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Tax Reform in Brazil and the unique Federal arrangement to implement its Dual-VAT

Melina Rocha Lukic (York University, Canada) · Monday, February 26th, 2024

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The long-awaited tax reform to implement a VAT system in Brazil was finally enacted after more than 35 years of discussions and several failed attempts. The main issue that prevented its approval since the late 80's was the conflict of interest between the Federal entities. Brazilian Constitution shares the jurisdiction to tax consumption between the three levels of government – Federal, State and Municipal. Under the current system, the jurisdiction is shared by fragmenting the tax base: while the Federal government levies broad-base taxes on business turnover (PIS/COFINS) and a tax at the manufacturing level (IPI), States collect tax on sales of goods (ICMS) and Municipalities on the provision of services (ISS). As the State Tax on Goods (ICMS) is partially levied on an origin base (i.e., by the State from where the goods are supplied), the richest and most industrialized States have acted as veto players in the previous tax reform attempts as they proposed to change to a destination-based system. How did Brazil finally overcome these conflicts of interest and has achieved the political consensus to approve the reform?

One of the main reasons for the historical approval was the adoption of a Dual-VAT system. The original main proposal – PEC 45/19 – created by a Brazilian think tank (CCiF) and discussed in the Chamber of Deputies proposed a single national VAT. However, the political and federative discussions evolved, and the enacted Constitutional Amendment adopted a Dual-VAT model introduced in the Senate by a parallel proposal (PEC 110/19) and originally formulated in 2017 by a group of experts from the Institute for Applied Economic Research[2]. The Constitutional Amendment adopts two separate but harmonized taxes: a Federal VAT (CBS) and a State and Municipal VAT (IBS) and determines that both taxes will be implemented and regulated by the same Complementary Law and their main rules should be identical. The Federal government and each State and Municipality can set their own VAT rates, which will be the same for all goods and services supplied in their territory, unless an exception applies.

The Brazilian Dual-VAT model was inspired by the Canadian and Indian systems – both countries have also implemented a Dual-VAT and, similarly to Brazil, their Constitutions share the jurisdiction to tax consumption with subnational entities. However, the three countries have adopted different solutions to the main challenge under a shared consumption-tax jurisdiction: how to reconcile the imposition of VAT at different levels of government with the application of VAT to interstate supplies within the country based on the destination principle?

Under unitary or federal countries without shared VAT-jurisdiction, the VAT is applicable and collected in the same way on all supplies across the country, irrespective on whether the supply is made within a State/Province or if it is an interstate supply. However, interstate supplies become a challenge when subnational levels have independent jurisdiction to tax. This happens because the supplier who collects and remits tax is located in a particular State/Province while the recipient of the supply is located in another State/Province. As the VAT system is based on the destination principle, the revenues collected on interstate supplies should be in theory assigned to the State/Province of destination, based on the place of supply rules of each country. Many scholars have debated different solutions to this challenge, especially in the European and Canadian context.

While Canada has adopted a harmonized and centralized system on which the Federal Government is responsible for the administration and collection of the VAT (HST) for the harmonized provinces; India has implemented a system where a separate federal government VAT (IGST) is applicable on interstate supplies. Thus, the solution in both countries was to assign to the Federal government either the jurisdiction to tax or the administration of the tax collected on interstate supplies. One could also consider the decentralized European experience with multiple jurisdictions imposing VAT and collecting tax through separate tax administrations, model that is conjugated with a mix of zero-rated intra-community supplies and a centralized “one stop shop” model to collect and distribute the tax collected on certain supplies to the various states.

However, Brazil decided to adopt a different and unique model to manage the VAT on interstate supplies as, on the one hand, States and Municipalities (and also the politicians during the discussion in the Parliament) rejected any kind of “delegation of power” or submission to the Federal government. On the other hand, a decentralized model as in Europe Union or through a “clearing system”, besides not simplifying the system, would also prevent the adoption of VAT at the Municipal level.

The Constitutional Amendment thus assigned the administration of the Federal VAT (CBS) to the Federal Revenue Agency and created a separate and independent entity – the “Steering Committee” – to administer the subnational VAT (IBS). The IBS Committee will be responsible for the centralized collection, administration and regulation of IBS and will be formed by 27 States and 27 Municipalities. The Committee will retain the IBS collected on B2B supplies and will only proceed with the transfer of revenues to the subnational levels when the tax is collected on a B2C transaction. In addition, the Committee will harmonize the interpretation and rulings, centralize the administrative disputes, and coordinate the subnational tax administration’s audits and responsibilities.

The Committee will also allow the implementation of the 50-year period transition for the change of the tax revenue allocation from origin to destination. The Constitutional Amendment determines that the revenues will initially be distributed according to the tax revenue share of each State and Municipality based on the current origin-based system. During a period of 50 years, the revenues will then be gradually transferred to the State and Municipality of destination, according to the new place of supply rules.

For suppliers, the centralized model through a Committee will bring many advantages, the most important one being the substantial simplification. Under the new system, the supplier will register for and remit the CBS to the Federal Revenue Agency and the IBS to the Committee only (instead of potentially dealing with 27 States and 5.570 Municipalities). In addition, tax credits and tax

refunds will no longer be dependent on each subnational level as it is the case under the current system, on which tax refunds may take years or never being paid by the various tax authorities.

How was it possible to achieve a Tax Reform in Brazil? While the Dual VAT system has satisfied both political and federal interests, the creation of a new independent entity to centralize the subnational collection will allow the implementation of the destination principle on interstate supplies without any interference from the Federal government, thus maintaining the autonomy of States and Municipalities to administer their own tax. In addition, the 50-year transitional period to transfer the revenues from origin to destination was necessary to achieve the political consensus mainly from the richest States, and this mechanism is only possible through a centralized Committee. In addition, the Reform was facilitated by an extra compensation of 3% of the IBS for federal entities that will most decrease the revenue share, as well as by the creation of equalization funds financed by the Federal Government.

Professor Richard Bird, who profoundly understood the Brazilian reality and always supported the Dual-VAT for Brazil, has provided the following advice in respect of the Brazilian tax reform in a keynote speech given in 2020: one should have “*endless patience, continual negotiation, and some willingness to compromise on details essential to one side without losing sight of core objectives essential to both*”. Brazil has certainly followed Prof. Bird’s advice to approve its tax reform. The Dual-VAT model and the IBS Committee arrangement are certainly the result of negotiations and compromises between the Federal Government, States and Municipalities, and represent the key features that allowed Brazil to achieve the political support necessary to approve the reform.

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[2] 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://repositorio.ipea.gov.br/bitstream/11058/9312/1/td_2418.pdf

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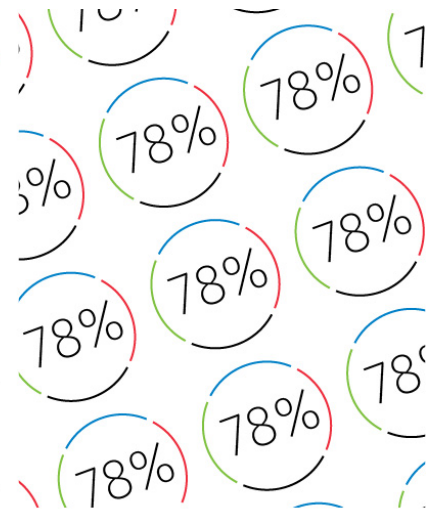
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