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Brazil's Historic Tax Reform: A Primer

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Latin America

Scope and Format

The Brazilian National Congress has approved a historic tax reform that revamps the existing consumption tax system, in place since the 1960s. The reform generally simplifies the Brazilian tax system, reducing the compliance cost for business. However, it also creates a new tax on certain goods and services.

The reform takes the form of a constitutional amendment and requires implementing legislation and regulation. The administration must introduce implementing legislation to Congress within 180 days. Implementation dicussions will be relevant because they will set the new system tax rates and, in some cases, scope, as well as detail exceptions.

Although primarily focused on the consumption tax system, the reform also includes provisions related to taxes on property and financial operations.

Why a constitutional amendment?

Brazil adopts a descriptive constitutional model in which the principles and limits of the tax system, as well as all federal, state, Federal District, and municipal taxes, and their respective scope and revenue distribution, are detailed in the Constitution. Therefore, any substantial change of the system requires a constitutional amendment.

Need for Reform

Over decades, the consumption tax system increased in complexity and compliance costs, ranking Brazil as one of the most inefficient tax jurisdictions among large economies.

The system, built upon thousands of tax-related norms and judicial interpretations, generated legal uncertainty and capital misallocation, creating negative incentives for investment, exports, and economies of scale and proximity, among others. It also generated numerous tax disputes, with estimates as high as 75 percent of Brazil's GDP, increased tax inequality, and reduced private sector competitiveness.

Many of the existing inefficiencies were created by federal government policies, or state and local governments providing tax incentives to attract investment, as well as economic sectors lobbying Congress and the administration for special tax regimes.

The need for a redesign of the consumption tax system was clear since the 1990s, when Brazil successfully curbed hyperinflation. With a stable currency, structural issues impacting business competitiveness resurfaced. These issues were grouped under the catch-all “Brazil Cost” concept, with the tax system as a prominent component of it.

Key Change: the “Dual” VAT

The core of the tax reform is the merger of five federal, state, and municipal indirect taxes into a so-called “dual” value-added tax (VAT), charged on goods, services, and rights, both at the national and subnational levels.

At the national level, the VAT will be called Contribution on Goods and Services (CBS) and will be the result of the following three existing taxes, merged:

- Federal tax on manufactured goods (IPI);
- Federal contribution for the financing of Social Security (COFINS); and
- Federal contribution for the financing of the private sector Social Integration Program (PIS).

At the subnational level, the VAT will be called Tax on Goods and Services (IBS) and will be the result of the following two existing taxes, merged:

- State tax on the movement of goods and services (ICMS); and
- Municipal tax on services (ISS).

The dual VAT will be charged at the destination and, in practice, will be the sum of the national VAT (CBS) and subnational VAT (IBS) rates. It will also be charged on imports, but not on exports.

In addition to simplicity and transparency, the new dual VAT system seeks to eliminate the existing distortion of tax-over-tax, that artificially increases the price of goods and services, and the so-called “tax war” among states, that compete with each other to attract investment by eroding the tax base.

Why a dual VAT?

The original version of the reform foresaw a single VAT. However, the proposed transfer of tax enforcement power to the federal government resulted in opposition from states, cities, and the Federal District. Subnational governments feared that a centralized consumption tax system would weaken the checks and balances of federalism. The compromise solution was a dual VAT with national and subnational components, enforced by different tax authorities.

Overview of the National VAT (CBS)

The first half of the dual VAT is its national component (CBS). Its purpose is to finance Brazil’s Social Security.

The CBS will have a single, national legislation. The Senate will approve a resolution with the tax rate, that will be used by every state, city and the Federal District. The rate can also be set by federal law, and apply to all goods, services and rights, with exceptions.

As a general rule, the CBS will also be non-cumulative and will not be used for tax incentives or have special tax regimes, but there will be exceptions to both.

The CBS will be enforced by the federal government.

What is a Senate resolution?

A resolution is used by the Senate to legislate or make decisions on matters that are exclusive or delegated to it by the Constitution or federal legislation.

