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# Kluwer International Tax Blog

## Will Brazil Finally Adopt a Modern VAT?

Melina Rocha Lukic (York University, Canada) and Ana Carolina Monguilod (Insper; Associação Brasileira de Direito Financeiro) · Friday, August 28th, 2020

Since the promulgation of its 1988 Constitution, Brazil has been trying to implement a national VAT. Over the past 30 years, the opposing interests of States and the Federal Government have caused at least three broad tax-reform proposals to fail in Congress. Moreover, several interest groups have also been opposed to changes.

Such conflicts of interests cannot hide the fact that tax reform has now reached a point of urgent necessity: Brazil's tax system, one of the world's most complex, creates severe economic inefficiencies, distortions and inequalities among economic sectors and taxpayers.

### **The Unbearable Complexities of the Brazilian Taxation on Consumption and the Hurdles for the Adoption of a Single VAT**

To understand this complex situation, one must keep in mind that Brazil is a federation in which the Constitution assigns consumption-tax jurisdiction to the three levels of government – Federal, State and Municipal. The most important Federal taxes on consumption were initially levied as business-turnover taxes (PIS[1]/COFINS[2]). However, the Federal Government created a special regime for PIS and COFINS (in 2002 and 2003, respectively), transforming them into a sort of subtraction-method VAT. At present, both PIS/COFINS systems co-exist – the old cascading system, levied at a 3.65% rate and based on gross revenues, and the newer, partially non-cascading one (as certain business purchases give rise to credits), levied at a 9.25% rate. Meanwhile, the Federal Government also has jurisdiction to levy the IPI[3], a tax mostly applied at the manufacturing level. As for States, they have jurisdiction over the ICMS[4], the country's tax-generating champion, which only applies to goods and a limited number of services, such as interstate and inter-municipal transportation and communication. Finally, Municipalities have jurisdiction over services in general (ISS[5]), as long as those services are not already subject to any State ICMS.

Not only does this fragmented and overlapping tax base cause endless disputes among Federal, State and Municipal government authorities, but it also gives rise to cascading effects and to complex legislation that lends itself to all kinds of administrative and judicial controversies. Moreover, the State Tax on Goods (ICMS) is partially levied not on a *destination base* but rather on an *origin base* (i.e., by the State where the goods are produced or supplied). In Brazil, this has literally created a “tax war”, a fierce competition in which a business may be encouraged to abandon one State for another to take advantage of sizable tax benefits. And since attracting such businesses can be extremely beneficial to a State's economy, States that successfully play this

game have been historically among the fiercest opponents of Brazilian tax reform in general.

Because of this complex tax structure and tax-jurisdiction sharing (implemented in the mid-60s!), Brazil's federal system is now the main impediment to the adoption of a single VAT. States and Municipalities are suspicious of the Federal Government, especially with regard to revenue sharing and the risk of losing the federative autonomy to offer tax benefits and to decide over and administer a new tax. And since the potential to raise tax revenues from services tends to increase in the modern economy, many Municipalities, particularly the larger ones, refuse to share their service-tax base with States.

Another controversy in Brazil's unrealized tax reform is the ISS-ICMS tax rate discrepancy: the 2%-to 5% Municipal tax rate on services is much lower than the average 18% State tax rate on goods. In addition, many businesses providing services are subject to PIS/COFINS under the old turnover system levied at a 3.65% rate, while the Federal rate under a single VAT would be much higher (probably higher than the non-cascading PIS/COFINS rate of 9.25%). Although the tax rates under a cascading and non-cascading systems are not comparable, service providers are afraid that, under a new non-cascading system, they will not be able to fully pass on the VAT to consumer prices and will end up having to bear part of it. Because of this and the fact that services are subject to a generally lower effective rate, the sector tends to oppose the tax reform's proposed single rate.

### **The Tax Reform Bills and the Dual-VAT as the Most Viable Alternative**

Since 2019, two Constitutional Amendment Bills (PEC[6]s) proposing national VATs have been under discussion in Congress. PEC 45, formulated by the Brazilian think tank *Centro de Cidadania Fiscal* (CCiF)[7], has so far garnered the most interest. Essentially, it aims to implement a single VAT (called "IBS[8]") that would cover Brazil's three government levels (Federal, State and Municipal) and would apply the same broad base and a single rate to all goods and services, though each one may also choose its own rate. The transition to the new tax would be accomplished over a period of ten years, during which time the current system would be gradually phased out.

In parallel to these proposals, on July 21, 2020, the Federal Government sent to Congress its tax-reform proposal, which aims to create a 12% Federal VAT ("CBS[9]") by unifying the two Federal social-security levies (PIS/COFINS) currently in force. Since the 2018 presidential campaign, the Minister of Economy has been advocating the implementation of a Brazilian Dual-VAT system. The Dual-VAT model was formulated and first proposed in 2017 by a group of experts[10] from the Institute for Applied Economic Research (IPEA)[11] and proposes a modular and gradual VAT adoption inspired by the Canadian GST/HST model. In this model, the Federal Government would implement a Federal VAT and, concomitantly or subsequently, another VAT for States and Municipalities would be created. The main advantage of this strategy lies in its adoption and implementation. As the initial Federal VAT phase does not require greater Federal arrangements but only changes in sub-Constitutional laws, the model avoids the Federal disputes that prevented the approval of past tax-reform bills.

