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BRAZILIAN TAX REFORM

PEC 45 – Preliminary Draft Bill

August 2023

Background and Status

- June 22, 2023 → The working Group released a preliminary draft bill for congressional review → Delivered by the Congressman rapporteur (Aguinaldo Ribeiro) during a meeting held between the House of Representatives' Speaker (Arthur Lira) and the Governors;

- The preliminary draft bill is a convergence between (**i**) PEC 45's original text, from the House of Representatives, which proposed a more "ambitious" unification of five taxes; and (**ii**) Constitutional Amendment Bill No. 110/2019 (**PEC 110**), from the Senate;

- After intense political negotiations, on July 7, 2023, the bill was approved by the House of Representatives' plenary à Voting quorum of 382-118 in the first round and of 375-113 in the second round;

- The original draft was subject to amendments in order to conform concessions articulated by:

  - **certain sectors** (e.g., agribusiness, services providers, religious entities);

  - **States** and **Municipalities** – From which the bill faced resistance to retain autonomy (as far as possible) regarding the institution/collection of taxes in the scenario of a future unification (ahead described).

Background and Status

What comes next

- **The bill will now be sent on for the Senate's review** and submitted to the National Tax System Evaluation Working Group of the Senate Economic Affairs' Committee (CAE) for analysis;

- After evaluation by the Senate Committees, the bill will then be **reviewed in a plenary session**, being its approval contingent to a quorum of <u>three-fifths</u> of the Senators' votes (49) over two rounds;

- If the bill's text is **significantly modified**, it shall be sent back to the House of Representatives for deliberation;

What to expect

- The Senate shall perform a **more careful analysis** of the bill, as already anticipated by Congressmen for the specialized media;

- Opportunity to reconsider provisions included by the House to meet requests from specific sectors/political entities without prior debates, to the extent the bill ended up **expanding the list of goods and services subject to reduced rates**, ultimately contradicting the original sense of PEC 45.

Procedures Before the Congress

1 Proposal submitted

2 Reviewed by commissions in House of Representatives

3 Approved in the House of Representatives

4 Submitted for analysis by the National Tax System Evaluation Working Group of the Senate Economic Affairs' Committee (CAE)

5 After the committees review the bill (if requested to do so), the next step is the submittance of the text for analysis by the Senate's plenary

6

If approved in both Houses without changes, the Congress will enact the bill as a constitutional amendment

If any substantial changes are made (i.e., beyond wording), the bill must return to the House of Representatives for further review

Any changes made by one House must be subsequently approved by the other

Main Topics

Value Added Tax (IVA)

- **Dual IVA:** Broad-based and non-cumulative tax on goods and services, charged in the destination, with few tax rates and exceptions;

- Establishes (**i**) a Federal-level Goods & Services Contribution Tax (**CBS**), and (**ii**) a State and Municipal-level Goods & Services Tax (**IBS**). A **National Council** shall be responsible for setting rules on the States' and Municipalities' jurisdictions regarding the **IBS** levy. Both taxes will be regulated by a **Complementary Law** enacted by Congress;

  - **CBS** → Replaces the current Federal Social Contributions (**PIS/COFINS**);

  - **IBS** → Replaces the current State Tax on the Circulation of Goods and Services (**ICMS**) and the State Tax on Services (**ISS**)

- Creation of an Excise Tax (**IS**) in order to replace the current taxation by the Tax on Manufactured Products (**IPI**):

  - Levied on the manufacturing, import and sale of goods and services harmful to human health and to the environment (except for exports and items subject to IBS reduced rate, on which the IS shall **not** levy), to be defined by ordinary law;

Main Topics

"Full" Non-Cumulativeness

- All expenses incurred by the taxpayer for performance of the economic activity will be entitled to credit, ensuring neutrality;

- Credits allowed as to all purchases of tangible and intangible goods and services, except (**i**) those destined for personal use or consumption, pursuant to Complementary Law; and (**ii**) the cases provided by the Federal Constitution (i.e. exemption or non-levy);

Main Topics

Calculation Method

- Tax levied upon the gross amount of the goods or services (so-called '*por fora*' calculation) and **not** upon the transaction's value, understood as the final price including taxes grossed up (so-called '*por dentro*' calculation).

