

Brazil's VAT Reform

December 22, 2023 | Edition nº 26

Constitutional Amendment enacted by the Brazilian Congress

VAT Reform: from risk to strategy

On December 20, 2023, the VAT reform was enacted by the Brazilian Congress, representing a historic milestone for Brazil, beginning the long-awaited modernization of our complex and uncompetitive tax system. Certain details of the new legislation are still outstanding, but it is time to assess the impacts on your business – in the processes and through modeling – and wring value out of it.

Main changes

Elimination of 4 taxes and reduction of the general IPI rate to zero. The IPI will be maintained for the same products that have industrialization in the Free Trade Zone of Manaus (out of the Free Trade Zone tax incentive).

Taxes eliminated:

Contribution to the Social Integration Program (PIS)

Social Security Financing Contribution (COFINS)

State Indirect Tax (ICMS)

Local Services Tax (ISS)

Creation of 3 new taxes:

Dual VAT

- 1 Federal Contribution on Goods and Services (CBS)
- 2 Subnational Tax on Goods and Services (IBS) (States and Municipalities)
- 3 Federal Excise Tax (IS)

New “contribution” imposed by States: taxing rights attributed to the States to create a “contribution on primary and semi-finished products”, replacing a similar contribution to state funds existing on April 30, 2023, imposed as a condition for the application of ICMS special tax exemptions by some States. The new contribution will be extinguished by December 31 2043, and must have a rate no higher and a calculation base no wider than the contribution that will be replaced.



Transition Period: Coexistence of two tax systems with old and new taxes collected in parallel during 7 years

- IBS will be charged at the State and Municipal rates of 0.05% each.
- CBS rate will be reduced by 0.1%.

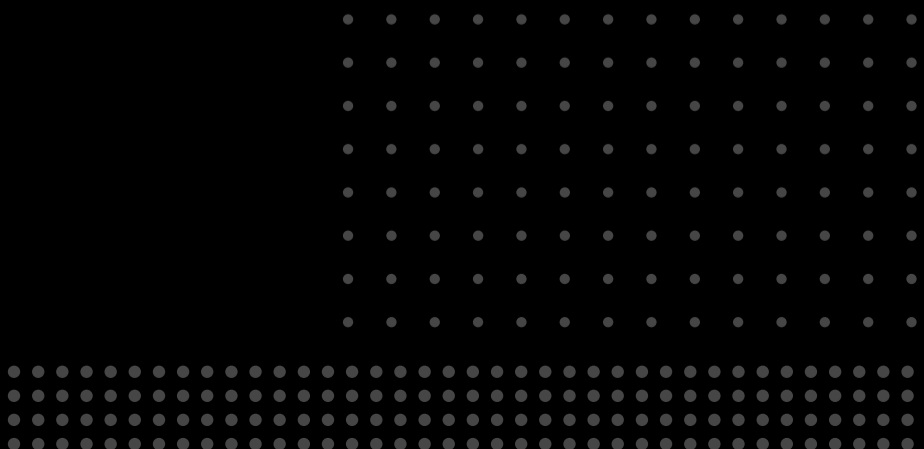
- Full adoption of the new consumption tax system.



- IBS shall have a rate of 0.1% and CBS of 0.9%, whereas the amount collected shall be offset against PIS and COFINS amounts due.

- Extinction of PIS/Cofins provided that CBS is created.
- Reduction of IPI rates to zero, except in relation to products that have industrialization in the ZFM.
- IS collection begins.

- ICMS and ISS rates will be reduced in the following proportions: 9/10 in 2029; 8/10 in 2030; 7/10 in 2031; and 6/10 in 2032.
- ICMS and ISS benefits or incentives will be reduced in these same proportions until 2032, when they shall be effectively discontinued.



IBS and CBS

System overview



Same definition of taxable events and base, under unified legislation. Broad incidence on goods and services, including tangibles and intangibles.



Destination Principle: Tax collection at the location of the final consumer, with no tax-on-tax cascading effect.



Non-cumulative (VAT) levies with broad input credit system with potential *split-payment* or equivalent mechanism enabling purchasers to settle output VAT of suppliers.



