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Brazilian Tax in a Context

Setting a tax strategy in a complex environment

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Introduction

Many foreign investors evaluating their opportunities at the Brazilian market place or already doing business in Brazil sometimes struggle to understand the particularities of the Brazilian tax system and relevant compliance framework and how they compare to some general tax practices adopted in other jurisdictions.

Considering such a scenario, PwC prepared this material, which does not aim to explain the entire complexity and peculiarities of the Brazilian tax system, but at demonstrating, in a summarized way and in a generic form, how the Brazilian tax collection framework is structured, bearing in mind the perspective of a foreign investor. PwC has more detailed publications, such as the **Doing Business and Investing in Brazil** and **Doing Deals in Brazil**, which represent valuable literature for foreign investors improving their knowledge of the local market place as more detailed information becomes necessary.

While providing the foreign investor with a quick general understanding of the Brazilian tax collection framework, the present material will also comment on the most significant recent changes perceived in the tax authorities' approach towards tax inspections, as well as on the compliance filings and submissions processes that the Brazilian taxpayers have become subject to, all of it underpinned by an unique digital tax compliance system managed and controlled by the tax authorities, which we suspect is currently unparalleled in the world.

It is generally known that Brazil is a country with an overly complex tax system, not only from the viewpoint of the governmental spheres with authority to create and collect taxes (Federal, State and Municipal), but especially because of the amount of existing taxes, which are far more numerous than those charged in any other jurisdiction in the developed world or in emerging countries. These circumstances place Brazil at a significant disadvantage when compared to other countries in the world, notably as it relates to the time spent to comply will all tax obligations as a whole.

Despite the above comments, it is important to point out that the initiative being carried out by governments (especially at the Federal level) around the creation of a strong digital system for tax management and control is already giving rise to positive changes in the context of local compliance, particularly in relation to tax inspection and tax collection. Such improvements are very important to place Brazil in the global arena as a territory with reduced space for illegitimate tax procedures, which are typical of an informal economy, therefore strengthening our competitiveness in relation to other countries and business partners.

The digital system in question is named SPED (a Portuguese acronym for the Public System of Digital Bookkeeping), which in a few words represents a direct real time connection between taxpayers and tax collecting entities. On one hand, the SPED system will gradually allow the reduction in time to comply with all major tax obligations, but on the other hand it represents increased transparency of the taxpayers to the tax authorities via digital reporting. In this sense, an anticipated analysis of the tax procedures adopted becomes important to avoid that the taxpayers are subject to undesired tax exposures.

In the following topics we have sought to address, in a summarized manner, the principal aspects of this new reality in the context of the Brazilian tax environment – of particular importance to foreign investors – providing useful information for those considering investment in our country.

Carlos Iacia
Tax Leader
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Brazil – a complex tax environment
Key features

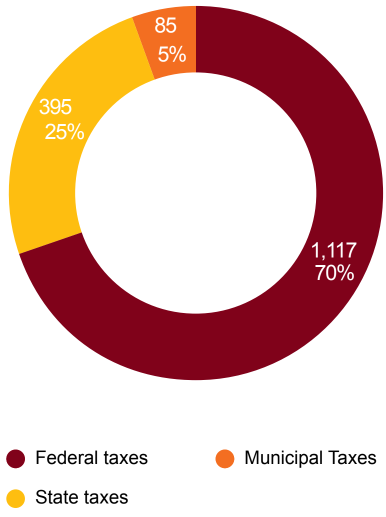
A practical way of explaining the Brazilian tax system is that its structure is quite similar in form and shape to other systems in the developed western world, such that it is sustained in a "tripod" comprising property taxes, income taxes and transaction taxes.

Nevertheless, a number of historical reasons have caused the tripod structure to have more complex features than in most other jurisdictions, such as:

- All three levels of Government (Federal Union, States and Municipalities) have the right to create their specific categories of taxes, as defined in the Brazilian Constitution;
- While most countries have one or two taxes in each group (property, income and transaction), in Brazil there are more taxes in each of these groups – the same being also true in terms of labor-related taxation;
- Brazil has far more ancillary obligations "per tax" than other jurisdictions, partially explained by local tradition going back to imperial times, and in part because of the SPED program (we will come back to the SPED program later in this material);
- Ancillary obligations were in many instances created to monitor tax collection and other performances of the Tax Administration (more specifically in the social taxation arena).