Tax Basis

- **Broad base:** Applies to transactions involving (**i**) tangible and intangible goods (and any respective rights linked thereto) and (**ii**) services;

- Complementary Law shall establish the concept, content and scope of the transactions involving services.

Tax Rates

- Resolution to be enacted by the **Brazilian Senate** establishing reference rates;

- Each federative entity (i.e., Union, States and Municipalities) shall set a single rate applicable to all goods and services, pursuant to the guidance established by the referred Senate Resolution.

State Contribution on Primary and Semi-Finished Products

- 'Undesirable' provision included minutes before the voting of the bill to meet a demand from States - mainly those that, historically, rely on revenues arising from specific funds to which taxpayers are subject to contribute as a counterpart for fruition of tax incentives;

- Destined to the financing of infrastructure and housing works, as a condition to the fruition of deferral, special regime or any other favored treatment regarding the ICMS;

- Contribution may continue **until 2043**.

Main Topics

Goods and Sectors Entitled to Reduced Tax Rate

- **60% reduction:** Education, health and public transportation services; medical and disabled people accessibility devices; medicines and basic healthcare menstrual products; agricultural, fishing, forestry and natural plant-based products; agricultural inputs, food for human consumption; hygiene products; national artistic, cultural, journalistic, audiovisual and sport activities; and goods and services related to national security and sovereignty, information security and cybersecurity;

- **100% reduction:** Medicines and basic healthcare menstrual products; medical and disabled people accessibility devices; vegetables, fruits and eggs; higher education services provided pursuant to the University for All Program (**PROUNI**); services linked to the Events Sector Emergency Recovery Program (**PERSE**) provided before February 28, 2027; urban recovery activities in historic areas or areas deemed critical for urban recovery and rehabilitation; and the National Staple Food Basket (‘**Cesta Básica Nacional**’), comprised by items provided by Complementary Law.

Main Topics

Immunity

- Books, religious organizations and temples, political parties and their associations, labor unions, and non-profit education and social assistance organizations (i.e., entities provided for in Section 150, VI, of the Brazilian Federal Constitution);

- Entities shall **not** be required to obtain specific certification for fruition of **CBS** immunity.

Favored Tax Regimes

- Manaus Free Trade Zone (**ZFM**) and Simples National Tax Regime current beneficial treatment **set to be continued**;

- ZFM provisions amended, as a concession to Amazonas State bench:
  - Mechanisms aiming at ensuring the competitiveness of the region shall be established by law;
  - Creation of a Fund for Economic Sustainability and Diversification in Amazonas State, funded by the Federal Union, in order to ensure the favored tax treatment to the transactions in the ZFM;
  - Inclusion of an explicit provision ensuring the maintenance of the benefits as to all Free Trade Areas.

Main Topics

Presumed Credit

- Granted to acquisitions of (**i**) goods and services from farmers/producers that are not CBS taxpayers; (**ii**) services from independent transport providers that are not CBS taxpayers; and (**iii**) materials intended for recycling.

Cashback

- Designed to return part of the tax collected to low-income families, towards the reduction of income inequality;
- Complementary Law shall establish the situations in which individuals are eligible to a tax refund, including its limits and beneficiaries

Taxation of Digital Platforms

- IBS and CBS levies indistinctly upon imported tangible or intangible goods (including any respective rights linked thereto) and upon services provided by individuals and legal entities, even if they do not regularly pay these taxes (i.e. not engaged in a business activity).

Main Topics

Specific Tax Regimes

- **Oil and gas:** Subject to monophasic taxation levied at a uniform rate (which may be specific, per unit of measurement, and differ according to the product);
- **Financial, hotel and regional aviation services, real estate transactions, healthcare plans, amusement/theme parks, restaurants, cooperative societies, and lotteries:** Entitled to specific tax rates, tax credits and tax basis, to the extent taxation is based on the revenue/billing (as opposed to a value-added amount);
- **Transactions involving Brazil's direct and indirect public administration:** IBS and CBS non-levy allowed, ensured the maintenance of the tax credits arising from those transactions.

