BRAZILIAN TAX REFORM

Brazil has one of the most complex tax systems in the world. The combination of numerous taxes, contributions, and fees, along with a high tax burden, presents a significant challenge for businesses, professionals and also for ordinary citizens. In this context, Constitutional Amendment No. 132, known as the Brazilian 2023 Tax Reform, is being announced as a solution to these challenges. This measure was enacted in December 2023 by the Brazilian Congress and includes, among other provisions, a new consumption tax model.

The primary objective of the Tax Reform is to simplify Brazil's tax system by replacing taxes such as PIS (Social Integration Program), COFINS (Contribution for Social Security Financing), IPI (Federal VAT on Industrialized Products), ICMS (State VAT on Circulation of Goods and Services), and ISS (City Services Tax) with the IBS (Goods and Services Tax). Additionally, the reform aims to modernize the system, boost the economy, enhance the competitiveness of businesses, and promote legal certainty.

- Simplification: to reduce the number of taxes and equalize taxes with the same tax basis.
- Transparency: to make the tax system clearer and more understandable to the population.
- Stimulate the economy: A simpler and more efficient tax system is expected to attract more investments and drive economic growth.
- Legal certainty: an efficient, modern, and transparent consumption tax system associated with formalized digital technology management.

The importance and reasons behind the Tax Reform

The Tax Reform is necessary because the current Brazilian tax system hinders economic and social growth by increasing business costs, hampering competitiveness, penalizing investments, and creating legal uncertainty. However, domestic products are clearly disadvantaged compared to competition from foreign markets.

The shortcomings in the Brazilian tax system are particularly detrimental to the industrial sector, which faces competition from abroad and is subject to a higher tax burden compared to other sectors.

In international market competition, foreign companies often face difficulties entering the Brazilian market due to differences in tax collection methods compared to those practiced in other countries. This requires a significant effort of adaptation on the part of these foreign companies.

In Brazil, ICMS (State VAT on Circulation of Goods and Services), ISS (City Services Tax), IPI (Federal VAT on Industrialized Products), PIS/Pasep (Social Integration Program), and COFINS (Contribution for Social Security Financing) are levied on consumption, whereas in most other countries, only the Value Added Tax (VAT) is applied. Furthermore, each of the 27 states has its own ICMS (State VAT on Circulation of Goods and Services) rules, and each of the 5.570 cities has its own ISS rules.

It's also worth noting that in 2020, the year of the last Doing Business report published by the World Bank based on an analysis of indicators on the ease of doing business in 190 countries, Brazil ranked 124th, behind countries like Mexico (60th), India (63rd), and South Africa (84th).[i]

Given this negative scenario, efforts have been made in recent years for Brazil to reverse or mitigate this situation, leading to advancements in many aspects of the business environment. This progress has been primarily achieved through the digitalization of government services, the enactment of the Economic Freedom Act (Act No. 13.874/19), and other legal provisions favorable to small businesses that have simplified the lives of entrepreneurs, particularly through Tax Reform.

Key Points of the Tax Reform

- New VAT called IBS (Goods and Services Tax) – Replacement of ICMS (State VAT on Circulation of Goods and Services) and ISS (City Services Tax) with the IBS (Goods and Services Tax), which shall be levied at the location where goods and services are consumed, with a credit mechanism for taxes paid in earlier stages of production. The IBS is part of the Value Added Tax (VAT) system.
- New VAT called CBS (Contribution on Operations Relating to Goods and Services) – This contribution shall replace federal consumption taxes such as IPI (Federal VAT on Industrialized Products), PIS (Social Integration Program), and COFINS (Contribution for Social Security Financing). The CBS is part of the Value Added Tax (IVA) system.
- Double taxation - part of the IBS (Goods and Services Tax) will be administered by the Federal Government and another part by the States and Cities.
- Selective tax - it will be a sort of surcharge on goods and services harmful to health or the environment.
- IBS (Goods and Services Tax) tax rates - there will be a standard tax rate and a differentiated tax rate for sectors such as healthcare. This is because these sectors do not involve as many stages (steps) as the manufacturing sector.
- Exceptions - the Manaus Free Trade Zone and the "Simples Nacional" (Simplified Tax Scheme for Small Businesses) shall maintain their current rules. Some sectors will have specific tax regimes: activities involving real estate, financial services, insurance, cooperatives, fuels, and lubricants.
- Zero-rate CBS - The Contribution on Goods and Services – CBS – will have a zero-rate for products in the Brazilian basic food basket, medications for serious illnesses, and higher education services ("*Prouni*").
- IBS and CBS with zero-rate taxation
  Individuals engaged in agricultural, fishing, forestry, and vegetable cultivation activities in nature;
  In the case of individual rural producers, the exemption from IBS and CBS applies to those with annual income of up to R$ 2 million.
- Books
  Books will continue to be tax exempt.