Overview of the Subnational VAT (IBS)

The second half of the dual VAT is its subnational component (IBS). Its purpose is to finance state and local government programs.

The IBS will have a single, national legislation. The Senate will approve a resolution with its reference tax rate, that will be used by every state, city, and the Federal District, unless each of them approves its own rate. In any case, either the reference rate or the combined specific rates of a state and a city (or the Federal District) will be applicable to all goods, services, and rights, with exceptions, and will have to comply with the same national legislation.

As a general rule, the IBS will also be non-cumulative and will not be used for tax incentives or have special tax regimes, but there will be exceptions to both.

The IBS will be enforced by an independent, national Management Committee, composed of representatives of states, cities, and the Federal District. The Committee will publish a single tax regulation with uniform interpretation and implementation rules. It will also collect and distribute the IBS. Finally, it will settle IBS-related administrative disputes.

Key Change: the Selective Tax

In addition to the dual VAT (CBS/IBS), the reform establishes a new Selective Tax (IS) to regulate goods and services it characterizes as having significant negative health and environmental externalities. The IS will be charged on production, extraction, sale, or importation of these goods and services. It will not be charged on exports, telecom operations, and electricity.

The new tax will take the form of an “ad valorem” or “ad rem” rate. In the case of extraction operations, it will have a cap equivalent to one percent of the good’s market value and will be charged independently of destination (*i.e.*, can include goods for export).

Senate changes to the IS

The House version of the IS provided for the Executive branch to issue regulations on the tax, including setting the tax rate. The Senate changed this, requiring Congress to establish both through law. The Senate also included “extraction” in the tax’s scope, so that the IS applies to extractive activities, including mining, oil, and gas—and even when these goods are exported. In practice, it is a backdoor to allow an export tax targeting these sectors.

Key Change: Property Taxes

The reform makes the existing state tax on inheritance and donations (ITCMD) progressive, but waives it for non-profits with relevant public or social goals. It will also expand it to include non-residents.

The reform also expands the existing state tax on motor vehicle ownership (IPVA) to aircrafts and vessels, but waives it for certain agribusiness vehicles and aircrafts, as well as for certain vessels used by the fish, maritime transportation, and oil and gas industries.

Finally, the reform allows the Executive branch of local governments to update the existing tax on urban property (IPTU) tax base through administrative act, as long as municipal law establishes the criteria for this action.

Key Change: Financial Operations Tax

The existing federal tax on financial operations (IOF) will no longer be charged on insurance-related operations. The tax is currently charged on credit, foreign exchange and insurance operations, as well as on operations related to securities.

Tax Level and Tax Burden

Since the initial discussions on the reform, there was widespread agreement that it should neither raise the overall tax burden—to avoid harming the private sector—nor reduce tax revenue, creating fiscal pressure on federal, state, and local governments.

However, private sector fear of reform "misuse" grew as the bill made its way through Congress in early 2023 and the incoming administration of President Luis Inácio Lula da Silva voiced support for it, but approved a new fiscal framework that is overly reliant on revenue increase (more details here).

In order to assure Congress' commitment to a reform that will not increase the overall tax burden, the Senate included in the constitutional amendment a tax level mechanism that imposes a ceiling on the dual VAT rate based on a ten-year revenue average from 2012 to 2021. There will be two windows, in 2030 and 2035, to reduce the rate in case of a tax burden increase.

A new CCTV tax?

Despite promises of not increasing it, the reform includes the creation of at least one new tax that will add to the existing tax burden. The Senate version of the amendment allows cities to establish a contribution to fund the operation, expansion and improvement of closed-circuit television (CCTV) cameras in public areas with a goal to increase security and contribute to their preservation.

The Political Economy of Approval: Exceptions

Although the basic assumption is that the new consumption tax system will not increase the overall tax burden, the reform will nonetheless shift this burden between sectors. By converging all sectors to a single rate, the new VAT-based system tends to reduce the burden for companies with longer supply chains and that are more capital intensive (*e.g.*, manufacturing) and increase it for companies with shorter supply chains and that are more labor intensive (*e.g.*, agribusiness, services).

