



## Brazil's VAT Reform

November 10, 2023 | Edition nº 24

### Constitutional Amendment Approved in the Senate

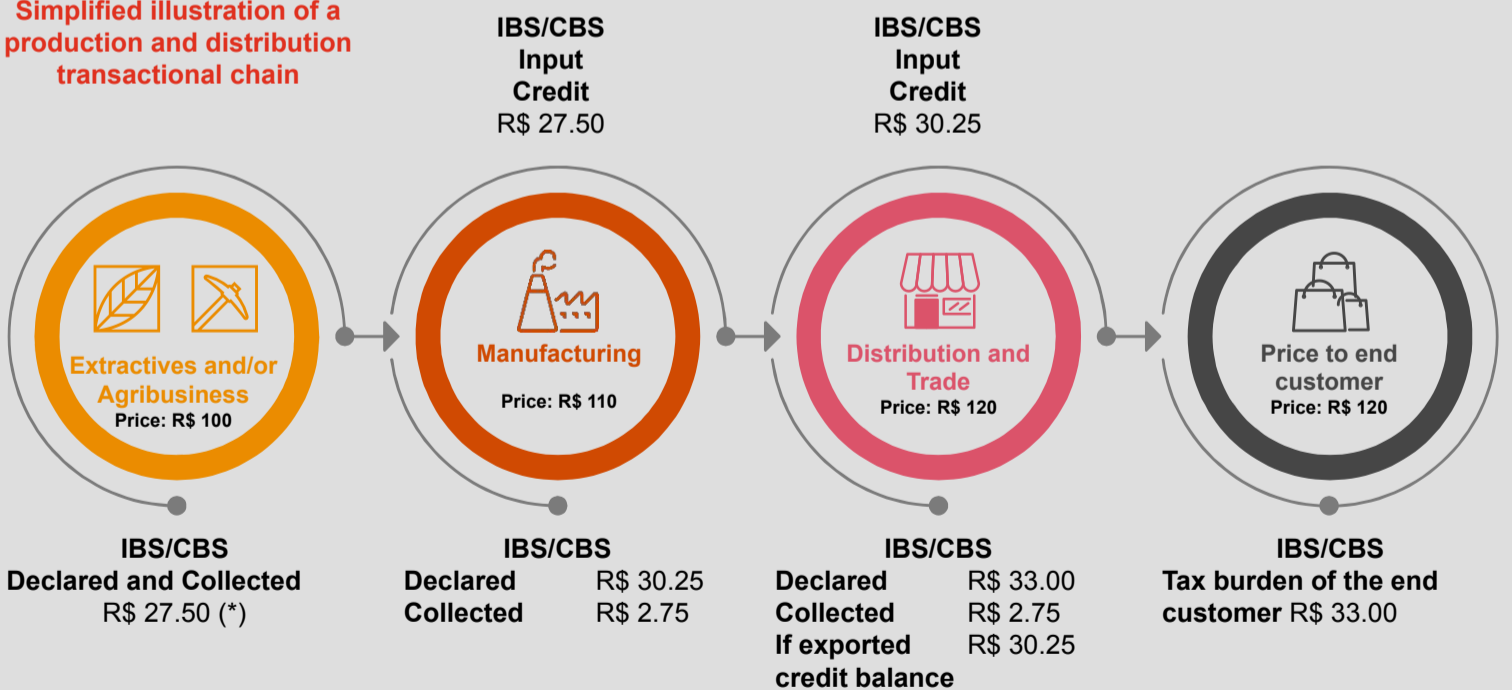
#### Brazil VAT/Excise reform overview

On November 08, 2023, Brazil's Federal Senate approved the substitute text of the Constitutional Amendment Proposal 45 of 2019 (PEC 45), which overhauls Brazil's federal, state and local consumption and transactional taxes.

Since the Senate introduced further amendments to the text originally proposed, amended and approved in the Lower House, now the PEC returns for a definitive vote at the Lower House, where it is expected to be approved and enacted yet this year. This constitutional amendment is the fundamental pillar of the broad tax reform which also requires a Law Complementary to the Constitution (LC), to be proposed in 2024 for likely enactment by 2025. This newsletter summarizes the main changes proposed.

#### The reform is based on the Value Added Tax (VAT) rationale

Simplified illustration of a production and distribution transactional chain



(\*) For ease of illustration, assumed no input taxes are paid.

