. The documents that support such requests need to be thoroughly reviewed by the tax authorities in order to confirm the existence and the amount of the credits. Such revision places a heavy burden on the tax administration, which has to use its

limited human resources to review such requests instead of using them to inspect taxpayers and collect taxes.

188. Secondly, the structural accumulation of tax credits hurts the cash flow of companies in such situation, putting them on a less favourable position than companies that do not structurally accumulate tax credits. The level of harm varies according to the level of credit accumulation — the higher the accumulation, the higher will be the harm to a company's cash flow.

189. Considering these reasons, and the importance of ensuring the implementation of the principle that debits must be higher than credits and companies must not structurally accumulate tax credits, Brazilian legislation adopts two tax administration schemes: one applicable to companies that do not tend to accumulate tax credits and another applied to companies that tend to accumulate tax credits. Both methods are an expression of one same general principle of taxation, according to which tax debits should be higher than tax credits.

190. Under the first method mentioned above, purchases of inputs and capital goods are subject to taxation and generate tax credits that can be totally offset against tax debits resulting from sales. Accumulation may, of course, occur eventually for several reasons. For example, it may be that in a certain period a company makes significant purchases of inputs but has low sales of its products. In the eventual cases of accumulation of tax credits, companies subject to this method may be authorized to request the refund of such credits or offset them against other federal taxes. This situation, however, is not common because companies subject to this method are exactly those that do not tend to structurally accumulate credits.

191. On the other hand, companies that tend to chronically accumulate credit are subject to the second method of tax administration mentioned above, under which taxes are suspended on purchases of inputs and capital goods and, in consequence, taxes resulting from sales must be paid in full without the utilization of any credits.

192. This scheme applies in Brazil to companies of many different sectors of the economy which have no or low taxation on their sales. With regard to the IPI, for example, this method of tax administration has been implemented through article 31 of the Provisional Measure No. 66/2006, later converted into article 29 of Law No. 10,637/2002, transcribed below:

Article 29. Raw materials, intermediary products and packaging materials intended for establishments dedicated primarily to the manufacture of products classified in Chapters 2, 3, 4, 7, 8, 9, 10, 11, 12, 15, 16, 17, 18, 19, 20, 23 (except codes 2309.10.00 and 2309.90.30 and Ex-01 under code 2309.90.90), 28, 29, 30, 31 and 64, under code 2209.00.00 and 2501.00.00, and at headings 21.01 to 21.05.00 of the Industrial Goods Tax Classification Table (Tabela de Incidência do Imposto sobre Produtos Industrializados, TIPI), including those assigned the notation NT (not taxed), shall have the cited tax suspended when they are released from the industrial establishment.

§ 1st The provisions of this Article also apply to raw materials, semi-manufactures and packaging materials released for purchase by the following:

I - industrial establishments that primarily manufacture:

a) Components, chassis, bodies, parts and pieces of the products referred in Art. 1st of Law No. 10,485 of July 3, 2002;

b) Parts and pieces intended for a industrial establishment manufacturer of a product classified in Chapter 88 of Tipi;

c) The goods referred to in § 1-C of Article 4 of Law No 8,248 of October 23, 1991, which enjoy the benefit referred to in the header paragraph of the said Article; (Added by Law No. 11.908 of 2009)

II - predominantly exporting legal entities;

193. As can be seen from the text of article 29, with regard to the IPI, this method of tax administration applies to companies of the following sectors:

- Producers of animal products classified in chapters 2, 3 and 4;
- Producers of vegetable products classified in chapters 7, 8, 9, 10, 11 and 12;
- Producers of animal or vegetable fats and oils and their cleavage products classified in chapter 15;
- Producers of prepared foodstuffs classified in chapters 16, 17, 18, 19, 20 and 23, or under headings 21.01 to 21.05.00;
- Producers of products of the chemical or allied industries classified in chapters 28, 29, 30 and 31;
- Producers of footwear classified in chapter 64;
- Manufacturers of components, chassis, bodies, parts and pieces of the machines and vehicles classified under headings 3.09, 7310.29, 7612.90.12, 8424.81, 84.29,

8430.69.90, 84.32, 84.33, 84.34, 84.35, 84.36, 84.37, 87.01, 87.02, 87.03, 87.04, 87.05, 87.06 e 8716.20.00 (products referred in Art. 1 of Law No. 10,485 of July 3, 2002);

- Manufacturers of parts and pieces intended for an industrial establishment manufacturer of aircraft, spacecraft, and parts thereof classified in Chapter 88 of Tipi;
- Manufacturers of informatics and automation products qualified under the Informatics Law; and
- Predominantly exporting companies.