Exemption of **exports** and taxation of **imports**, regardless of the location of the taxpayer (affects the digital economy).



Long Transition based on the proportion between current collections/GDP. ICMS overall benefits will end proportionally to the current system phase-out timeline.



Possible **cashback system**, benefiting lower-income consumers, making the system less regressive. Mandatory for electricity and domestic fuel for low-income consumers.

Complementary laws will provide criteria for ancillary tax obligations, aiming at its simplification.

Tax rates (to be defined)



Standard rate (to be defined) for **all goods and services**, with exceptions set out in the PEC permitting reductions from 30% up to 100%.



Each State sets its IBS rate, based on the reference rate set forth in a Federal Senate resolution, unless otherwise established in a specific law.



Reference ceilings based on the average collection revenue in relation to GDP over a 10-year period (2012 to 2021), for the respective taxes.



The latest estimates from the Ministry of Finance indicate that the general rate of Dual VAT should be between 25.9% and 27.5%.





Exceptions:



60% CBS / IBS rate reduction for:

- Education services;
- Healthcare services;
- Medical devices (which can be reduced by 100%);
- Accessibility devices for people with disabilities (which can be reduced by 100%);
- Medication (which can be reduced by 100%);
- Basic menstrual healthcare products, (which can be reduced by 100%);
- Public transport sector, with potential exemption.
- Food intended for human consumption;
- Personal hygiene and cleaning products mostly consumed by low-income families;
- Agricultural, aquaculture, fishing, forestry, and 'in natura' plant extraction products;
- Agricultural and aquaculture supplies;
- National artistic, cultural, event, journalistic, and audiovisual productions, sports activities, and institutional communication;
- Goods and services related to national security and sovereignty, information security, and cybersecurity.

100% CBS / IBS rate reduction for:

- Vegetables, fruit and eggs;
- Services provided by a non-profit Scientific, Technological and Innovation Institution (ICT);
- Passenger cars, when purchased by people with disabilities and people with autism spectrum disorder or by professional drivers, who intend the car for use in the rental category (taxi).



Zero rate for products of basic staple food



30% reduction in IBS/CBS rates for the provision of intellectual services, of a scientific, literary or artistic nature, as long as they are subject to supervision by a professional council.



Exemption or reduction of up to 100% of the CBS/IBS rates for activities related to urban restoration of historic areas and critical areas of urban recovery and reconversion.

100% CBS rate reduction, higher education services under the Program "University for All" (PROUNI).

CBS/IBS is not triggered on the provision of communication services in the form of sound broadcasting or on the free reception of sounds and images.



IBS and CBS

Non-cumulative (VAT) system



General non-cumulative, with input credits corresponding to amounts charged by suppliers; input credits **may be conditioned to the confirmation of the tax collection in the previous stage only if infra-constitutional legislation enables:**

- the acquirer to directly collect the tax levied on the purchases of goods or services; or
- the tax collection takes place upon the financial settlement of the transaction (split payment).

Exports

Exempt with unrestricted carryforward of credits.



No deadline has been set for the refund of IBS/CBS credit balances, which will be addressed in the infra-constitutional legislation.

The revenues raised from IBS collections will only be distributed to the States, DF and Municipalities after the retention, by the Federative Council, of credits owed to taxpayers at the end of each computation period.

Exemption and immunity

- as a general rule, exempt or immune sales cause the forfeiture of input tax credits (causing a cumulative effect or VAT-chain breakage); infra-constitutional legislation (complementary law) can prevent this damaging effect.

IBS

Tax Administration

The IBS Federative Council will consist of 27 members from States and DF, and 27 members from Municipalities and DF. The Council will have the following administrative powers:

- to issue a **single guideline**, and **standardize the interpretation and application of the new tax** legislation;
- **to collect** the tax, perform credit balance **offsets** and **distribute the collection proceeds** among the States and Municipalities;
- **to settle matters** raised in the context of tax administrative litigation.



Tax Incentives, Favorable Tax Regimes and Tax Benefits



Small Taxpayers' System

The taxpayer under “Simples” may choose between the two taxation regimes for IBS/CBS:

- Simplified, single-tax system currently in place, nonetheless with a right to recover input tax credit in the same reduced amount charged under “Simples”;
- general non-cumulative regime.