The illustration considers the "general tax rate" of 27.5% which, although not formally proposed, has been publicly mentioned by the government as a potential rate needed to accommodate the multiple "special regimes" or industry-specific lower rates approved in the House and in the Senate

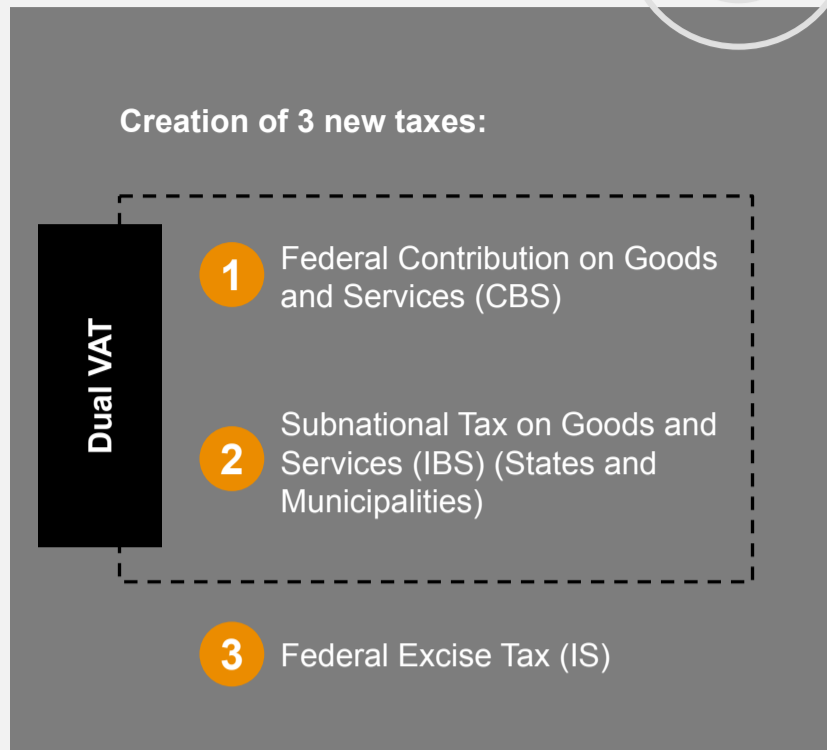
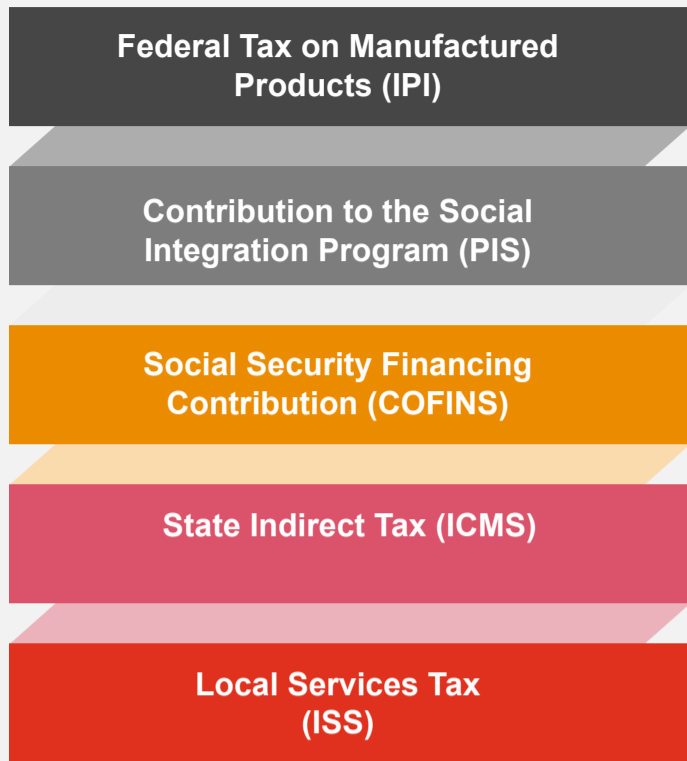
The large number of exceptions to the general rule (lower tax rates, exemptions, and special regimes that are potentially cumulative) is not as convoluted as the current system yet it remains complex.

The inclusion of the Federal Excise Tax (IS) in the IBS and CBS calculation base goes against simplicity and neutrality.