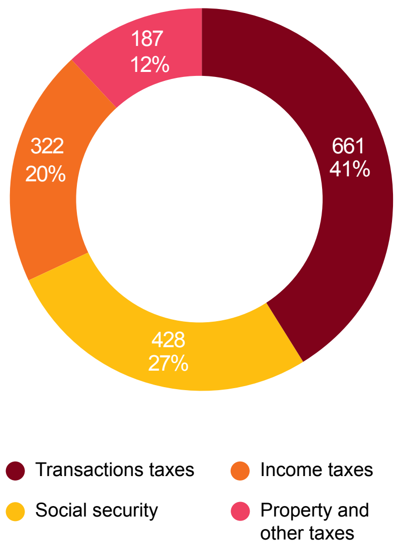
The following sheet discloses the current tax collection level, taking into account the principal taxes levied:

Total tax collections in 2012
(in millions of Reais)



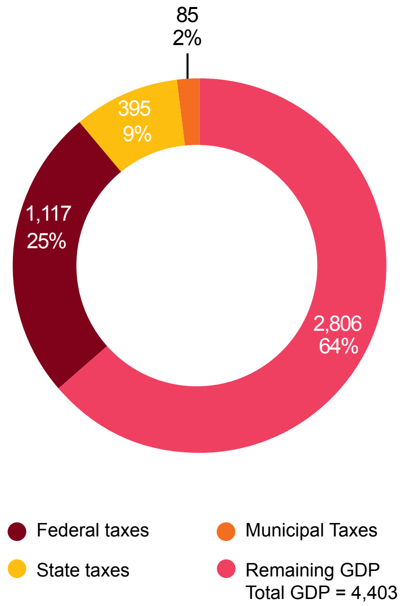
Source: The Brazilian Institute of Tax Planning – IBPT

Total tax collections in 2012, per type of tax
(in millions of Reais)



Source: The Brazilian Institute of Tax Planning – IBPT

Total tax collections in 2012 as a % of GDP
(in millions of Reais)



Source: The Brazilian Institute of Tax Planning – IBPT

As noted, collection of transaction taxes is the most representative as a proportion of other categories of Brazilian taxes, while in other jurisdictions income taxes are usually the most significant portion of tax collections. This feature of the Brazilian tax system is commonly indicated by the private sector as an element that places additional cost to their operations, in terms of management structure, multiple systems and controls, heavier documentary costs, among others.

The concentration of taxes over transactions is also cited by Brazilian taxpayers as one of the reasons why prices to end-consumers or end-users tend to be higher than in other jurisdictions with purchase power parity comparable to Brazil. Other important perceptions usually posed by economic commentators are along the lines that comprehensive tax policies (e.g. segment driven incentives, regional benefits) in such a complex environment are difficult to implement and of questionable effectiveness – this aspect is high on the Federal Government's agenda and actions towards simplification of the system and relevant ancillary obligations are continuously being evaluated.

Hot topics for a foreign investor

A common exercise carried out by foreign investors planning to do businesses in Brazil is to compare tax implications based on their experience in other jurisdictions or in their home countries with the information they collect on the Brazilian tax system. Initially, the usual reaction out of this exercise is deep concern, not only for the overwhelming number of particularities and uniqueness of the Brazilian tax-related matters, but also because of overlying financial implications such taxes provoke on the supply chain and other complications relative to start-up/ registration activities.

The multiple issues generate a greater feeling of vulnerability, resulting from the many tax variables to be factored into the businesses plan. Investment models are, therefore, influenced by mixed perceptions as to tax implications and are commonly populated with greater administrative budgets to cope with the cost of the tax functions in Brazil, which quite often jeopardize the ability to use global cost-cutting structures (e.g. shared service centers, centralized administrative groups etc.).

The following chart is an extract of data compiled by PwC Brazil[1] in a study sponsored by the World Bank, aiming at comparing the costs with the Brazilian tax functions and other tax charges between similar businesses established in various jurisdictions.

A foreign investor doing business in Brazil should consider reading through PwC-Brazil's **Doing Business and Investing in Brazil**[2], a comprehensive and updated guide with information relative to many aspects of the local business environment in general, as well as some detailed information about the Brazilian tax system, generic registrations required (particularly important for start-ups), procedures for foreign direct investment, cash repatriation, transfer pricing, tax incentives, intellectual property taxation etc.