Special Customs Regimes

- The Draft Bill does not encompass the incentives of special customs regimes but it has a general delegation of its regulation to the complementary law.

National Council

- Composed by the Brazilian States, Municipalities and the Federal District;
- Provisions regarding the structure/composition and voting rules amended to meet demands from States and Municipalities;
- Highest authority body as to deliberation and budgeting issues, where a general assembly shall be established;
- **Attributions:** Issuance of guidance/infralegal rules regarding the IBS; standardization of the interpretation/application of the tax legislation; collection of taxes; refund of tax credits; distribution of the proceeds arising from the taxes collected; and conduction of administrative litigations.

Main Topics

Tax Benefit Compensation Fund

- Designed to compensate taxpayers for the termination of current incentives (granted under specific conditions and for a certain term);
- Funded by a **BRL 160 billion** contribution by the Federal Union, the fund will remain active until **December 31, 2032**, date originally set for termination of all tax incentives.

Regional Development Fund (FDR)

- Destined for the States and Municipalities destined for infrastructure, productive activities, and scientific and technological development;
- Designed to reduce regional and social inequalities and encourage business in low-developed areas potentially impacted by the reduction of the tax collection, prioritizing environmentally sustainable projects;
- Initial contribution of **BRL 8 billion** to the fund in 2029, reaching **BRL 4 billion** from 2033 on;
- Funded by the Federal Union, although the States shall decide on the application of the resources.

Main Topics

IBS and CBS credit refunds

- Method and timeframes to be determined via Complementary Law;
  - Important aspect, to the extent the interpretation of the current rules governing the **ICMS and PIS/COFINS credit appropriation** are responsible for a considerable number of ongoing **litigations**.

State-level sales tax (ICMS) credit balance refunds

- Until January 1, 2032 → Credits can only be offset against **remaining ICMS installments**;
- As of January 1, 2032 → The remaining credit balance **must be approved by the States/Federal District** for purposes of enabling offsetting with the IBS;
- Credits related to permanent current assets will follow a 1/48 per month appropriation system;
- In other cases, the credits will be compensated in 240 equal, consecutive monthly installments;
- As of 2033 → Credit balances will be updated pursuant to the National Consumer Price Index (**IPCA-E**);
- Complementary Law will regulate the credit **transfers to third parties** and **refunds as to any remaining balances**.

Main Topics

Transition Framework

- The transition period from the current to the new tax system shall take place **over 7 (seven) years** – faster regarding the extinction of **PIS/COFINS** and **IPI** and gradual as to **ICMS** and **ISS** – as follows:

  - **2026**: 0.9% CBS and 0.1% IBS tax rates offsetable against PIS/COFINS;

  - **2027**: Implementation of CBS, extinction of PIS/COFINS, and IPI rates reduced to zero (except for ZFM);

  - **2029 to 2032**: Proportional implementation/increase of IBS levy and proportional extinction of ICMS and ISS levy;

  - **2033**: End of the transition period, the new system takes full effect.

Takeaways

Despite covering many widely debated principles, the preliminary draft bill leaves several aspects subject to regulation by Complementary Law

Desired Effects

- **End of the Tax War** – The strategy historically adopted by the States, or reducing taxes aiming the attraction of business to its jurisdiction will no longer be feasible in view of the destination-based method provided by the bill;

- **Economic Growth** – The unification of the current taxes in a broad-based dual IVA, with few tax rates and exceptions and full non-cumulativeness simplifies the system, thereby eliminating costs for companies;

- **Tax Burden on Exports Relieved** – The tax relief on the tax burden upon foreign sales maintained, to the extent the tax is only assessed upon consumption (of the good or service). On the other hand, imports will be taxed equally to national products;

- **Legal Safety** – Considering the elimination of differential tax treatment applied to products and services, several controversies that nowadays give rise to litigations between taxpayers and tax authorities are likely to cease;

- **Transparency** – Consumers shall be aware of the amount of taxes levied on each product or service, as a result of the '*por fora*' calculation method;

- **Reduction of Social Inequalities** - Fairer taxation model, where goods and services are taxed equally, with a consequent reduction of the tax burden currently borne by the poorest, to the extent low-income families end up committing a significant portion of their income in taxes levied upon consumption.