There is no deadline in the PEC for the refund of credit balances, which must be regulated by LC.

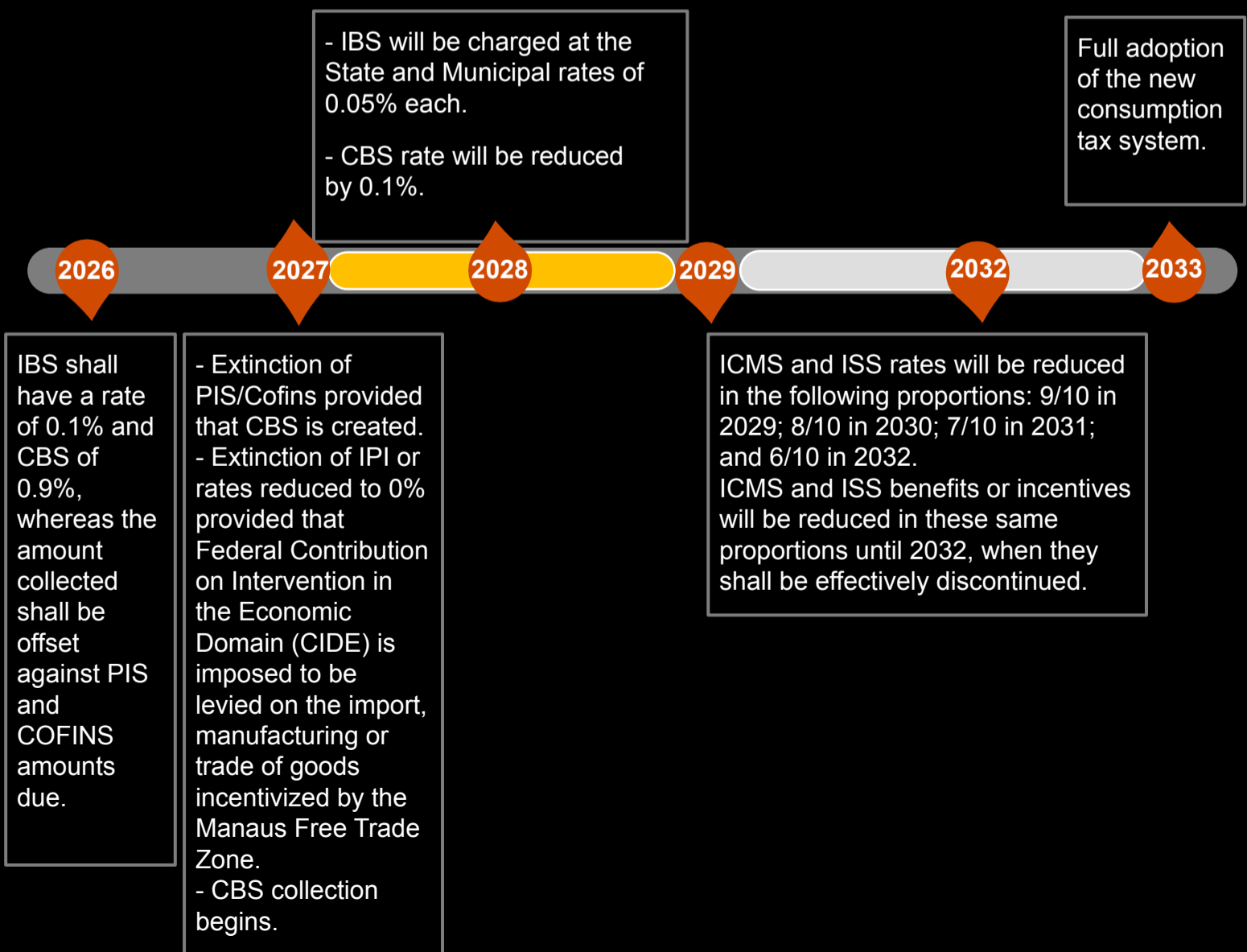
# Main changes proposed

Elimination of 5 taxes



**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 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.

LC 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 LC rate reduction for:

- Vegetables, fruit and eggs;
- Acquisition of medicines and medical devices by direct administration, autarchies and public foundations of federative entities, as well as by non-profit social assistance entities, used for their essential purposes;
- Services provided by a non-profit Scientific, Technological and Innovation Institution (ICT);
- Passenger cars, as established in LC, 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**, under the terms of the LC, 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



**Fully 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); infraconstitutional 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. Under the terms of the LC 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 Nacional;
- 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;
- the production of parts for the aforementioned vehicles.