Economy	Hours to comply	Total tax rate	Total tax payments	Overall ranking position
Brazil	2600	69.3	9	156
China	338	63.7	7	122
Russia	177	54.1	7	64
India	243	61.8	33	152
South Africa	200	33.3	9	32
UK	110	35.5	8	16
USA	175	46.7	11	69
Mexico	337	52.5	6	107
Turkey	223	41.2	15	80
Vietnam	872	34.5	32	138
Poland	286	43.8	18	114

Source: World Bank

1 http://www.pwc.com/gx/en/paying-taxes/assets/pwc-paying-taxes-2013-full-report.pdf
2 Available for download at http://www.pwc.com.br/pt/publicacoes/doing-business-in-brazil.jhtml

Special attention should be given in relation to the following aspects:

- Tax registrations (and other major registrations that may be required – Board of Commerce, Brazilian Central Bank) may take longer to be obtained and it is recommended that experienced professionals with the relevant expertise be involved.
- The principal taxes levied upon sales transactions in Brazil are as follows:
  - IPI (manufactured items; importations) – Federal;
  - ICMS (commercial transactions with merchandises in general; importations) – State;
  - PIS and COFINS (kind of turnover taxes, charged upon all kinds of revenues) – Federal;
  - ISS (services in general) – Municipal.
- Except for the ISS, the aforesaid taxes usually permit the deduction of tax credits taken on the prior acquisitions – the exceptions are numerous and require specialized case-by-case analysis.
- All the aforesaid taxes have their set of ancillary obligations, which are due on a monthly basis. In view of the number of particularities and level of detail required, ERPs are usually not capable of meeting all legal requirements, which causes companies to have specific tax application systems bolted on to their ERPs, in order to extract, compile, calculate and generate the tax data submitted monthly to the tax authorities. It is very important that foreign investors anticipate any complexities that may impact the implementation of their accounting, tax and payroll systems in Brazil – the support of experienced professionals is strongly recommended.
- Other taxes are also important in Brazil and may play a significant role, depending on the type of transactions being carried out in the country. It is therefore of critical importance that a detailed analysis of tax implications around the transactions planned to be carried out in Brazil is performed.
- Brazilian Transfer Pricing rules are substantially based on a fixed profit system, rather than on overall margins (OECD model), thus requiring a cautious analysis of intercompany prices and conditions be carried out by specialists, should intercompany sales be significant in the business model.
- Additional areas with specific tax implications also require special attention, such as thin capitalization rules, capital repatriation and capital gains, Tax Treaties, Intellectual Property taxation, tax levies applied over intercompany services and charges, labor taxes including expatriates working in Brazil, among others. Subject-matter experts should be consulted accordingly, as many of these specific areas have legislations which can be substantially different from those existing in other jurisdictions.
- Industry knowledge in a target country is core to foreign investment and in certain situations industry specific taxes/levies may also apply (e.g. oil & gas, energy, finance services, insurance, public utilities etc.).

Tax Administration – the former scenario

In this section we will discuss overarching aspects around the evolution path taken by the Federal Tax Administration (The Federal Revenues Department – RFB) as regards their practices in the areas of tax inspections, management of tax collection and general relationship with the taxpayers in Brazil. The State and Municipal Revenues Departments in general follow the same steps and adopt tax administration approaches similar to those of the RFB, although they are in earlier stages of development. Therefore, the comments herein would be only in part applicable to State and Municipal taxes and tax collections.

Tax administration – the former scenario

In a past starting not more than about 20 years ago, there was an overall perception related to the RFB's organizational and structural features which may not be seen as best practice in terms of efficiency and effectiveness, as follows:

- Numerous tax inspectors, primarily organized in geographic divisions and just a few areas of expertise (e.g. customs, IPI);
- Tax audits were substantially hand-made work with very little support in systems and technology;
- The operating model adopted lacked agility to perform tax audits and resulted in a reduced ability to detect issues and complete the assessments;
- Intelligence built up on taxpayers data was limited and perception around tax issues in industries and group of taxpayers was obtained through practical knowledge collected in tax inspections and other forms of investigation;
- Exposure to corruption (bribery) was higher;
- The system was in general more vulnerable to articulated schemes structured by taxpayers aimed at tax evasion;
- The approach towards tax evasion in informal economy was far less efficient;
- Higher internal administrative costs;
- Tax collection revenues were sometimes lost due to lack of agility in processing tax assessments and administrative procedures, caused by heavy internal procedures and lower organizational efficiency;
- Deficient capabilities in the interpretation of the most complex aspects of the tax legislation;
- Very little constructive communication with taxpayers.