194. Companies from all these sectors have the great majority of their products subject to low or no taxation by the IPI and, in consequence, tend to accumulate IPI credits. For this reason, the payment of IPI has been suspended on their purchases of raw materials, intermediary products and packaging materials. Predominantly exporting companies are only one of the many kinds of companies that tend to accumulate IPI credits that have been addressed by article 29 of Law No. 10,637/2002.

195. Some of the products sold by companies from the above-mentioned sectors are subject to IPI. However, companies from these sectors have been identified by the Brazilian government as accumulators of IPI credits because the great majority of their sales are subject to low or no IPI.

196. On the other hand, some products sold by companies from other sectors may be subject to low or no IPI. These sectors, however, have not been identified as accumulators of IPI credits for several possible reasons. These companies may sell products subject to IPI as well as products exempt from IPI, their sales of the former being sufficient to be offset against their IPI credits. It is also possible that the inputs used by such companies are subject to no or low IPI, preventing them from accumulating credits.

197. Therefore, as Brazil has previously explained, in defining which sectors should be under the method of tax administration provided by Article 29 of Law No. 10,637/2002, the Brazilian Government analyzed the situation of companies from several sectors of the economy, rather than analyzing separately the situation of each product, as the complainants insist to claim[73].

[73] It is worth mentioning that the IPI related to purchases of capital goods cannot be taken as a credit by any company, *i.e.*, the IPI related to capital goods is never recoverable by the buyer, it is always a cost. For this reason,

198. This also explains why in order to be subject to Article 29 of Law 10,637/2002, companies must be accredited by the Federal Revenue. This accreditation has the purpose of verifying if the companies really belong to the sectors listed above. For example, in order to be considered a credit accumulator and be subject to this method of tax administration as a manufacturer of footwear, a company needs to prove to the tax authorities that the majority of its sales consist of sales of footwear.

199. Contrary to what has been argued the complainants, there is no doubt that the purpose of article 31 of the Provisional Measure No. 66/2006 (later converted into article 29 of Law No. 10,637/2002) was to implement the principle that debits must be higher than credits and companies must not structurally accumulate tax credits. Such purpose is clear in the Explanatory Memorandum issued by the Brazilian Ministry of Finance, in which the legal justification for the Provisional Measure No. 66/2006 is submitted to the President the Republic, as copied below in relevant part:

> "20. Article 31 [converted into article 29 of Law No. 10,637/2002] provides for the suspension of the Tax on Industrialized Products (IPI) on the exits of products listed therein **aiming at avoiding the accumulation of credits**."

200. Each and every Explanatory Memorandum mentioned by the EUROPEAN UNION and Japan clearly states that the measures concerned therein aim at avoiding the accumulation of tax credits and that, by doing so, those measures intend to support the activities of the affected companies. The European Union and Japan, however, have preferred to highlight in their submissions only the parts of the Explanatory Memorandums that make reference to the support to the companies' activities, without mentioning the relevant parts which state that such support is a consequence of the non-accumulation of tax credits.

201. With regard to PIS and COFINS, there are fewer cases of accumulation of credits of these taxes in comparison to the IPI credits, especially because there are many less products subject to

---

there is no accumulation of IPI credits resulting from purchases of capital goods and, in consequence, there is no suspension of IPI on purchases of capital goods by any company.

low or no PIS and COFINS. Another reason is that PIS and COFINS are charged not only on sales of products, but also on sales of services.

202. In consequence, accumulation of PIS and COFINS credits is found in companies in sectors of the economy that had their sales exempted from PIS and COFINS under certain special regimes. These companies are the following:

- Companies accredited under the RETID - Special Regime for the Defense Industry;
- Companies accredited under the RETAERO - Special Regime for the Brazilian Aerospace Industry;
- Companies accredited under the REIMCOMP - Special Regime to Incentive Computers for Educational Use;
- Companies accredited under the REPES - Special Tax Regime for the Exportation Platform of Information Technology Services;
- Companies accredited under the PADIS - Support Program for Technological Development of the Semiconductor Industry; and
- Companies accredited under the PATVD - Support Program for Technological Development of the Equipment Industry for Digital TV.