Transition to the new model

2026

0.9% **CBS** and
0.1% **IBS** tax rates
offsetable against
PIS/COFINS

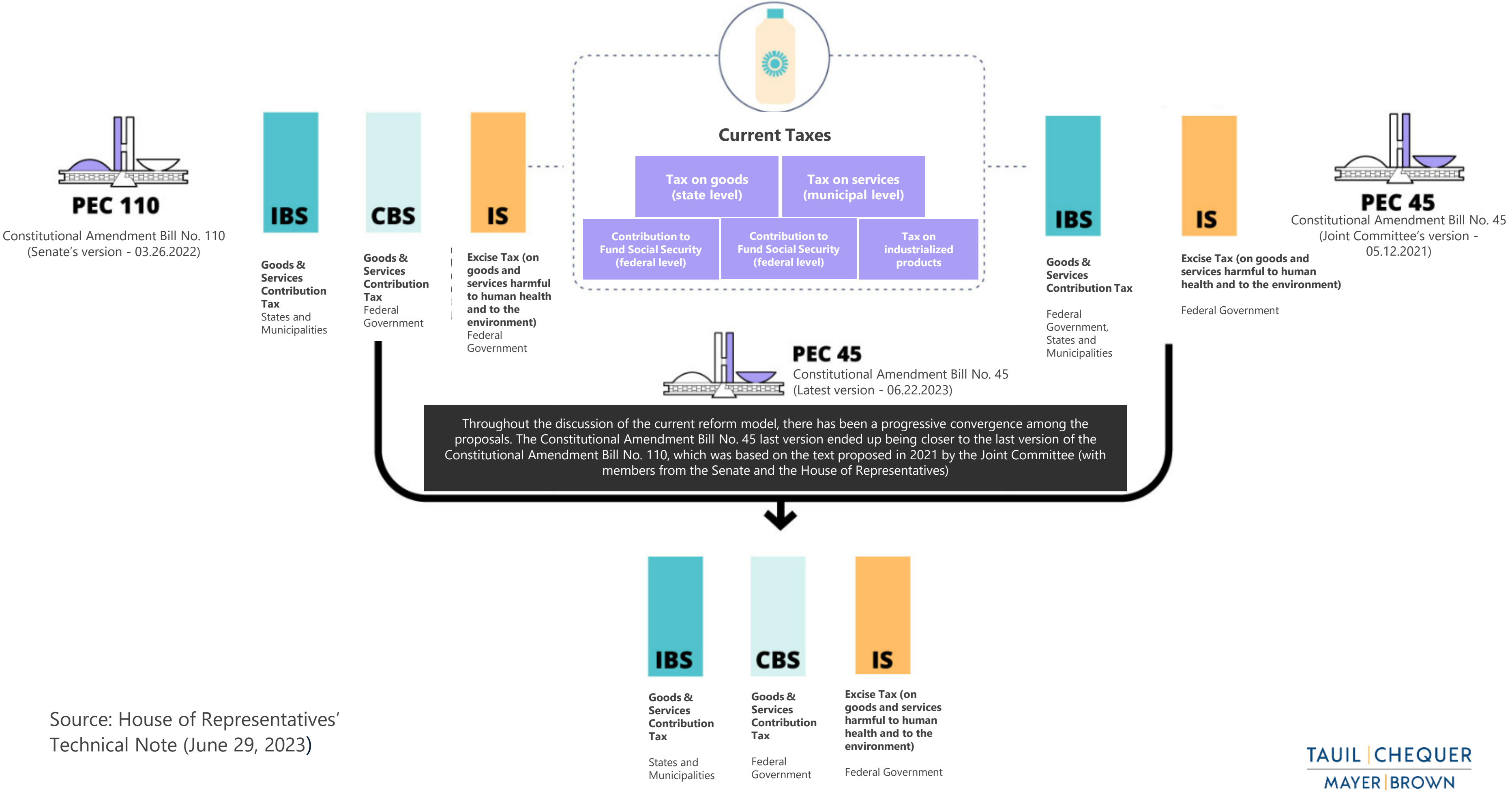
2027

Implementation of **CBS**
Extinction of **PIS/COFINS**
IPI rates reduced to zero
(except for ZFM)