Tax administration – the turnaround strategy

The former scenario demanded strong improvements in efficiency and effectiveness of the Tax Administration in general and a number of actions have been taken over the past two decades around training, building capabilities, organizational enhancement, specialization, international exchange of information, constant follow-up of data collection and tax activities of major taxpayers (the 10,000 Group) etc., which places the RFB in a totally different level in terms of efficiency. Nevertheless, no other action had a more significant impact in the RFB's capabilities than the implementation of a program named **SPED - Public System of Digital Bookkeeping**, which started in the middle of the past decade and comprises a large framework of detailed tax, commercial and operating data, organized in standard formats, which taxpayers must prepare and submit electronically to the tax authorities.

SPED submissions are mandatory on a regular basis, irrespective of any related tax inspection. Depending on the file, electronic filing must be made monthly, annually or even instantly, on a transaction-by-transaction basis (which is the case of the "Nota Fiscal Eletrônica" – NF-e – Electronic Tax Invoice).

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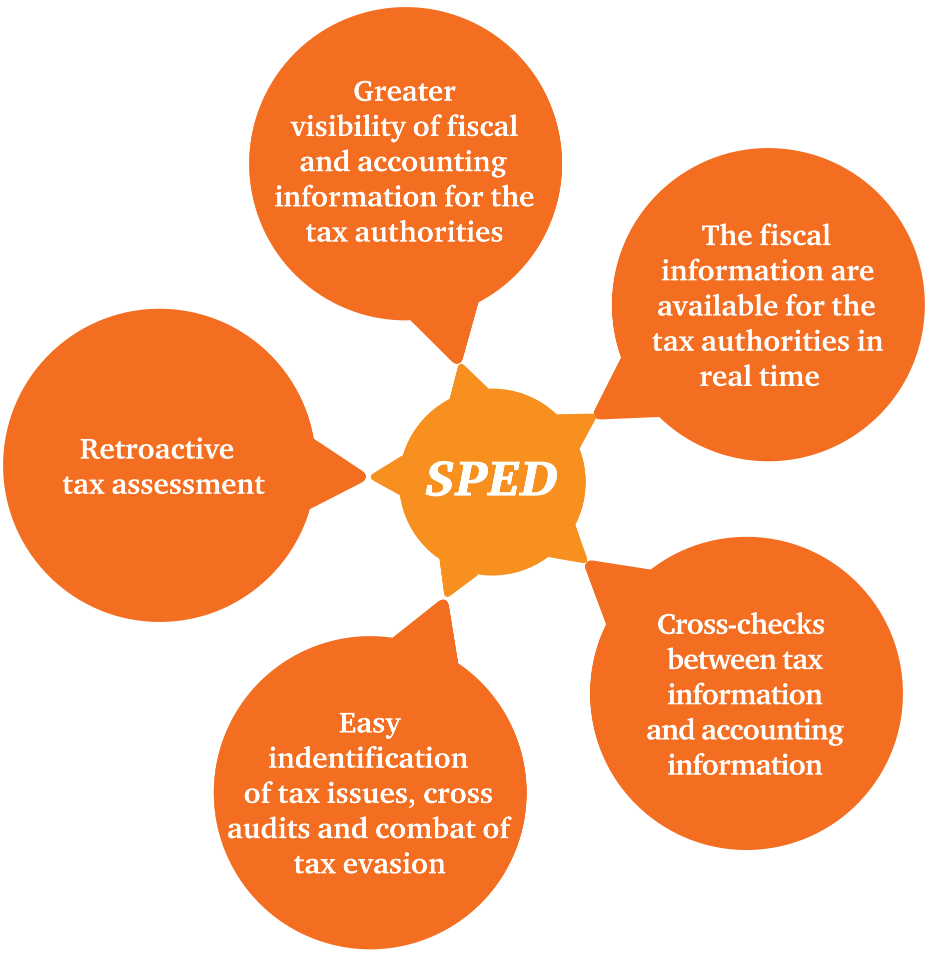
Tax Administration – the current scenario

Tax administration – the SPED initiative and other improvements

The SPED initiative comprises a set of improvements in the Tax Administration's structure, infrastructure, technology, systems and strategic approach that could certainly be taken as a case of success and benchmark by tax bodies in other jurisdictions. The following diagram provides some context of the reach of the SPED system:

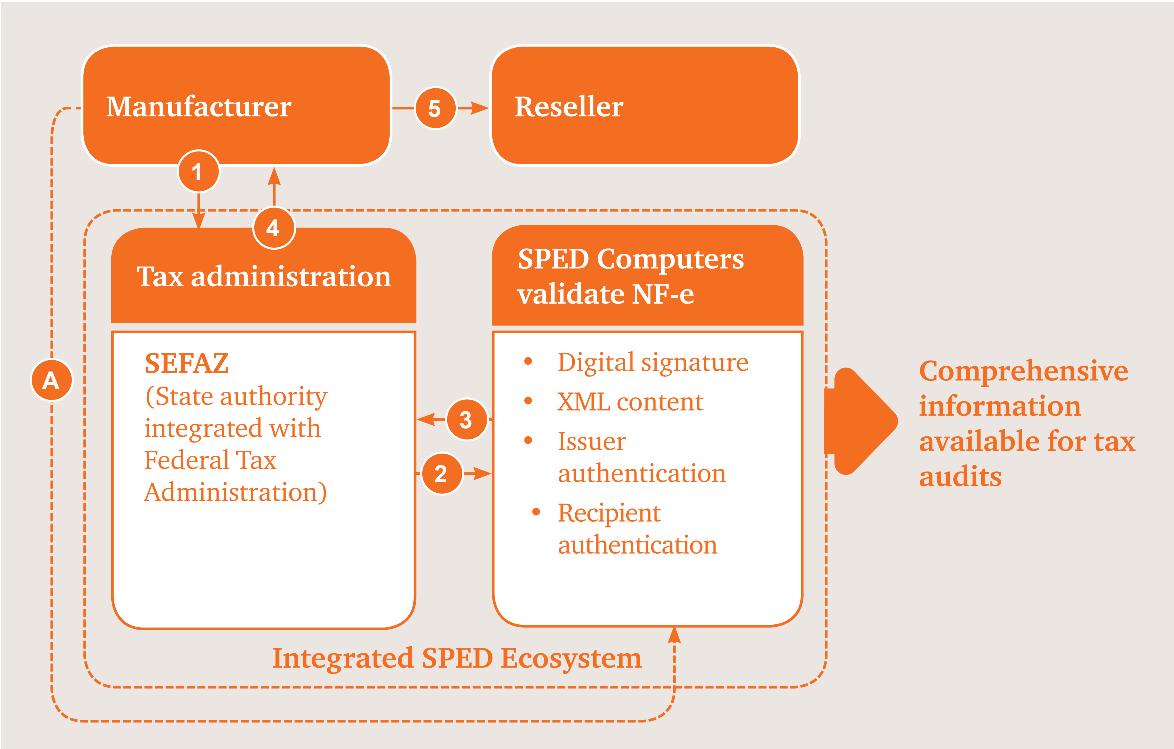


Some key transformational aspects of the SPED program encompass the following:

- RFB's heavy investment in technology and infrastructure;
- All major ancillary obligations were re-formatted into electronic files, which are submitted by taxpayers on a regular basis;
- SPED files are set out in standard layouts with detailed and comprehensive data, allowing extensive cross-check testing, including with data submissions from other taxpayers;
- Instant electronic transaction reporting (the electronic invoice or "Nota Fiscal Eletrônica" – NF-e) allows immediate access to tax data and conveys greater efficiency in preventing tax evasion all the way through the supply chain;
- A large portion of tax inspections are carried out by RFB's systems and a number of tax notifications are electronically generated and mailed to taxpayers;
- The substantial investment made in tax legislation capabilities gradually led to more robust technical grounds in the assessments, strengthening RFB's positions in tax disputes;
- Stronger data intelligence capacity and more subject-matter focused inspections have created a more efficient tax audit environment;
- Improvements in communication with taxpayers.

A quick view of the SPED communication framework

The following diagram is an example of a standard purchase-and-sale transaction subject to the generation of an Electronic Tax invoice (NF-e), with a summary of the information flows in connection with the SPED:



Legend:

1 Submission of NF-e file with all information pertaining to the transaction between the Manufacturer and the Reseller (mandatory **before** the manufactured items are even shipped).