203. Each of these programs exempts or reduces PIS and COFINS on the sales performed by the concerned companies. In consequence, such companies would tend to accumulate PIS and COFINS credits. However, considering the principle that debits must be higher than credits and companies must not structurally accumulate tax credits, these programmes, also suspend the PIS and COFINS on purchases of inputs and capital goods made by the concerned companies.

204. In some cases, these programs also exempt or reduce the IPI on sales performed by the concerned companies. In these cases, these programs also suspend the IPI on purchases of inputs in order to avoid the structural accumulation of tax credits.

205. Predominantly exporting companies are just one of the kinds of companies that tend to accumulate PIS and COFINS credits and, similarly to the other kinds of companies mentioned above, have the payment of PIS and COFINS suspended on their purchases of inputs (by article

40 of Law No. 10,865/2004) and capital goods (article 12 of Law No. 11,196/2005, which created the RECAP).

206. Similarly to the discussion related to article 29 of Law No. 10,637/2002 there is no doubt that the purpose of article 40 of Law No. 10,865/2004 and article 12 of Law No. 11,196/2005 was to implement the principle that debits must be higher than credits and companies must not structurally accumulate tax credits. Here again, such purpose is made clear in the Interministerial Explanatory Memorandum issued to justify to the President of the Republic the submission of the Provisional Measure No. 252/2005 (later converted into Law No. 11,196/2005), copied below in relevant part:

> "5. This regime suspends the levy of the Contribution for PIS/PASEP and of COFINS on sales and on imports of new machines, devices, instruments and equipment, listed in the regulation, when acquired by predominantly exporting legal persons. **Likewise REPES, RECAP aims at avoiding the accumulation of credits of PIS and COFINS by exporting companies, supplementing the provision already existing in article 40 of Law No. 10,865, of April 30, 2004**, which suspends the levy of these contributions on sales of raw materials, intermediary products and packaging materials when destined to predominantly exporting legal persons."

6.2 Brazil has demonstrated that the suspension of taxes on purchases of raw materials, intermediary products and packaging materials ("PEC") is consistent with the Covered Agreements

207. Brazil would like to emphasize again that the suspension of taxes on purchases of raw materials, intermediary products and packaging materials by companies that tend to accumulate credits (among which are the predominantly exporting companies) is consistent with the SCM Agreement, since it does not constitute a financial contribution from the government or confers a benefit to such companies within the meaning of that Agreement. Furthermore, such suspension is not contingent upon export performance but rather upon the accumulation of tax credits. Each of these aspects is addressed separately in the following sections.

6.2.1 Brazil has demonstrated that "PEC" does not provide a subsidy

208. For a measure to be considered a subsidy, it must satisfy the criteria listed on Article 1.1 of the SCM Agreement: there has to be a financial contribution or price/income support from the government or any public body that confers a benefit on the recipient.

209. The suspension of taxes on purchases of raw materials, intermediary products and packaging materials by companies that tend to accumulate credits (among which are the predominantly exporting companies) does not satisfy such criteria, as demonstrated below.

6.2.1.1 Brazil has demonstrated that "PEC" does not provide a financial contribution

210. The complainants argue that "PEC" constitutes a financial contribution in the sense of Article 1.1(a)(1)(ii) of the SCM Agreement, as Brazil would forego revenue which is otherwise due. Such allegation, though, is the result of an incorrect comparison between a company under "PEC" – and as such a structural accumulator of tax credits – and companies that do not tend to accumulate credits.

211. An accurate understanding of the legal framework of the tax suspensions described above makes it clear that there is no revenue foregone, within the meaning of Article 1.1(a)(1)(ii) of the SCM Agreement, which reads:

> 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:
> […]
> (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits);
> […]
> (Footnote omitted)

212. There is extensive jurisprudence on this provision. The Appellate Body in US – Large Civil Aircraft (Second Complaint)[74] put forth a three-step analysis for identifying whether revenue that is otherwise due is foregone: (1) identification of the tax treatment that applies to

[74] Appellate Body Report,*US – Large Civil Aircraft (second complaint), para. 812.*

the income of the alleged recipients; (2) identification of the appropriate benchmark, *i.e.*, the tax treatment of comparable income of comparably situated taxpayers; and (3) comparison of the reasons for the challenged tax treatment with the benchmark tax treatment it has identified after scrutinizing a Member's tax regime.

