Brazilian Tax Reform

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Technology and data analytics required in order to allow companies to operate successfully under two parallel tax systems

Organizations will need to assess aspects such as price formation and better understand the repercussions of potential variation in tax burden, in addition to training professionals in the use of technologies such as artificial intelligence to take advantage of existing opportunities under both systems during the upcoming period of tax reform

With the proposed **tax reform**, which is expected to be enacted this week, being approved by the Brazilian House of Representatives, companies will need to act in order to comply with the two different tax systems that will be in effect during the long period of transition that lies ahead. They will also have to quickly assimilate the rules existing under the new taxation model in a profound manner in order to assess, for example, whether changes should be made to business-related aspects, such as the final price of products and services, in addition to changes in the production and logistics chains.

“As organizations learn to co-exist with two different tax systems, they need to measure the corresponding effects on transactions, strategic repositioning within the value chain, as well as existing technological and technical capacity in order to respond to emerging opportunities and the issue of tax compliance in an appropriate manner," Waine Peron, EY Brazil's lead tax partner, affirmed. "Many companies are already experiencing difficulties in planning out their strategy and delivering all primary and ancillary obligations under a single system. The need to adopt to two different tax systems poses an even greater challenge given the urgent need to train those involved in such efforts. Such individuals will need to generate intelligence through the interpretation of data so that companies are able to take full advantage of both systems”.

With the increasing volume of tax-related obligations among organizations under these two parallel systems, companies, according to Mr. Peron, should seek to automate processes as much as possible through the use of connectors, accelerators, and technological enablers in order to efficiently implement taxation processes. "The role played by tax departments in defining corporate strategies will necessarily involve the effective use of artificial intelligence tools. In order for tax professionals to be able to focus on insights generated by AI, there is a current movement towards outsourcing tax-related activities that do not involve both strategic elements and the calculation of taxes and preparation of tax returns. Companies will otherwise have to deal with a huge amount of tax-related activities, which, will effectively be doubled during the upcoming transition period".

Under the recent tax reform, three federal taxes (PIS, COFINS, and IPI (tax on manufactured goods)), one state tax (ICMS) and one municipal tax (ISS) will be replaced by two new taxes: IBS (Goods and Services Tax) and CBS (Contribution on Goods and Services). IBS will be replacing ICMS (tax on the circulation of goods, transportation and communication services) and ISS (services tax). CBS, on the other hand, will bring together contributions previously made under PIS (Social Integration Program) and COFINS (Contribution to Social Security Financing). A Selective Tax, which will be governed at the federal level and levied on goods and services that pose a risk to public health and the environment, will also be established under the reform.

The new IBS and CBS taxes will be constituted under the VAT (Value Added Tax) model used in several countries outside Brazil and be based on the premise of a full non-cumulative system. Under this model, amounts owed under the previous stages of the production chain may be offset. A seven-year transition period will be provided for full implementation of these new modifications, which will begin in 2026 and end in 2032. "Dual VAT, through the IBS and CBS taxes, will seek to neutralize tax residues (term used in Brazil to refer to taxes accumulating within the production chain during exportation processes and not offset) formed as the result a ripple effect and offer increased transparency in relation to today's model since it is calculated without what is known as gross up, thereby allowing consumers and companies to better understand how much they are paying in taxes," Mr. Peron continued.

Tax benefits

The gradual removal of [tax incentives], which will be rendered extinct in 2033, will lead organizations to rethink their business models, including positioning of the production chain and the logistics network.

"Many companies are seated in areas subject to increased logistics costs that were previously offset by tax benefits. When these incentives are no longer available, logistics costs will weigh more heavily on operation, forcing the company to rethink its operating model," Phelippe Grande, indirect tax partner at EY Brazil, explained. According to the executive, this may lead companies to choose to position themselves closer to their consumer market, moving distribution centers or points of sale to other states, since the operational sites located at a distance will no longer be attractive due to a lack of available tax incentives.

"It is also necessary to account for digital environments that will increasingly be adopted across a range of industries in order to generate business opportunities. Under Brazil's tax reform, the definition of taxation will necessarily involve the destination and not the point of origin, which is why it will be necessary that strategic analyses take this factor into consideration, including by analyzing the implications of such changes in relation to online sales," Mr. Grande continued.

Price formation

The new tax system, including the upcoming transition period, will affect companies' bottom line, regardless of their respective industry. In Mr. Peron's assessment, it is necessary to better understanding the resulting tax burden to determine the true impacts of the new dual VAT model. "Price formation is part of this process. It is therefore important to understand how potential variations in tax burden will impact the relative prices of inputs or raw materials and companies' lists of products and services. In this context, organizations will need to study the manner in which the upcoming tax reform impacts the formation of prices and adopted margins," Mr. Peron continued.

It will also be necessary to verify the collateral effects associated with these new price formations, particularly with regards to import and export, that will be generated in transfer prices. Beginning in 2024, **new transfer pricing rules aligned with those** published by the OECD (Organization for Economic Cooperation and Development) will become mandatory in Brazil.

Accumulated credits

Another urgent action that must be taken by companies involves preparing a plan for the monetization of accumulated credits. This plan ranges from the use of the instruments provided for under legislation, requesting reimbursement through all possible means, including through corporate restructuring or strategic logistics, to the formation of a joint venture with suppliers/customers in order to bring organizations that owe these taxes together, thereby fostering symmetry in business activities that will allow existing credit balances to be monetized.

"This topic needs to be included in **the C-Level agenda** in order to turn these credits into cash as soon as possible. It is important to remember that, beginning in 2033, ICMS, PIS, and COFINS will no longer exist in Brazil, and companies will run the risk, if they do not immediately take action, of facing difficulties in obtaining these credits, since they will need to request that the government provide reimbursements, which in turn involves a significant level of uncertainty regarding how this process will work," Rogério Gomes, associate tax partner at EY Brazil, noted.

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