Brazilian Tax Reform

Overview & Future Perspectives

December 2023

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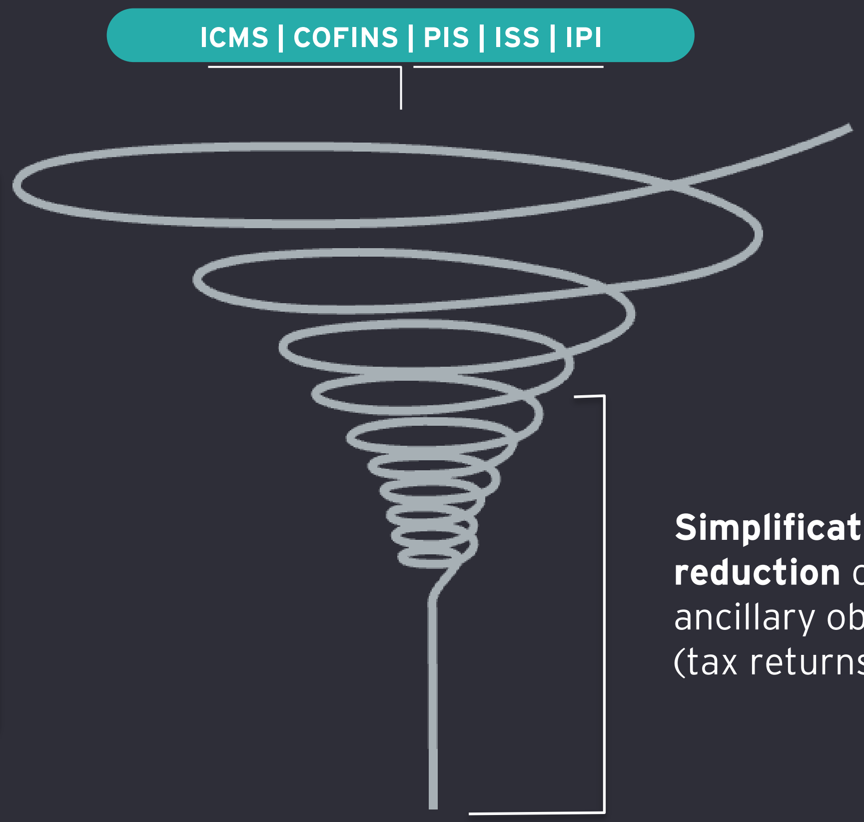
General Considerations

Proposed Tax Model (Dual IVA)

Notoriously ranked as one of the most complex tax systems in the world, Brazil's legislative framework for indirect taxes is poised for significant alterations, with the Tax Reform having been enacted on December 20, 2023.

Although one of the Reform's aims is to simplify the Brazilian tax system, the approved text encompasses provisions that could perpetuate existing complexities.

In accordance with the approved text of PEC 45/19, promulgated as Constitutional Amendment No. 132/23, the new tax model will operate in the following way:



** The IPI will continue to be the tool for maintaining the competitiveness of the Manaus Free Trade Zone (ZFM).*

Main Amendments to the Indirect Tax Framework

Current system:

Five Taxes, Multiple Rules

PIS, COFINS, ICMS, ISS, and IPI. A multitude of laws and regulations (Federal Government, 27 States, and 5,000 municipalities). Each entity has its own rules regarding the same taxes.

Countless Possible Rates

Rates can vary based on various factors, for example: origin, destination, location, type of good or service, involved parties, and nature of the operation.

High Complexity in Calculation

Multiple methods for determining the tax payable (eg. gross-up used for ICMS). There are also rules for collection at the operation's destination location, in addition to different guides and ancillary obligations.

Credit Limitations and Tax Residues

Diverse tax regimes and limitations on credit, even within the "non-cumulative" system, create distortions and tax residues.

New Tax system[1]:

IBS, CBS, IS, State Contributions, and IPI-ZFM

Unified legislation, allowing for federal entities to define only their general incidence rates. There is also a forecast for the creation of a state contribution[2] until 2043 and the provision of the IPI as a permanent tool to maintain the competitiveness of the ZFM.

Few Rate Variations

There will be established: a general rate, rates reduced by 30%, 60%, and 100%, as well as a cap on the maximum rate based on GDP. In a recent IPEA study, the unified general rate could reach up to 28.5%, while Federal Government estimates range between 25.45% and 27.5%[3].