213. Brazil has explained at length the three requirements and how the complainants have failed the test in its First Written Submission. First, the complainants have not identified the correct tax treatment applicable to the relevant taxpayers under PEC. There is no revenue foregone that is otherwise due. The Federal Revenue collects precisely the same amount of taxes it would have collected without the suspension provided by the programme. As already explained, the suspension simply prevents the accumulation of tax credits and the administrative burden – for the government and the companies – to later reimburse the taxes not due in the first place that would be collected. The reason why the complainants fail to acknowledge this is because they fail to identify the appropriate benchmark. Brazil will address now this issue.

214. In *US — FSC (Article 21.5 — EC)*[75], the Appellate Body clarified that, in identifying the appropriate benchmark for comparison, panels should identify and examine fiscal situations which are legitimate to compare:

> In our Report in US – FSC, we recognized that it may be difficult to identify the appropriate normative benchmark for comparison under Article 1.1(a)(1)(ii) because domestic rules of taxation are varied and complex. In identifying the appropriate benchmark for comparison, panels must obviously ensure that they identify and examine fiscal situations which it is legitimate to compare. In other words, there must be a rational basis for comparing the fiscal treatment of the income subject to the contested measure and the fiscal treatment of certain other income. In general terms, in this comparison, like will be compared with like. For instance, if the measure at issue involves income earned in sales transactions, it might not be appropriate to compare the treatment of this income with employment income.

215. In that same decision, the Appellate Body reiterated that the appropriate benchmark under Article 1.1(a)(1)(ii) are comparably situated taxpayers:[76]

> In identifying the normative benchmark, there may be situations where the measure at issue might be described as an "exception" to a "general" rule of taxation. In such situations, it

[75] Appellate Body Report, *US — FSC (Article 21.5 — EC)*, para. 90.
[76] *Id.*, para. 91 and 92.

> may be possible to apply a "but for" test to examine the fiscal treatment of income absent the contested measure. We do not, however, consider that Article 1.1(a)(1)(ii) always requires panels to identify, with respect to any particular income, the "general" rule of taxation prevailing in a Member. Given the variety and complexity of domestic tax systems, it will usually be very difficult to isolate a "general" rule of taxation and "exceptions" to that "general" rule. Instead, we believe that panels should seek to compare the fiscal treatment of legitimately comparable income to determine whether the contested measure involves the foregoing of revenue which is "otherwise due", in relation to the income in question.
>
> In addition, it is important to ensure that the examination under Article 1.1(a)(1)(ii) involves a comparison of the fiscal treatment of the relevant income for taxpayers in comparable situations. For instance, if the measure at issue is concerned with the taxation of foreign-source income in the hands of a domestic corporation, it might not be appropriate to compare the measure with the fiscal treatment of such income in the hands of a foreign corporation.

216. Moreover, in *US — FSC*[77] the Appellate Body also stated that the identification of the benchmark should be made based on the tax rules applied by the Member in question, which has the sovereign authority to choose its own kind of tax system:

> We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question. To accept the argument of the United States that the comparator in determining what is "otherwise due" should be something other than the prevailing domestic standard of the Member in question would be to imply that WTO obligations somehow compel Members to choose a particular kind of tax system; this is not so. A Member, in principle, has the sovereign authority to tax any particular categories of revenue it wishes. It is also free not to tax any particular categories of revenues. But, in both instances, the Member must respect its WTO obligations. What is "otherwise due", therefore, depends on the rules of taxation that each Member, by its own choice, establishes for itself.

217. Considering the referred findings and having in mind all the explanations presented before about the Brazilian tax system, it is clear that Brazilian companies that tend to structurally accumulate credits are not comparably situated taxpayers to Brazilian companies that do not tend to accumulate tax credits. Therefore, it is not legitimate to compare the tax situation of these two kinds of companies.

218. In the present case, an appropriate comparison under Article 1.1(a)(1)(ii) should be made between the fiscal treatment of predominantly exporting companies and other companies that tend to structurally accumulate credits. Since these companies are all subject to the same method of tax administration, there is no revenue otherwise due that is foregone.

[77] US — FSC, para. 90.