2029/2032

Proportional
implementation/increase of
IBS Proportional extinction of
ICMS and **ISS**
Full validity of the new model in 2033

*7-year transition period, faster regarding PIS/COFINS
and gradual as to ICMS and ISS



Source: House of Representatives' Technical Note (June 29, 2023)

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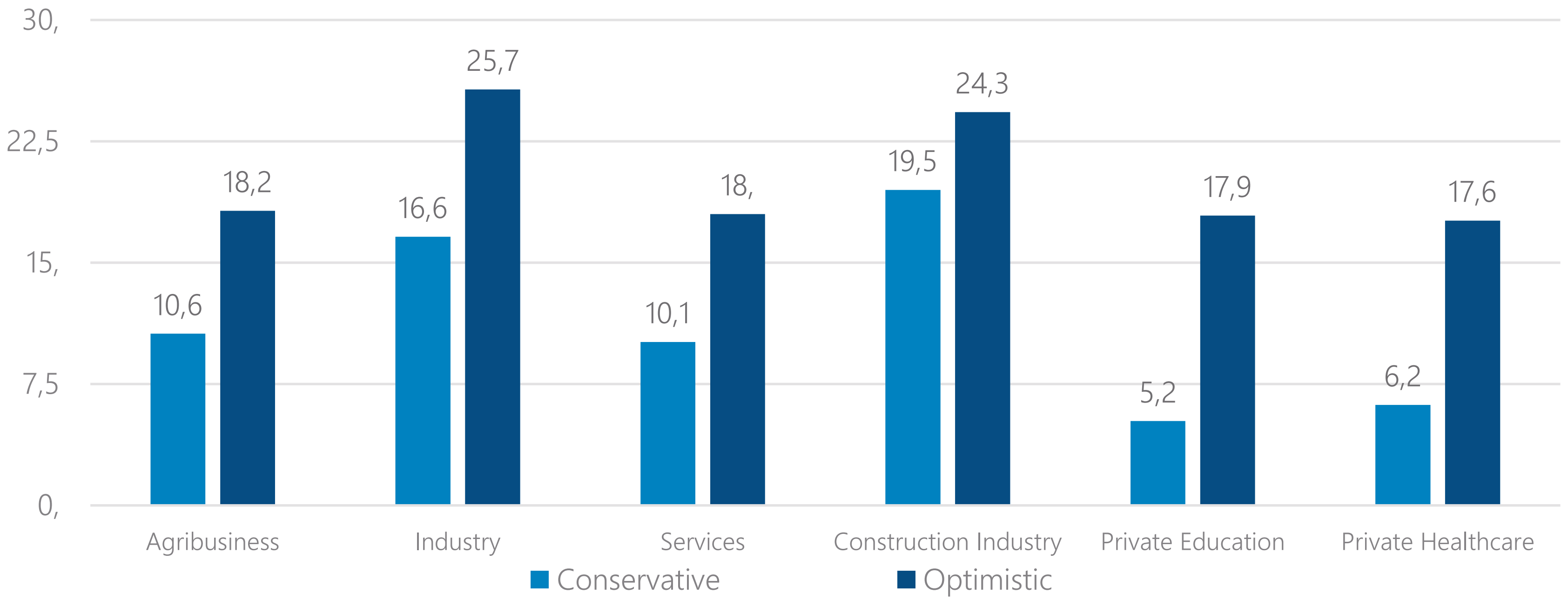
Reform's Impact on Sectorial GDP



Source: Brazilian Treasury Office. Data corresponding to the impact in 15 years.

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