Simplification and the principle of destination

The calculation basis for IBS and CBS will be the same, with a regular value added tax method of calculation, owed to the destination. Simplification of ancillary obligations and collections is also expected, topics which are awaiting regulation by complementary law.

Non-cumulativity

Specific and differentiated regimes only for goods and services indicated in the Federal Constitution. The general regime with a wide credit base, only prohibits credits on "personal use" acquisitions, mitigating the incidence of tax residues.

1. According to the Bill (PEC 45) published on 15th of Dec, 2023, available at camara.leg.br 2. Applicable for primary and semi-finished products, in replacement of the contribution to the State funds. 3. Technical Note - Ministry of Treasure, Aug 8, 2023: fazenda.gov.br. The estimates were not updated after the approval of PEC 45 by the Senate on 8th Nov, 2023.

Main Amendments to the Indirect Tax Framework

Current system:

Tax Benefits

Several types of tax benefits competing for what we call " the fiscal war" among the states. Social politics and regional development are controlled through tax reduction/exemption.

Accumulation of credits and refunds

VAT accumulated credits recovery has limitations, and in many cases is only mitigated with tax planning or special regimes. The credits refund is slow and bureaucratic in federal and most state governments.

Effective tax burden and tax litigation

Distortions, tax residues, gross-up method and different tax treatment among taxpayers, goods and services, complicates the exact determination of the tax burden.

New Tax system:

Essentiality and cashback

Less tax benefits. Exceptions are for the Manaus Free Trade Zone, SIMPLES regime, public acquisitions (medicines) and goods/services/activities indicated by the amendment (basic food, health, education, etc.). Creation of FNDR[5] and cashback of taxes paid by the underprivileged population.

Tax management and assurance

The refund will be granted by the newly created IBS Comitee[6] whose duty is to collect and manage the revenue collection, without a connection to the Treasury, speeding up the refund process.

Transparency and legal certainty

It is expected that the new calculation methodology, reduction of tax benefits, and uniformity of rates will result in greater transparency, allowing the identification of the actual value of taxes paid by the taxpayer and promoting tax neutrality in business environments.

Federal Transition (applicable to governments): 50 Years due to the significative impact in the tax revenue composition of the States.

ICMS Tax and Financial Benefits Offsetting Fund: Will receive contributions from the Union from 2025 and aims to compensate until 2032 the companies benefited from tax incentives under conditions and by a determined deadline. It will be required to comply with conditions and follow criteria to be determined by Complementary Law.

National Fund of Regional Development (FNDR) : Replacing the regional tax incentives, aims to gather resources to reduce reginal inequalities, promote development, generate new jobs and bring revenue to less developed regions.

Accumulated Credits: After the transition period, the remaining ICMS (state VAT) balance will be updated by the inflation and can be offset with IBS in monthly installments up to 240 months. The new law will determine the rules for these offsetting, for the transfers to third parties or refund of the credit's balances.

5. National Fund of Regional Development for offsetting due to the end of "the fiscal war". 6. Federal Council of Tax on goods and services.