219. The complainants have argued that "Brazil has failed to prove the existence of such a rule, norm or 'organising principle' in Brazil's taxation system, according to which 'predominantly credit-accumulating companies' are not subject to taxation with regard their acquisition of capital goods and certain inputs."[78]

220. This argument is incorrect. As demonstrated before, the method of tax administration applicable to credit-accumulating companies was created in 2002 by one single provision — article 31 of the Provisional Measure No. 66/2006, later converted into article 29 of Law No. 10,637/2002 — that applied to credit accumulators in many different sectors of the economy. As also demonstrated before, the Explanatory Memorandum to the Provisional Measure No. 66/2006 clearly states that such rule was aimed at addressing the problem of credit accumulation.

221. Predominantly exporting companies are just one of the several kinds of credit accumulating companies that are submitted to that rule. The complainants, however, took the one item of article 29 of Law No. 10,637/2002, which referred to predominantly exporting companies and presented it to this panel as if it were an isolated programme named "PEC". It is important to note that there is no such "programme" in Brazil.

222. The complainants[79] have further misinterpreted a statement made in Brazil's First Written Submission and argued that Brazil itself would have said that the general rule under the Brazilian tax system is that purchases of inputs are taxed and generate credits for the purchaser even in case these inputs are used to produce products exempted from taxation, as provided in Article 11 of Law No. 9,779/1999.

223. Contrary to what the complainants have argued, Brazil merely clarified in that part of its First Written Submission that, when a purchase of inputs is subject to the IPI, the purchaser is entitled to accrue an IPI credit even if these inputs are used to manufacture products that are subject to no or low IPI. Article 11 of Law No. 9,779/1999 further provides that if these credits eventually accumulate, the company is allowed to offset them against debits of other federal taxes under specific circumstances, or to request their refund.

[78] Responses to the Questions from the Panel to Parties after the First Substantive Meeting by the European Union, para. 150.
[79] *Id.*, para. 151.

224. The mentioned rule provides a solution for cases of eventual accumulation of credits, which are not solved by the method of tax administration applicable to structurally accumulating companies. As explained before, companies that do not structurally accumulate credits may eventually accumulate credits and, in that case, request the refund or offset of these credits.

225. The complainants have also argued that Brazil is not consistent in applying the method of tax administration to companies that tend to accumulate credits because some "products" are non-taxed or have low taxation, but are not subject to this method of taxation, or on the contrary are taxed but are subject to this method.[80]

226. As explained before however, the method of tax administration applicable to structural credit-accumulating companies is not concerned with specific products, but with sectors of the economy that tend to structurally accumulate credits Predominantly exporting companies are only one of the many kinds of sectors subject to such method.

227. Some of the products sold by companies from the referred sectors are indeed subject to IPI, for example. This notwithstanding, the Brazilian government has identified companies from these sectors as accumulators of IPI credits because the great majority of their sales are subject to low or no IPI.

228. On the other hand, some products sold by companies from other sectors may be subject to low or no IPI. However, these sectors have not been identified as accumulators of IPI credits for several possible reasons. Possibly, companies from these other sectors sell both products subject to IPI and products exempt from IPI, and their sales of the former ones are sufficient for them to offset their IPI credits. It is also possible that the inputs used by such companies are subject to no or low IPI, preventing them from accumulating credits.

229. In defining which sectors should be under the method of tax administration provided by Article 29 of Law No. 10,637/2002, the Brazilian government analyzed the situation of companies from several sectors of the economy, rather than analyzing separately the situation of each product, as the complainants did.

[80] *Id.*, para. 156.

230. Finally, the complainants[81] have argued that "Brazil has not submitted any evidence showing that all companies that meet the 50% threshold also necessarily accumulate tax credits."

231. Once again the complainants' argument is incorrect. In its First Written Submission, Brazil[82] provided a table demonstrating the tax credits and debits for companies under the non-cumulative system divided by the share of exports in their revenue for the year of 2012. As can be seen in this table, copied below, the turning point for credit accumulation is in the 45 to 50% range of share of exports in the revenue.