2 Data is instantly transmitted to SPED computers for validation of the NF-e.

3 Validation of data and approval of the NF-e document.

4 Authorization for the use of the NF-e in the transaction.

5 Actual shipment and transportation of the manufactured items.

A Other SPED files submitted on monthly and annual basis, comprising all the transactions performed by the taxpayer.

Despite the progress experienced by the Tax Administration after the SPED program, the Federal Government recognized that fully complying with it could be overly burdensome to taxpayers running small sized businesses, let alone the other many complexities of the ordinary tax legislation in Brazil. Bearing in mind such circumstances, in the last two decades special tax regimes were created for certain categories of small businesses (Simples, Super Simples and others), featuring (i) lower combined tax rates, (ii) easier calculation criteria and (iii) relief from the obligation to comply with certain SPED filings which are mandatory to more sizable taxpayers. The outcome came in the form of a perceived reduction of tax evasion and informal economy, not statistically measured by official bodies.

SPED reality – looking ahead

Responses to the new challenges brought by the SPED program

The tax environment after the implementation of the SPED program triggered a number challenges to be faced by taxpayers – most of them ultimately resulting in higher compliance costs, as follows:

- Improvement and cleaning of master data files and other information stored in data banks;
- Review of processes and redefinition of controls (types, purposes and positions in the process);
- Detailed review of parameters included in ERPs;
- Implementation of dedicated systems to treat tax data and generate SPED files;
- Stronger data storage capacity.

SPED reality – looking ahead

Like in many other circumstances, a challenging scenario also comes with opportunities. In this sense, a number of taxpayers have leveraged on their experience with the SPED implementation to make improvements in the quality of their data, in processes, controls and many other elements of the tax function in general. A list of such improvements would comprise:

- Enhancement of data management and data analytics functionalities;
- Expansion of the skill set of personnel with the tax function, especially by adding capabilities on data management and analytics;
- Improvements in processes, gaining efficiencies and allowing the implementation of more effective controls;
- Update or modernization of tax applications;
- Improvements in various internal aspects of the tax function, such as workflow, documentation, back up, reporting, among others.

The SPED program is far from maturity. Still to come, other mandatory ancillary obligations are expected to be soon approved and become mandatory within the next 2-3 years, especially covering income taxes and labor-related data as well as the relevant taxation. Once again, the expectation is that such files will be as comprehensive and detailed as those already in force. Thus, even though companies' efforts to get set for the next SPED obligations should not be as much demanding as those already implemented, close attention should be paid to the SPED program schedules, so that companies can ensure they leverage on previous experiences to more efficiently complete the next rounds of SPED implementation.

It should also be expected that notifications and further inspection activities deriving from the SPED filings will increase in volume and detail year after year. For the time being, tax authorities have informally expressed their concern as to the quality of the SPED files being submitted by taxpayers – which may be holding back the expected efficiency in performing electronic audits and issuing notifications. But this should be seen as a temporary situation and companies should keep investing in continuous improvements to their SPED-related routines and files as well as leveraging on lessons learned to reduce risks and protect value through efficient tax compliance.

How PwC can help

Tax Governance		Challenges	Responses
	Content Data	Mapping all gaps between existing data and information required in the SPED files; issues resulting from poor quality of master data and data bank	Extensive expertise in all tax areas Experienced teams in SPED implementation projects Clean up (“sanitation”) of data contained in master data files and data banks Sourcing
	Content Data	Data extraction and generation of files; layout and consistency validation	Review of data extraction specification Review of files prior to submission and recommendations
	Operations	Efficient and effective SPED implementation project	Project planning PMO
	Operations	Efficiency in processes; adequate controls; adequate workflow	Review of processes and controls Best Practices Workflow design and implementation Sourcing
	Operations	Data analytics; data management	Validation of files and analysis of results Validation tools and toolkit Effectiveness of data analysis Competences analyses Change management Back up management SPED compliance platform (the “Total Tax” platform)
	Operations	Performance measurement: how to ensure workflow efficiency	KPIs Total Tax workflow dashboard Continuous improvement programs
	Quality	How to ensure SPED data quality?	Anticipation of cross-checks Simulated tax audits Review of SPED data in the supply chain Continuous improvement programs
	Quality	Performance measurement: how to measure increasing SPED data quality	KPIs Continuous improvements programs
	Srtategy	Business Intelligence	Effective rates fluctuation analysis Collections fluctuation analysis Improvement in the use of tax credits and other benefits Benchmarking
	Srtategy	Strategic insights	Solutions sets in the supply chain New business approaches

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