Automotive – Regional Incentive

CBS “presumed credit” granted to industries in the North, Northeast and Central-West regions and by SUDENE and SUDAM areas, under certain conditions, to incentivize:

- production of electric or hybrid vehicles with combustion engines that use biofuels alone or simultaneously with petroleum-derived fuels;
- production of vehicles powered by an internal combustion engine that use biofuels alone or cumulatively with petroleum-derived fuels.



Low-carbon biofuels and hydrogen

The favored tax regime was maintained to ensure a taxation lower than the one levied on fossil fuels.



Manaus Free Zone (ZFM) and Free Trade Area (FTA)

Complementary Law will establish the necessary mechanisms to maintain the competitive advantages granted to the ZFM and FTA available on May 31, 2023.

Tax, economic or financial instruments and, alternatively, CIDE will be used, individually or cumulatively, on the import, production or commercialization of goods that are incentivized in the ZFM.

Complementary Law will establish a Sustainability and Economic Diversification Fund for the States of the Western Amazon (Acre, Amazonas, Rondônia, and Roraima) and Amapá.

Special Customs Regimes and Export Processing Zones (EPE).

Specific Tax Regimes

Specific treatment of IBS and CBS for the following businesses and activities, which will be out of the non-cumulative system

- Fuels and Lubricants;
- Financial Services;
- Real Estate;
- Health Insurance;
- Special Lotteries;
- Cooperatives;
- Hotel services, amusement parks, and theme parks, travel and tourism agencies, bars and restaurants, sporting activities developed by Soccer Society (“Sociedade Anônima do Futebol”), and regional aviation;
- Operations covered by international treaties or conventions, including those relating to diplomatic missions, consular offices, representations of international organizations and their respective accredited employees;
- Air, waterway, rail and road interstate and inter-municipal public transportation.



Federal Excise Tax (IS)

System overview



Triggered on the production, extraction*, sale or importation of **goods and services deemed harmful to human health or the environment**, pursuant to Complementary Law.



Rates can be modified by ordinary law.

Included in the tax base of ICMS, ISS (transition period), IBS, and CBS, perpetuating a tax-on-tax cascading effect.



Not covered by the non-cumulative system. – not a VAT but a cumulative levy.



Exemption of exports as a general rule, with the exception of **extractive industries**.



It may have the **same taxable event and tax base of other taxes**.



Subject to the principle of **annual anteriority****.

**such principle establishes an initial term for the collection of the tax after its creation or increase

*in extraction, the taxation applies at a maximum rate of 1% of the market value of extracted products, regardless of its destination, which may represent double-taxation since extractives are generally subject to industry-specific levies with the same purpose (e.g. Mining-Cefem, Oil-Royalties).

Not imposed on:

- Electric power and telecommunications services;
- Goods and services subject to a reduced IBS/CBS rates.

It is foreseen the possibility of being triggered also on weapons and ammunition, except when intended for the use of the public administration.

Treatment of accumulated credit balances of eliminated taxes

ICMS

Accumulated ICMS credit balances still existing by the end of 2032, recognized by the respective states, **by offsetting it against the IBS from 2033 onwards:**

- for the remaining term of the current regime for credits related to the entry of **goods destined to permanent assets;**
- **in 20 years** (240 equal and successive monthly installments), **in all other cases;**
- updated by Extended National Consumer Price Index (IPCA) from 2033 on.

PIS/Cofins/IPI

Offset against other federal taxes or cash reimbursement under the terms of Complementary Law.



ICMS benefits validated by Complementary Law nº 160/2017

- The **Compensation Fund for Tax or Financial-Tax Benefits of ICMS** will be established to compensate, by December 31, 2032, the legal entities benefiting from exemptions, incentives, and tax or financial-fiscal benefits related to ICMS, granted for a certain period and under defined conditions;
- Applies to beneficiaries of ICMS incentives regularly granted until May 31, 2023, including extensions or renewals and to those who, due to changes in state legislation, have migrated to other programs or benefits between May 31, 2023 and the date of promulgation of the Constitutional Amendment;
- The criteria will be established in Complementary Law.