Export revenue /Total revenue		Number of comp.	Total revenue	Exports revenue	PIS/Cofins debit	PIS/Cofins credit	PIS/Cofins credit-debit balance
%	%						
0	0	105168	4.359.740,44	0,00	403.275,99	132.726,84	270.549,15
0	5	3625	801.166,71	12.120,13	72.986,81	37.804,48	35.182,33
5	10	864	327.730,28	23.879,01	28.106,24	14.445,49	13.660,75
10	15	455	515.499,48	69.689,31	41.237,44	18.586,03	22.651,41
15	20	329	120.752,41	20.805,61	9.245,08	5.403,04	3.842,04
20	25	245	86.539,98	19.759,67	6.177,18	4.211,48	1.965,70
25	30	168	29.228,40	7.946,31	1.968,59	1.291,00	677,59
30	35	116	64.676,96	21.190,29	4.022,52	3.231,47	791,05
35	40	109	32.106,51	12.016,70	1.858,31	1.411,17	447,14
40	45	89	23.818,94	10.205,33	1.259,26	957,74	301,52
45	**50**	**76**	**42.057,72**	**19.944,67**	**2.045,46**	**2.454,83**	-409,37
50	55	114	38.635,99	20.431,89	1.683,88	2.137,99	-454,12
55	60	85	25.279,25	14.343,33	1.011,57	1.497,85	-486,28
60	65	74	18.219,92	11.513,16	620,38	1.004,71	-384,33
65	70	68	21.075,82	14.330,23	623,97	1.074,54	-450,57
70	75	74	13.320,35	9.666,84	337,95	562,25	-224,30
75	80	66	11.304,24	8.747,00	236,55	663,68	-427,13
80	85	61	16.137,94	13.366,39	256,37	1.154,06	-897,69
85	90	74	87.112,10	75.268,36	1.095,55	1.617,11	-521,56
90	95	94	24.265,70	22.587,03	155,28	1.136,16	-980,89
95	100	176	27.064,03	26.449,62	56,83	922,62	-865,79
100	> 100	558	17.511,16	17.511,16	0,00	731,13	-731,13

232. In conclusion, Brazil has demonstrated that under the proper benchmark PEC does not confer a subsidy within the meaning of the SCM Agreement. For this reason, it is not even

[81] Japan's opening statement to the first hearing, para. 5.

necessary to analyze whether the challenged tax suspensions confer a benefit to the recipients. However, for the sake of argument, Brazil demonstrates in the next section that these tax suspensions confer no benefit.

6.2.1.2 Brazil has demonstrated that "PEC" does not confer a benefit

233. Brazil has demonstrated in the previous section that there is no financial contribution in the form of revenue foregone. Brazil will now demonstrate that the challenged tax suspensions do not confer a benefit within the meaning of the SCM Agreement.

234. A benefit is a measure that places its recipient in a better off position according to a given standard of comparison. There is a basic understanding behind a benefit – that without it, the recipient would be in the same standpoint as the companies that did not receive the same benefit. This is not the case here.

235. Companies that do not tend to accumulate credits recover their tax credits on their sales. This is how indirect taxes work. However, companies that structurally accumulate credits are not able to recover them on their sales. Maybe in a developed country with (i) one single indirect tax, (ii) funds constantly made available by the government to refund companies of their accumulated tax credits, (iii) enough taxation on income to allow the complete offset of accumulated credits, and (iv) a tax administration fully equipped to process and promptly refund or offset requests, companies that tend to structurally accumulate credits of the one indirect tax may be able to easily recover such credits, thus being in a not so worse situation than companies that do not tend to accumulate such credits.

236. In Brazil, however, there are not one but three indirect taxes. Taxes on income normally are not sufficient to allow the complete offset of accumulated credits. Funds are rarely made available to refund companies of their accumulated tax credits. The tax administration takes a long time to process refund or offset requests.

[82] Brazil's First Written Submission, para. 848.

237. Considering, on the one hand, the difficulties in offsetting or being refunded of tax credits and, on the other, the high value of the indirect taxes and consequently of the accumulated tax credits, Brazilian companies that tend to structurally accumulate credits are in a much worse position than companies that do not tend to accumulate tax credits

238. In this context, the challenged tax suspensions do not place the recipient in a "better off" position. They just provide for an efficient tax administration procedure.

239. Even if the panel disregards the context described above, it is not possible to conclude that the challenged tax suspensions "as such" provide a benefit. A suspension on purchases of inputs possibly affect four scenarios:

(i) purchases in the domestic market of inputs used to manufacture exported products;
(ii) imports of inputs used to manufacture exported products;
(iii) purchases in the domestic market of inputs used to manufacture products sold in the domestic market; and
(iv) imports of inputs used to manufacture products sold in the domestic market.

