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Brazil’s recent IPI tax cut: generosity with others’ money?

Phelippe Toledo Pires de Oliveira (postdoctoral researcher at the Institute for Austrian and International Tax Law (WU)) · Thursday, April 7th, 2022

Phelippe Toledo Pires de Oliveira[1]

In late February 2022, the Brazilian federal government published a decree slashing the federal tax on manufactured goods (IPI). For those unfamiliar with the country’s taxes, IPI is one of the many VATs levied in Brazil. IPI is levied by the federal government and is often used as an excise tax as products such as liquor and tobacco are subject to heavier rates than other products.

The decree cuts down IPI tax rates. For passenger cars, the percentage of reduction in the tax rate is 18.5%; for all other products, except cigarettes and alike, which rates remain unchanged, the percentage of reduction is 25%[2]. As a result of the tax cut, the IPI levied on passenger cars with a 1.0 cc engine goes from 7% to 5,7%, while the IPI levied on personal fridges goes from 15% to 11.25%.

- **Expected boost to the industrial sector**

According to the government, the measure intends to boost the industrial sector, spur economic growth and create jobs. It is also expected to help slash consumer prices and contain the country’s rising inflation. However, it is unclear whether the tax cut is, in fact, going to be fully passed on in the retail price to the end consumers.

The IPI is considered a regulatory tax, and, as such, it is subject to more flexible rules compared to most other taxes. For instance, rates can be altered within certain limits by a presidential decree without congressional approval[3]. Similarly, IPI tax reductions are exempted from budgetary compensatory measures to neutralize potential revenue losses estimated at approx. USD 4 billion for the year 2022 alone[4].

The measure was welcomed by the industrial sector, whose products are now subjected to a lower tax burden. Not surprisingly, the industry trade association and lobby group, São Paulo-based FIESP, released a public statement praising the measure on the very same day the decree was published[5]. Automakers also celebrated the tax cut as beneficial for the car industry, job creation and consumers.

- **Not everyone is happy with the tax cut**

But not all industries were happy with the IPI tax cut. Companies established in the Manaus Free

Trade Zone (MFZ) – created in the 60s to attract investment to the state of Amazonas by giving tax breaks to companies[6] – did not take kindly to it. Companies established in the region benefit from IPI exemption. Hence, an IPI tax cut reduces their competitive tax advantages.

State governors and local politicians also opposed the IPI tax cut, complaining that the federal government gave away their money. Under Brazil's fiscal federal system, almost half of the IPI is transferred to intergovernmental funds and then distributed to state and local governments based on allocation keys as part of a vertical tax revenue sharing scheme.

The IPI tax cut upset state and local politicians also for other reasons. Rumors have it that the federal government wanted to kill two birds with one stone. In addition to boost the industrial sector, the federal government wanted to inspire fiscal sustainability from states and local governments, preventing them from giving civil servants salary increases to gather votes in an electoral year.

The topic is not new and affects not only IPI but also all other taxes subject to revenue sharing with different levels of government, such as income tax, state-level VAT and rural land tax. Every time there are talks of cutting a tax subject to revenue sharing, discussions on the topic re-emerge. That was the case last year after the government put forward a tax proposal that reduced income taxes (Bill N. 2,337/2021).

- **Brazilian Supreme Court's position**

It is understandable that a reduction involving a tax, the proceeds of which are shared with other levels of government, generates noise to the extent that it adversely affects the finances of other levels of government. Discontent is such that the matter often ends up in the Supreme Court, which has the authority to decide conflicts between different levels of government under the Brazilian Constitution[7].

In 2016, Brazil's Supreme Court decided that the federal government has sole discretion to reduce taxes that fall within its taxing powers, even when it must share their proceeds with other levels of government – as with IPI. In that case, the federal government is not required to compensate for potential revenue losses incurred by intragovernmental funds[8].

The decision, however, did not put an end to discussions. Last year, the Supreme Court accepted a case to rule whether state-level VAT tax incentives can reduce local governments' revenue-sharing quota[9]. At this point, it is unclear if the Court will somehow mitigate the previous decision distinguishing this case from the one decided earlier in 2016.

The recent IPI tax cut was already taken to Brazil's Supreme Court by the Amazonas state business association. The petitioner argued the tax cut weakens MFZ competitiveness and adversely affects jobs in the region, therefore violating the constitution that says building a fair and solidary society, eliminating poverty and reducing regional inequality are among the stated fundamental purposes[10].

The petition filed against the recent IPI tax cut primarily focuses on the impact on the MFZ, including the fact that Congress has recently enacted a Constitutional Amendment extending MFZ benefits until 2073[11]. However, a later *amicus curie* petition also brought to light the fact that the IPI tax cut adversely affects all Brazilian cities' finances because of the constitutional tax revenue sharing scheme.

The petition against the IPI tax cut has just been distributed to the case's rapporteur Justice. Following the legal procedure, the Supreme Court is expected to request information from the President and the Attorney-General. There is still no indication when the court is expected to decide the merits of the case. However, judging by experience, it may take a long time before the Supreme Court reaches a decision.

- **Final remarks**

Briefly, taxes subject to revenue sharing are always a sensitive matter, particularly when a tax cut is involved. Though the recent IPI tax cut can be viewed as generosity with (half of) others' money, this situation derives from an inherent feature of Brazil's fiscal federalism in which part of the tax revenues from states and local governments derive from revenue sharing and part from their own taxes.

Cutting taxes subject to revenue sharing often sparks controversy. News that an additional IPI tax cut is in the federal government's crosshairs may also fuel the discussions on the topic[12]. Revenue sharing and MFZ competitive advantages have also hampered debates over a consumption tax reform in Brazil, contributing to stalling current proposals from moving forward.

The controversy sheds light on two features of Brazil's fiscal federalism. It shows how the different levels of government can interfere in one another's finances through their taxes and how some subnational governments accommodate with revenues pouring in from the revenue sharing system and forget to take measures to effectively impose and enforce their own taxes.

[1] The author holds a Ph.D in tax law from the University of São Paulo and is a postdoctoral researcher at the Institute for Austrian and International Tax Law (WU).

[2] Published in Brazil's Official Gazette on 25 February 2022. Available at: D10979 (planalto.gov.br)

[3] Art. 153, par. 1, of the Constitution.

[4] Art. 14, par. 3, I, of Supplementary Law 101/2000.

[5] FIESP press release welcoming the IPI tax reduction available at: Nota oficial: corte de até 25% no IPI – FIESP.

[6] According to article 1º of Law-Decree N. 288/67 "The Manaus Free Trade Zone is an import and export free trade zone with special tax incentives with the purpose to create an industrial, commercial and agribusiness center in the Amazon region to develop it in view of local factors and the distance from the consumer centers" (free translation).

[7] Art. 102, I, f, of the Constitution.

[8] BR: STF, Extraordinary Appeal (RE) N. 705,423/SE. Available at: Supremo Tribunal Federal (stf.jus.br).

[9] BR: STF, Extraordinary Appeal (RE) N. 1,288,634/GO (pending decision).

[10] BR: STF, Request for Non-compliance of Basic Precept (ADPF) N. 948 (pending decision).

[11] BR: Constitutional Amendment N. 83/2014.

[12] See Lu Aiko Otta, Valor Econômico, March 18, 2022. Availabe at: Corte do IPI para todos os produtos volta a entrar na mira | Brasil | Valor Econômico (globo.com).

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