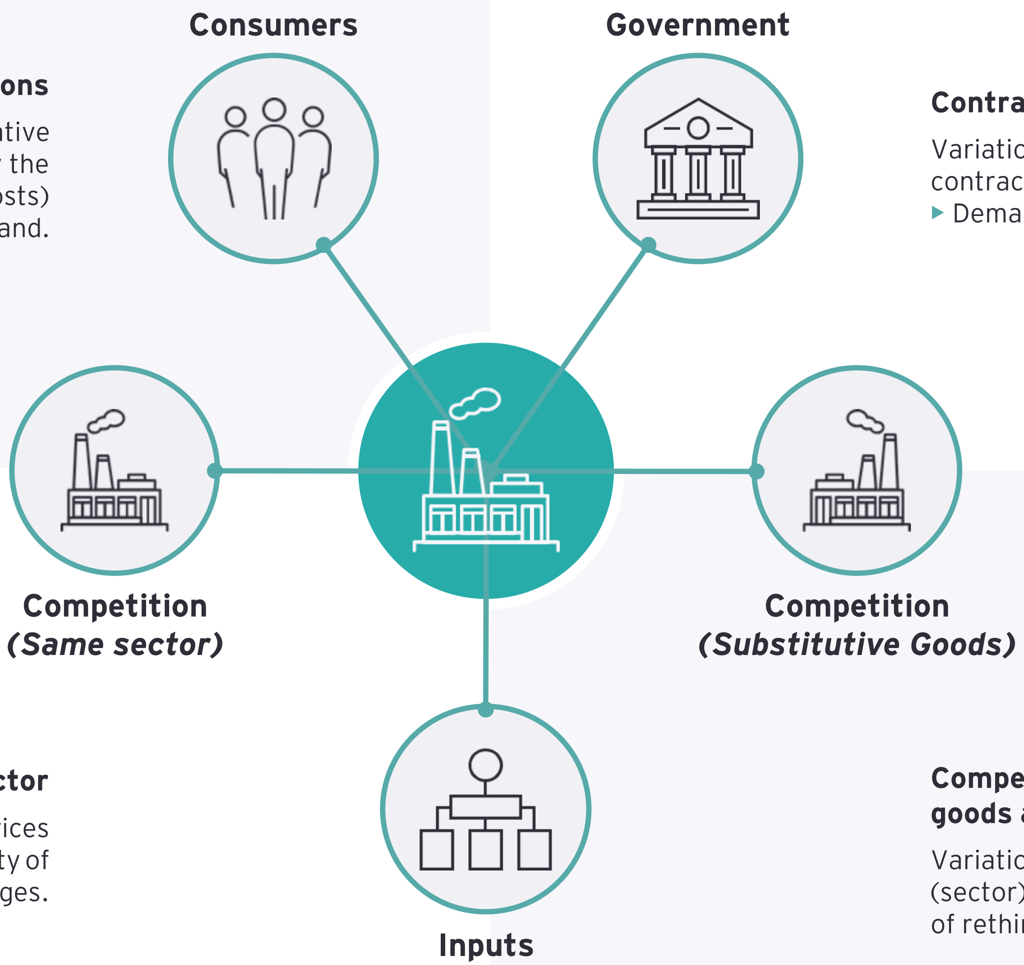
Transition Period

	2026 (a)	2027 (b)	2028	2029 (c)	2030	2031	2032	2033
ICMS	No Changes			Reduced to 90%	Reduced to 80%	Reduced to 70%	Reduced to 60%	Extinction
ISS	No Changes			Reduced to 90%	Reduced to 80%	Reduced to 70%	Reduced to 60%	Extinction
IPI	No Changes	Zero rate + IPI ZFM	IPI ZFM					
PIS	No Changes	Extinction						
COFINS	No Changes	Extinction						
IBS	0,1%			Rate to be determined by TCU* and Senate				
IS		Rate to be determined by TCU* and Senate						
CBS	0,9%	Rate to be determined by TCU* and Senate						

(a) In 2026, the amount collected of IBS and CBS can be deducted from the amount of PIS and COFINS due. If there is no tax due, it can be offset with other federal taxes or refund in up to 60 days. *(b)* In 2027, the 0,1% IBS rate shall be subtracted from the CBS rate to be defined by the Federal Court of Accounts (TCU) and the Senate. At the same time, IPI rates will drop to 0%, with the exception for products which have similar ones manufactured at the Free Economic Zone of Manaus (ZFM) aiming at keeping ZFM differentiated; *(c)* From 2029, the progressive reduction will be also applied to the tax benefits related to ICMS.

Market Relations

What are the expectations considering the Tax Reform?



Regular operations

Variations on tax burden ▸ Variation of relative prices between goods and services provided by the same company (inputs and other costs) ▸ Changing of consumer's demand.

Contracts with Government Institutions

Variations on tax burden ▸ Renegotiation of contracts and tax benefits ▸ Shock on tax collection ▸ Demand for public services and assistance.

Competition between companies of the same sector

Variations on tax burden ▸ Variation of relative prices (clients) ▸ Innovation on goods and services ▸ Necessity of rethinking competitive drawbacks and advantages.

Competition between companies of substitutive goods and services

Variations on tax burden ▸ Variation of relative prices (sector) ▸ Innovation on goods and services ▸ Necessity of rethinking competitive drawbacks and advantages.

Model of taxation IVA

Anticipating impacts, transition and opportunities for the future

1

Study of Impacts and Tax modeling:

Tax benefits and tax burden variations

For the proper assessment of the impacts that the tax reform will trigger, Companies should properly understand the current tax burden. Furthermore, those impacts are surely to affect current tax benefits, which is why it is very important to anticipate the analysis of the reduction and later extinction of those benefits through tax modeling that includes an assessment on the future tax calculations under various envisaged scenarios.