240. The first and second scenarios fall squarely on the scope of Footnote 5 to the SCM Agreement, combined with items (h) and (i) of the Annex I to the referred agreement. As such, the characterization of them as possible export subsidies is not even at issue.

241. In the third scenario mentioned above it is not clear that the recipient of the suspension will have any benefit. Let us remember that the seller is the one who pays the taxes. There is no legal requirement for the seller to reduce its price proportionately to the tax suspension. Therefore, it is up to the buyer to negotiate with the seller a reduction of the price because of the tax suspension. This negotiation hardly results in the transference by the seller to the buyer of the totality of the tax suspension. The result of this negotiation depends, among other factors, on the price elasticity of the concerned input. If the reduction in the price of the input is lower than the amount of taxes suspended, the buyer may have a loss. Depending on the payment terms negotiated between the supplier of inputs and the accredited company, the tax suspension may result in a worse "cash flow" scenario for the recipient company rather than a better one as the

complainants argue. This is a consequence of the fact that the buyer is entitled to the tax credits immediately after buying the inputs. However, it will only disburse the cash to pay for such credits when it actually pays the supplier. Therefore, considering, for example, a case in which the supplier grants 90 days for the recipient company to pay for the inputs, the tax suspension will worsen the cash flow of the recipient company because it will not be able to use the tax credits freely for 90 days before paying for them.

242. Out of the fourth scenario mentioned above, the only one where the recipient of the tax suspension is likely to have a small cash flow gain would be the fourth and even then this cash flow has to be analyzed in light of the situation of the company as a whole. In any case the combination of the four scenarios does not allow the conclusion that in general the challenged tax suspensions provide a *de jure* benefit to the recipient.

243. In conclusion, considering the jurisprudence on the interpretation of article 1(b) of the SCM Agreement and the fact that the challenged tax suspensions merely equalize the fiscal situation of structurally credit-accumulating Brazilian companies (which include predominantly exporting companies) with the fiscal situation of Brazilian companies that do not tend to accumulate credits, the measures at issue do not confer a benefit within the meaning of the SCM Agreement.

244. Furthermore, a close analysis of the transactions affected by the challenged tax suspensions does not allow for the conclusion that these suspensions "as such" confer a benefit on the recipient. As the complainants decided not to make a *de facto* claim and, consequently, submitted no evidence establishing that in the actual operation of the measure the fourth scenario is prevalent to such an extent that it defines the nature of the programme, their case must fail.

6.2.1.3 Brazil has demonstrated that "PEC" is not contingent upon export performance: the 50% export requirement is an objective threshold relating to tax credit accumulation

245. The Appellate Body has stated that to “prove the existence of an export subsidy within the meaning of this provision, a Member must […] establish (i) the existence of a subsidy within

the meaning of Article 1 of the SCM Agreement and (ii) contingency of that subsidy upon export performance"[83].

246. Brazil believes it has proven that the measure at issue does not confer a financial contribution nor does it translate into a benefit, within the meaning of the SCM Agreement. Nevertheless, even if the Panel understands that there is a subsidy, Brazil submits that the measure at issue is not a subsidy contingent upon export performance under Article 3.1(a) of the SCM Agreement. The relevant provision reads:

> 3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
>
> > (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I (footnotes omitted)

247. The complainants seem to assert that the alleged subsidies supposedly granted through the challenged tax suspensions are *in law* contingent upon export performance, asserting that the conditions for accreditation have an export threshold which, if not met, leads to the imposition of fines.

248. As already demonstrated, however, the criteria for the accreditation of the programme do not reflect an export contingency, but an objective threshold related to the accumulation of tax credits, as the table below shows. The overall logic and functioning of the programme is, as previously mentioned, to prevent the accumulation of credits for companies that produce goods with low or no taxation.

[83] Appellate Body Report, *US – Large Civil Aircraft* (second complaint), para. 813.