Other topics

Enlargement of the Contribution base, which can be established by the Municipalities and the DF, to finance, expand and improve the public lighting service and monitoring systems for the safety and preservation of public places.

IPVA – automotive vehicles tax: it may be progressive and triggered on vehicles for water and air transport.

ITCMD – gift and estate tax: progressive according to the value/amount transferred (inheritance or donation).

IPTU – property tax: authorization for the Executive Branch to update the taxable bases by decree.

Development Funds: Establishment of the National Fund for Regional Development, with the goal of mitigating regional and social inequalities, as well as Funds to Combat Poverty, established by the States, DF, and Municipalities and managed by entities that rely on the participation of civil society.





Takeaways

After the transition period, the expected simplification and rationalization of the consumption tax regime is expected to be achieved, since the VAT reform:

- unifies the municipal, the state, and two federal taxes on consumption into the same type of Value Added Tax (“VAT”), although divided into a Federal and a Subnational VAT (“dual VAT”);
- brings transparency, with the tax burden visible to taxpayers and consumers, and taxation at destination, eliminating the so-called "fiscal war" between States, contributing to business decisions mainly driven by economic-financial rationale rather than tax advantages;
- implements a fully non-cumulative system, eliminating tax leakages that are harmful to the competitiveness of Brazilian companies;
- reinforces the tax relief on exports and investments through a reimbursement mechanism for accumulated credits;
- contributes to reducing the country's tax litigation and compliance costs;
- creates a fund to compensate companies benefiting from tax benefits related to ICMS, respecting the return on investments legitimately planned based on such incentives.

Notwithstanding, it should be outlined that in the final approved taxation model the figure of the single and comprehensive VAT ended up not prevailing, as well as that a federal “Selective Tax” was created with a broad and uncertain basis of incidence and specific contributions on primary and semi-finished products, among others measures not aligned with the purpose of simplifying and rationalizing the system. Still, such provisions in the Tax reform represent smaller systematic distortions when compared with those of the current model.

The approved Constitutional Amendment seems to represent the possible result for the reform of the consumption taxation in the country, in the current political circumstances, with the multiple interests of federative entities and different economic sectors. It will probably still be the subject of many discussions within the scope of elaboration of the Complementary Laws required for its regulation. We hope that consensus can be found so that this regulation fulfills its purpose of bringing improvement to the business environment and economic development through simplification, modernization and rationalization of our tax system.



The impact on business

From a macroeconomic perspective, there is a consensus, already documented in several studies and analyses by qualified and renowned entities, that even the Dual VAT model - with all the exceptions that mischaracterize it as a traditional VAT, as well as with the new cumulative incidences - will have a positive impact on increasing Brazil's GDP, with gains in productivity and job creation.

In the more specific dimension of business sectors and individual companies considered, the impacts are diverse. It is necessary to emphasize that the “cuts” of the system represented by specific incentives and tax regimes are so diverse, fragmented and opaque, that any analysis of the impacts of the Reform has to be done case by case, with an important degree of granularity and specificity.

However, from a broader perspective, it is possible to foresee that most companies in the industrial sector tend to operate at a lower tax burden, to be either retained as an increase in profitability (which encourages investments) or passed on to internal consumers, or the external market, or even the supply chain. Utilities such as electricity and telecommunications, in addition to investments in infrastructure, also tend to operate with a lower tax burden, benefiting national productivity.

The majority of the service sector (B2C), should not be impacted by an increase in the tax burden, as the sector mainly operates under the Simples Nacional tax regime. Another relevant part of the services sector, which is in the middle of the production chain (B2B), tends to benefit from the new full non-cumulative system. There will be, however, commercial pressure to pass on the new taxes to the next links in the value chain so that the B2B services sector does not experience an increase in its burden.

An important part of the services sector, especially the medium-sized companies that currently operate under the presumed profit tax regime, will be subject to a higher tax burden as compared to the current one, with a possible impact on demand when they sell to end customers (B2C), which represents an inevitable reallocation of the global tax burden, which is expected not to be increased in general. It would be essential to ensure that, with all the other gains arising from the Reform, this redistribution of burden is beneficial for everyone.