Although the Minister of Economy supports the Dual-VAT system, he has also contradictorily expressed his intention to pursue negotiations with the States and Municipalities to guarantee the adoption of PEC 45's National VAT. However, the head of Brazil's Federal Revenue Service has also stated that the three Federal entities still need to agree on some critical points to reach an understanding on this matter. Among these points, the States are demanding the creation of two

Federal Government-subsidized compensation-and-equalization funds, an event that, as the Economy Minister highlighted in a recent public hearing, has little chance of taking place in a devastated, post-Covid 19 economy. Additionally, a further agreement will have to be worked out concerning the governance rules of the tripartite Federal, State and Municipal agency that will administer the tax.

Furthermore, considering that a single National VAT rate has been projected at anywhere from 25% to 30% (or probably even higher) in order to maintain the same tax revenue level, the sharing of such a rate among the Federal, State and Municipal Governments is likely to create great controversy. And in fact, these unresolved disagreements mean that a consensus on a single National VAT is still far away.

### **Although There Is a Clear Need for Change, Is the CBS the Best Way Forward?**

Besides that, several possible design flaws in the Federal Government's VAT/CBS recent proposal have attracted severe criticism. For example, while the Constitution does allow the Federal Government to tax business turnover, levying a tax on the supply of goods and services is clearly outside the Federal Government's Constitutionally granted jurisdiction. Therefore, any attempt to implement a transaction-based VAT model using a turnover tax will very likely trigger Constitutional battles. Likewise, the proposal makes reference to "transactions with goods and services" – but the meaning of "transactions", "goods" and "services" under Brazil's current tax system and prevailing case law tends to be different from the generally accepted meaning under the international VAT models. As an example, Brazil's Federal Supreme Court[12] considers rentals neither a service nor a supply of goods, resulting in them not being taxed by ICMS and ISS (being subject only to PIS/COFINS). Another situation the Court has left undefined is "transactions with intangibles," such as software licenses[13]. What all this implies is simple but problematic: if such concepts are left vaguely defined in the proposal, the current narrow interpretation of what may or may not fall under the rubrics of "goods" and "services" can be applied in a way that restricts the broad VAT base proposed for the new tax. In this case, any attempt by tax administration to force the application of a broader VAT base risks worsening the already unbearable level of tax litigation in Brazil.

With some changes in place, the proposal can then certainly be viewed as a first move towards a Dual-VAT system or even – if the three levels of the federation are able to reach an agreement – a single national VAT. Therefore, the implementation of a Brazilian Federal VAT does represent a small but significant step forward in overcoming the formidable barriers that were built around a single national VAT. But even more important, the proposal also represents perhaps the only feasible way to implement a broad but gradual reform that will enable the Brazilian tax system to *finally* take a giant leap forward into modernity and efficiency.

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[1] PIS – *Contribuição para os Programas de Integração Social.*

[2] COFINS – *Contribuição para o Financiamento da Seguridade Social.*

[3] IPI – *Imposto sobre Produtos Industrializados.*

[4] ICMS – *Imposto sobre Operações relativas à Circulação de Mercadorias e sobre Prestações de Serviços de transporte interestadual, intermunicipal e de comunicação.*

[5] ISS – *Imposto sobre Serviços.*

[6] PEC – *Proposta de Emenda Constitucional.*

[7] CCIFF's proposal is accessible via the following link:  
[https://ccif.com.br/wp-content/uploads/2020/08/NT-IBS-v2\\_2\\_English.pdf](https://ccif.com.br/wp-content/uploads/2020/08/NT-IBS-v2_2_English.pdf)

[8] IBS – *Imposto sobre Bens e Serviços.*

[9] CBS – *Contribuição sobre Bens e Serviços.*

[10] One of this article's co-author, Melina Rocha Lukic, participated in the IPEA's expert group and is one of the co-authors of the Dual-VAT proposal.

[11] IPEA is a publicly funded research institute that provides technical support to the Federal Government IPEA's Dual-VAT proposal is accessible via the following link:  
[https://www.ipea.gov.br/portal/index.php?option=com\\_content&view=article&id=34402](https://www.ipea.gov.br/portal/index.php?option=com_content&view=article&id=34402)

[12] In 2010, the Federal Supreme Court issued Binding Precedent nº 31, which states: "the incidence of the tax on services (ISS) on rentals of movable property is unconstitutional." Many other court cases have followed this view: RE 626.706/SP, Rcl 28.324/SC, ARE 1.082.875/SP, Rcl 24.917/MG, RE 602.295 AgR, AI 623.226 AgR, AI 623.226 AgR.

[13] The cases under discussion in Brazil's Federal Supreme Court are: ADIs 1.945, 5659, 5.958, 5.576 and RE 688.223.

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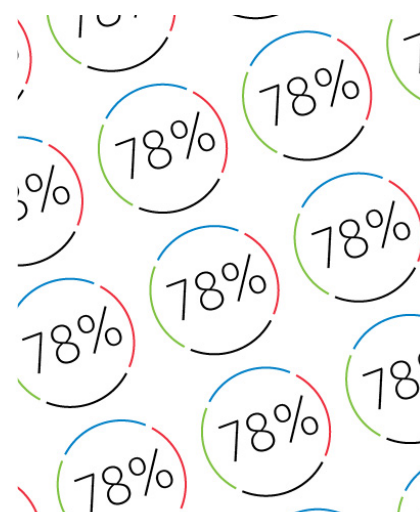
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