This shift among sectors, combined with other policy priorities, led Congress to adopt a number of exceptions to the general dual VAT rate and rule. These exceptions take the form of either a discounted rate—at 30, 60 or 100 percent—or a special tax rule, as follows:

Discounted Rate	Special Tax Rule
30% discount: ▪ Professional services of an intellectual, scientific, literary, or artistic nature, as long as regulated by professional councils established through legislation **60% discount**: ▪ Agriculture, livestock, aquiculture, fishing, forestry, and extractive (vegetal) products "in natura" ▪ Agriculture, livestock, and aquiculture inputs ▪ Artistic, cultural, event-related, journalistic, and audio-visual national productions; sports; and institutional communication ▪ Collective public passenger transportation services through road and rail (metro), with the possibility of full exemption of VAT to be regulated by federal law ▪ Education services ▪ Food destined for human consumption ▪ Goods and services related to national security, information security, and cybersecurity ▪ Health services ▪ Medical and accessibility devices ▪ Menstrual health and hygiene-related products	▪ Collective passenger transportation through road (intercity and interstate), rail, and river ▪ Cooperatives ▪ Financial services, real estate, private healthcare insurance, and lotteries ▪ Fuel and lubricants ▪ Government procurement ▪ Hospitality industry, amusement parks, travel agencies, bars and restaurants, public soccer companies, and regional aviation ▪ International treaty-related operations, including foreign services and international organizations

▪ Personal care products for low income families ▪ Pharmaceuticals **100% discount**: ▪ Federal program for university inclusion (with 100% discount of CBS only) ▪ Fruits, vegetables, and eggs ▪ Medical and accessibility devices ▪ Menstrual health and hygiene-related products ▪ Pharmaceuticals ▪ Services provided by non-profit science, technology, and innovation institutions ▪ Urban rehabilitation of historic zones, and reparation and rehabilitation of critical areas ▪ Vehicles for people with disabilities and Autism Spectrum Disorder, or for use as taxi	

In addition to these sectors, activities, and government programs, there will also be special tax rules for biofuels and green hydrogen, capital goods, export processing zones, and special customs regimes. In addition, radio broadcasting, and free TV and radio broadcasting will both be exempt from the IBS.

The reform will also preserve existing special tax rules for small business (Simples), the Amazon Free Zone (ZFM), and free trade zones (FTZs). To keep the existing tax-related competitiveness of ZFM, the reform allows the federal government to keep the tax on manufactured goods (IPI) on the production, sale, and importation of goods benefiting from incentives in the Amazon Free Zone.

Finally, it will fully exempt (from CBS and IBS) goods to be classified as part of the new National Basic Food Parcel program.

Auto industry tax incentives

The Senate version of the amendment included a contested provision that maintains, until 2032, existing tax incentives for auto companies operating in Brazil’s lesser developed North, Northeast, and Mid-West regions, despite strong opposition from companies operating in the more developed South and Southeast regions.

The Political Economy of Approval: Funds

Also as part of its strategy to garner enough votes for its approval, Congress included in the reform four new funds with the goal of promoting the development of states that will no longer be allowed to provide tax incentives to attract investment, as well as to compensate companies that are currently benefiting from these incentives, which will be phased out when the reform is fully implemented.

The four new funds are as follows:

Fund	Goal
Regional Development National Fund	Fund infrastructure, job creation, and science, technology, and innovation. Priority must be given to sustainability and emission reduction-related projects. The federal government will transfer to the fund up to BRL 60 billion per year.
Financial and Tax Benefits Compensation Fund	Compensate companies with state-level (ICMS) tax credits, from 2029 to 2032. The federal government will transfer to the fund a total of BRL 160 billion.
Western Amazon and Amapá States Sustainable Development Fund	Promote development and diversification of economic activities in the Amazon region; compensate the states for potential revenue losses; and compensate the reduction of tax incentives granted in the FTZs. The federal government will transfer resources in an amount to be determined by federal law.
Amazonas State Economic Diversification and Sustainability Fund	Promote development and diversification of economic activities in the State of Amazonas; compensate the state for potential revenue losses; and compensate the reduction of tax incentives granted in the ZFM. The federal government will transfer resources in an amount to be determined by federal law.