Topics that require attention and improvement by Complementary Law

The EC still needs to provide more effective responses regarding sensitive topics, which is expected to be addressed by the pending Complementary Laws, such as the treatment to be given to ICMS credit balances, ensuring faster reimbursement that mitigates relevant financial losses incurred by taxpayers, mainly exporters in general.

In particular, the lack of definition of goods and services “harmful to health and the environment” for the application of the Selective Tax (IS) deserves attention from the legislator. Imprecise concepts can result in legal uncertainty and economic irrationality. It must be avoided that such a tax, which would serve extra fiscal policy purposes, becomes solely a collection mechanism.

Another element of concern is the process of defining the reference rate for new taxes created, especially after the impact of concessions made reducing rates and providing beneficial regimes for CBS and IBS. To maintain the intended collection neutrality, the rates of reference for non-favored regions, sectors, or products tend to be higher. Also noteworthy is the inclusion of a forecast so that States can create a new contribution by 2043.



What should companies focus on?

The impact of the new tax system on each business will vary by business segment and by the location of each link of the chain within Brazil, requiring strategic and operational repositioning that considers various elements, such as:

- the gradual loss of tax incentives against gains in logistical and operational efficiency resulting from the relocation of operations;
- changes in sales prices or supply costs;
- reduction of working capital investment in multi-location inventories;
- reduction of freight costs and transport flows;
- synergy gains resulting from the integration of operations and reduction of legal entities within the same economic group.

It is necessary to anticipate the economic impacts, macro and micro, by segment and market of activity, considering the effect of changes to the competitive environment and newcomers, considering the impact on the new effective rates on consumer demand, among other factors that may substantially affect the return of the investments.

The strategic analysis begins now, and should be revisited when Complementary and Ordinary Laws are enacted – however, macro trends of operational transformation can already be identified, and strategic decisions can already be made. The faster, more strategic and holistic these analyzes and decisions are, the greater could be the (tax and non-tax) efficiency gains achievable, and the lower could be the impacts of appreciation (or unavailability) of real estate and workforce in the event of relocation, for instance.

In this scenario, from now on the Reform must be seen as a disruptive element in the context of the organization's' strategy, which due to its complexity, scope and relevance, must remain present on the agenda of the Boards and C-Level over the next years.

The Reform must be considered as a great opportunity to gain competitive advantage in domestic and external environments, which tends to be achieved through a holistic approach to managing risks turning it into opportunities, supported by technology and predictive data analysis to be converted into value for your business.



To better understand how these changes will impact your business, talk to PwC

Paula Romano
paula.romano@pwc.com

Dante Stopiglia
dante.stopiglia@pwc.com

Romero Tavares
romero.tavares@pwc.com

Hadler Martines
hadler.martines@pwc.com

Marcelo Vieira
marcelo.vieira@pwc.com

Audrei Okada
audrei.okada@pwc.com

Durval Portela
PwC Brazil Tax Leader
durval.portela@pwc.com

The content of this material is intended for general informational purposes only, does not constitute an opinion, endorsement or interpretation by PwC, and cannot be used as, or in lieu of, formal consultation with a qualified professional.

The information contained herein should always be used in conjunction with guidance of tax consultants for the specific case of your company. Referring to the material reported herein requires regular checks for any subsequent changes made thereto, including in the legislation. The topics covered in this newsletter are presented as a summary. All copyrights reserved to PwC. Reproduction is allowed as long as the source is cited.

© 2023 PricewaterhouseCoopers Brasil Ltda. All rights reserved. In this document, "PwC" refers to PricewaterhouseCoopers Brasil Ltda., which is a member firm of the PricewaterhouseCoopers network, or, as the context may suggest, the network itself. Each member of the PwC network is a separate and independent legal entity. For more details about the PwC network please visit: www.pwc.com/structure



PwC Brasil



PwC Brasil



@PwCBrasil



@PwCBrasil



PwC Brasil



@PwCBrasil