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

LC 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.**

LC 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;
- Sanitation and highway concession services;
- Air, waterway, rail and road interstate and inter-municipal public transportation;
- Operations involving the provision of the shared structure of telecommunications services;
- Operations with microgeneration and distributed mini-generation of electrical energy, including the Electrical Energy Compensation System - SCEE;
- Goods and services that promote the circular economy aiming at sustainability in the use of natural resources.

# 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 ordinary 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 LC.

## ICMS benefits validated by LC n° 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 PEC;
- The criteria will be established in LC.



## 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

The approval of PEC 45/2019 by the Federal Senate with changes that have been negotiated by congressional leadership of both houses and with a text that is close to that approved by the Lower House, makes the long-awaited Brazil VAT Reform virtually certain. It is a historic milestone for Brazil. The latest changes to PEC 45 will be reconciled in the Lower House, but it is likely that the Reform will indeed be approved in 2023, and the country will concretely begin the reform of its very complex and anti-competitive National Tax System. The details of the new System will be regulated through a future Complementary Law (LC), to be proposed in 2024 and likely debated and approved in 2025.

Some topics that needed improvement were duly addressed in the Senate, such as having a provision expressly guaranteeing the possibility of offsetting credit balances of PIS, Cofins, and IPI with other federal taxes or reimbursement in cash. The Senate also included an express requirement for the Federal Excise Tax (IS) to be subject to the principle of annual anteriority and for IS not to be imposed on electricity and telecommunications services of any kind. Also noteworthy is the reference ceilings for the general tax burden on consumption, based on the average collection in relation to GDP over a 10-year period (2012 to 2021).

Other equally sensitive topics, however, were not covered and are still worrisome. Monetization of ICMS credit balances remains insufficient, and taxpayers remained subject to economic losses from accumulated ICMS credits. Technically, constitutional tax law should not be too extensive or detailed; however, whilst PEC 45 is extensive in some matters, it may have over-delegated too much authority to infra-constitutional law on key topics, such as the breadth and lack of definition of the IS triggering event. This can adversely affect not only the extractive industry but cause an overapplication of the levy in situations that have greater positive spillovers, that are beneficial for Brazilian society and the economy. It should be noted that, in cases where there is a reduction in the IBS and CBS rate, allowing imposition of IS on extractives may directly adversely impact some industries that use extracted natural resources essentially as inputs. Issues like this should be addressed and resolved via Complementary Law, bringing another round of sectoral discussion in the National Congress.

It is also worth highlighting the provision for States to create contributions on primary and semi-finished products, presenting an adverse and unexpected potential for an increase in the tax burden with a cumulative and opaque levy, contrary to the general expectation that the Reform should increase transparency and not result in an increase in the current general burden on Brazilian consumers.



The impact of the proposed new tax system on each business will vary by business segment, by the location of each link of the value chain within Brazil, among other factors, requiring precise economic modeling exercises with tax intelligence that take into account, for example, elements such as the gradual loss of tax incentives against gains in logistics efficiency, changes in sales prices or supply costs, reduction of working capital investment in multi-located inventories, reduction of freight costs, transport flows and carbon footprint. It is necessary to anticipate macroeconomic and microeconomic impacts by segment and market, and by taxpayer, considering the effect of changes to the competitive environment and new entrants, the impact on new effective rates on consumer demand, in addition to other factors that can substantially influence returns on investments.

The conclusion of these analyses will probably indicate, regardless of the deadline, the need to review the logistics structure of the operation, redefine procurement and pricing strategies, and readjust the structure, processes and technological systems of the tax department. There will be a possible redistribution of functions, assets, workers, capital and labor, among the States, and also between Brazil and abroad.

Companies, in the different economic sectors, must use these analyses not only to redesign their operations but to engage in the democratic debate, whether directly or through representative organizations or coalitions. The quality of the new system depends upon the proper consideration of these macro e microeconomic effects in the formulation of the Complementary Law regulating PEC 45. The necessary transformation of Brazil's tax system can be beneficial not only for Brazilians, but for the global economy. This is a time of transformation of value chains, especially in the domestic economic scenario, for which your business must be prepared.



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

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