Export revenue /Total revenue %	%	Number of comp.	Total revenue	Exports revenue	PIS/Cofins debit	PIS/Cofins credit	PIS/Cofins credit-debit balance
0	0	105168	4.359.740,44	0,00	403.275,99	132.726,84	270.549,15
0	5	3625	801.166,71	12.120,13	72.986,81	37.804,48	35.182,33
5	10	864	327.730,28	23.879,01	28.106,24	14.445,49	13.660,75
10	15	455	515.499,48	69.689,31	41.237,44	18.586,03	22.651,41
15	20	329	120.752,41	20.805,61	9.245,08	5.403,04	3.842,04
20	25	245	86.539,98	19.759,67	6.177,18	4.211,48	1.965,70
25	30	168	29.228,40	7.946,31	1.968,59	1.291,00	677,59
30	35	116	64.676,96	21.190,29	4.022,52	3.231,47	791,05
35	40	109	32.106,51	12.016,70	1.858,31	1.411,17	447,14
40	45	89	23.818,94	10.205,33	1.259,26	957,74	301,52
45	**50**	**76**	**42.057,72**	**19.944,67**	**2.045,46**	**2.454,83**	**-409,37**
50	55	114	38.635,99	20.431,89	1.683,88	2.137,99	-454,12
55	60	85	25.279,25	14.343,33	1.011,57	1.497,85	-486,28
60	65	74	18.219,92	11.513,16	620,38	1.004,71	-384,33
65	70	68	21.075,82	14.330,23	623,97	1.074,54	-450,57
70	75	74	13.320,35	9.666,84	337,95	562,25	-224,30
75	80	66	11.304,24	8.747,00	236,55	663,68	-427,13
80	85	61	16.137,94	13.366,39	256,37	1.154,06	-897,69
85	90	74	87.112,10	75.268,36	1.095,55	1.617,11	-521,56
90	95	94	24.265,70	22.587,03	155,28	1.136,16	-980,89
95	100	176	27.064,03	26.449,62	56,83	922,62	-865,79
100	> 100	558	17.511,16	17.511,16	0,00	731,13	-731,13

249. The table shows the tax credits and debits for companies under the noncumulative system divided by the share of exports in their revenue for the year of 2012. As can be seen, the turning point for credit accumulation is in the 45% to 50% range of exports in the revenue.

250. The progressive reductions of the threshold for accreditation to the challenged tax suspensions are a consequence of the fiscal reality rather than a concentrated effort towards exporting. This logic is explicit in the Explanatory Memorandum to the Provisional Measure No. 563, later converted into Law No. 12,715/2012, which reduced the referred threshold to 50%: "[…] almost all Brazilian companies that generate credits to be reimbursed in kind in relation to their export activities are covered. Thus, it is expected that, at least at the federal level, the accumulation of export credits loses relevance. [...] 97. Finally, the adoption of a measure that contributes to solve the serious problem of accumulation of tax credits arising from exports,

which erodes the working capital of exporting companies and reduces their competitiveness, undoubtedly makes this proposal for a provisional measure to meet the requirements of emergency and relevance."

251. The reference in the challenged measures to exports is not *per se* evidence enough that there might be an export contingency, as their role in the structure of the tax regime shows. As indicated above, despite its name, these tax suspensions are contingent upon the accumulation of credits. Any examination that neglects this context ignores the panel in Australia – Automotive Leather II[84] when determining that "***all facts*** *surrounding the grant and/or maintenance of the subsidy in question may be taken into consideration in the analysis*" (emphasis added).

[84] Panel Report, *Australia – Automotive Leather II*, para. 9.57.

6.3. Brazil has demonstrated that RECAP is consistent with the Covered Agreements

252. The suspension of taxes on purchases of capital goods by companies that tend to accumulate credits (among which are the predominantly exporting companies) is consistent with the SCM Agreement, since it does not characterize a financial contribution from the government or confers a benefit to such companies within the meaning of the SCM Agreement. Furthermore, such suspension is not contingent upon export performance but rather upon the accumulation of tax credits.

253. As the nature of RECAP is similar to that of PEC, the arguments submitted in section 6.2 apply *mutatis mutandis* to RECAP and are incorporated by Brazil[85].

[85] Exhibit BR-113 illustrates the joint operation of PEC and RECAP for a single exporting company. It demonstrates that the programmes do not overlap and that there is no benefit for the exporters.

7. CONCLUSION

254. In light of the above, Brazil respectfully requests that all of the measures challenged by the complainants be found consistent with the WTO provisions raised and that each of their claims be dismissed.