Major changes in the taxation structure of other taxes

IPVA – Vehicle Tax

- Possibility of making the tax progressive based on the environmental impact of the vehicle;

- Possibility of lower tax rates for electric vehicles;

- Inclusion of IPVA (Vehicle Tax) for water and air vehicles, such as jets, helicopters, yachts, and jet skis, with the following exceptions: agricultural aircraft and aircraft owned by operators certified to provide air services to third parties (e.g., airlines, air taxi companies); vessels owned by legal entities licensed to provide water transport services; vessels owned by individuals or legal entities involved in industrial, artisanal, scientific, or subsistence fishing; platforms capable of self-propulsion in water, including those primarily intended for economic activities in territorial waters and exclusive economic zones, and vessels primarily intended for such activities; tractors and agricultural machinery;

ITCMD – Inheritance and Donation Tax

- Progressivity of ITCMD (Inheritance and Donation Tax) from 4% to 8% on total wealth;

- The tax rate will increase based on the value of the transfer; transfer of tax on movable property, securities, and credits to the state where the person is domiciled;

- Tax on inheritances abroad will also be incident.;

- Exemption from ITCMD (Inheritance and Donation Tax) for transfers to non-profit entities with a public and socially relevant purpose, including charitable and philanthropic organizations, religious institutions, and scientific and technological institutes.

IPTU – City Property Tax

- Cities may adjust the calculation basis of IPTU (City Property Tax) through resolutions;

- The resolutions shall comply with the general criteria established in the City Act;

- This measure meets a request from city governments.

Public lighting

- A contribution to fund public lighting, which falls under city jurisdiction, may be used to expand and improve the service, purposes not currently provided for by the constitution.

Exemption of payroll taxes

- If the potential creation of more jobs through the exemption of payroll taxes results in increased tax revenue for certain sectors of the economy, this increase should be used to reduce taxes on the consumption of goods and services.

<u>Effects of the Tax Reform over time</u>

According to the proposal for Tax Reform, the two new taxes will be introduced in 2026 with initial tax rates of 0,9% for CBS (Contribution on Goods and Services) and 0,1% for IBS (Goods and Services Tax). Starting in 2027, the CBS (Contribution on Goods and Services) will come into effect with a tax rate yet to be determined, while the PIS/Pasep (Social Integration Program) and COFINS (Contribution for Social Security Financing) will be phased out. As for the IBS (Goods and Services Tax), the transition will begin in 2029 and extend until 2032.

Each year, the ICMS (State VAT on Circulation of Goods and Services) and ISS (City Services Tax) tax rates will be reduced by 10 percentage points, while the IBS (Goods and Services Tax) tax rate will increase by the same percentage. Therefore, the IBS (Goods and Services Tax) tax rate in 2029 will be equal to 90% of the ICMS (State VAT on Circulation of Goods and Services) and ISS (City Services Tax) tax rates in 2028, and in 2032 it will be 60%.

As a result, the IBS (Goods and Services Tax) will come into effect with a full tax rate only in 2033, at the same time that the ICMS (State VAT on Circulation of Goods and Services) and ISS (City Services Tax) are abolished.

Fiscal impacts

In addition to macroeconomic, regional, and sectoral impacts, the approved tax reform will also have a significant fiscal impact on the federal government, based on two constitutional funds: the Fund for Compensation of Fiscal and Financial-Fiscal Benefits and the Brazilian Development Fund, as well as two other funds authorized to be established by Supplementary Act: the Sustainability and Economic Diversification Fund of the State of Amazonas and the Sustainable Development Fund of Western Amazon and Amapá.

The fiscal or financial-fiscal benefits compensation fund will reach R$ 32 billion in 2028, a figure that will repeat in 2029, when contributions will begin to decrease by R$ 8 billion per year until it expires in 2032. [ii]

The amounts stipulated in the Tax Reform will be adjusted for inflation by the IPCA (Consumer price index). In case of a deficit in the payment of agreed fiscal benefits, the Brazilian Federal Government will be required to supplement them.

Conclusion

The Value Added Tax (VAT) from the new taxation model proposed in the Tax Reform has already been adopted by more than 170 countries. The transition to the new tax system will take a long time. Ten years until the effective introduction of the IBS (Goods and Services Tax). Fifty years until the taxable event is fully shifted from origin-based to destination-based.

The expectation is that no Public Body will incur significant losses, which will be mitigated by the lengthy transition and compensation mechanisms being implemented. This implies that overall multiple gains will more than compensate for any losses incurred by individual states or cities.

The current moment presents an exceptional opportunity to strengthen national competitiveness, which for decades has seen its industrial prominence diminish in favor of agribusiness, which lacks significantly in creating added value, jobs, and generating technology.

Despite the aim to simplify the tax calculations, however, with the complexity of the new double-tax system, most probably this simplification “desideration” shall not take place.

Sources:

[i] BANCO MUNDIAL. Doing Business, 2021. Available at: https://archive.doingbusiness.org/pt/reports/global-reports/doing-business2020#:~:text=O%20Doing%20Business%202020%2C%20uma,ou%20restringem%20as%20atividades%20empresariais.

[ii] BRAZILIAN FEDERAL GOVERNMENT. Constitutional Amendment No. 132, 2023. Available at: https://www.planalto.gov.br/ccivil_03/constituicao/emendas/emc/emc132.htm