2

Accumulated tax credits:

Monetization planning

The accumulated tax credits of the current tax model should be monetized during the transition period, considering that the new model will likely have additional rules and limitations. In this situation, it is important to have a monetization plan, using tax planning encompassed with the validation and official approval of tax credits by the tax authorities.

3

Indirect tax credits:

5 Years look back review

The tax reform proposals states that companies will start the new VAT System with very restricted possibilities to deduct old credits. It is recommended that companies analyze their current and past operations in order to make sure there is no tax credits unaccounted prior to the end of the transition period and/or extinction of the current taxes.

Model of
taxation IVA

Anticipating impacts, transition and opportunities for the future

4 Funds and extinction of tax benefits:

Compliance review

One of the requisites for the taxpayers to be eligible to the compensation of the reduction and/or extinction of ICMS tax benefits is the timely compliance with the current tax regulations and clauses of fruition of the specified benefits. In this sense, companies should review and document their current benefited operations and its tax returns, in order to be ready and eligible to the fund support.

5 Exports and customs special regimes:

Evaluation of possible changes of procedure

The tax reform maintains the exemption of tax over exports but currently guarantees only the tax credits over the acquisitions of goods and services that indicate the exporter as buyer. Other than that, it is left to Complementary Law to indicate the applicable benefits to the current customs special regimes (e.g. RECOF, Drawback) and the means for a reduction of impacts over capital projects. Considering this, its important to evaluate the possible changes to the current processes within Brazilian global trade operations.

6 Strategic decision review:

Site Relocation / Distribution Structures

The so called “fiscal war” was often a decisive factor when choosing were to establish. Companies' branches, distribution centers, importation points and other facilities’ locations where determined based on state incentives, that will end with the Tax Reform. Based on the proposed tax reform guidelines, EY can provide advice for the reviewing the decisions as well for the allocation of new investments.

Model of
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7

Income tax and transfer pricing:

Corporate restructuring and new payment flows

The conjunction of a Transfer Pricing system aligned with global practices and a consumer tax system without tax residues can bring competitiveness to the Brazilian market, creating opportunities for studying new models of asset compensations, risks and functions of the Brazilian operation in a global perspective.

8

Strategic Planning:

Prices variation

Variations in the tax burden and in the costs of the Companies impact the relative prices of goods and services of the companies. It is recommended to study the possible impacts of the tax reform on the relative prices, profits, margins and competitive landscape (sector and goods replacement) and its economic consequences.

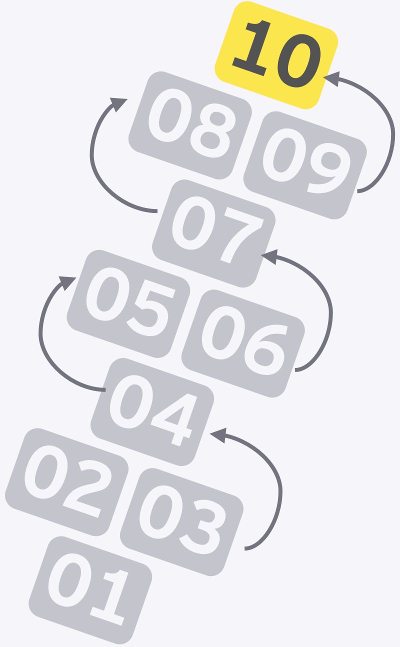
9

Econometric Studies:

Financial and economic rebalance of contracts

The tax reform is intimately connected to an outlook of economic growth, so its implementation, from transaction to full effectiveness, should take into account economic indicators. It's also important to note that alterations to tax laws and regulations could warrant requests for economic and financial rebalancing of contracts, in accordance with future regulations established by the Supplementary Law, as dictated by the approved constitutional amendment.

Anticipating impacts, transition and opportunities for the future



10 Technology and organizational review:

Tax function and systems upgrade

A simpler tax model may potentially lead to a reduction in compliance costs for businesses, but also will bring challenges such as the transition period on which both tax systems will coexist. In this sense, its important to evaluate current structures, systems, processes and people, so that the implementation of the new model is effective and aligned with the best practices available.

Whatever the challenges of a new tax regulation may be, EY's tax specialists are ready to help our clients to understand, calculate the impacts and assimilate the Brazilian tax reform to their companies' processes and routine.

EY

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