The new fiscal framework rules do not limit spending on regional development, financial and tax benefits compensation funds, and the transfer of resources from the federal to state and local governments to compensate for potential tax revenue loss related to the new Selective Tax (IS). This will likely substantially increase fiscal pressures on the federal government.

Transition to the New System

The dual VAT and IS will be phased in from 2024 to 2033 in five phases, as follows:

Phase	National level	Subnational level
1 (2024-2025)	No changes take effect.	No changes take effect
2 (2026)	**CBS** (national VAT) charged at 0.9% tax rate for testing purposes. No IS charged. CBS coexists with the federal taxes (IPI, COFINS, and PIS).	**IBS** (subnational VAT) charged at 0.1% (state) tax rate for testing purposes. IBS coexists with the state and municipal taxes (ICMS and ISS).
3 (2027-2028)	**CBS** charged in full (minus IBS). **IS** charged in full. **COFINS** and **PIS** extinct. **IPI** zeroed for all goods, except those related to the ZFM.	**IBS** (subnational VAT) charged at 0.05% state tax rate and 0.05% municipal tax rate for testing purposes
4 (2029-2032)	**CBS** charged in full.	Gradual increase of **IBS**. Gradual reduction of **ICMS** and **ISS**.
5 (2033 onwards)		**IBS** charged in full. **ICMS** and **ISS** extinct.

Implementing Legislation

The reform will require further legislation to be approved by Congress, including the following:

Aspect	Legislation required
National VAT (**CBS**)	▪ Supplementary law to establish the new tax, including: • Rules for compensation and refund; • Exceptions to the non-cumulative rule; • Criteria for destination and rules for non-residents (might include digital platforms); • Discounted rates; • Special tax rules and exceptions, including related to the Amazon Free Zone (ZFM) and free trade zones (FTZs); • Cashback; and • Accessory obligations; ▪ Senate resolution (or ordinary law) to establish the tax rate.
Subnational VAT (**IBS**)	▪ Supplementary law (in the same piece of legislation of CBS) to establish the new tax, including: • Rules for assessment, distribution, compensation and refund; • Exceptions to the non-cumulative rule; • Criteria for destination and rules for non-residents (might include digital platforms); • Discounted rates; • Special tax rules and exceptions, including related to ZFM and FTZs; • Cashback; • Accessory obligations; • Administrative procedures; and • Functioning of the Management Committee; ▪ Senate resolution to establish the reference tax rate, to be used whenever states, cities and the Federal District do not have their own rate, as well as rates for special tax regimes; and ▪ State and municipal laws to set the tax rate for each state and city willing to do so.

Dual VAT (**IBS/CBS**)	▪ Supplementary law to detail exceptions for cooperatives and small businesses; and to integrated administrative tax settlement procedures. Can be the same piece of legislation abovementioned.
Selective Tax (**IS**)	▪ Supplementary law to detail its scope and rules; and ▪ Ordinary law to establish its tax level. Can be a provisional measure issued by the President and voted by Congress.
Federal tax on manufactured goods (**IPI**) Federal contribution for the financing of Social Security (**COFINS**) Federal contribution for the financing of the private sector Social Integration Program (**PIS**)	▪ Supplementary law to detail use of existing tax credits.
State tax on the movement of goods and services (**ICMS**)	▪ Supplementary law to detail compensation of existing tax credits.
State tax on inheritance and donations (**ITCMD**)	▪ Supplementary law to detail reformed tax.
Funds	▪ Supplementary law to establish the Amazonas State Economic Diversification and Sustainability Fund and the Western Amazon and Amapá States Sustainable Development Fund.
Food parcel program	▪ Supplementary law to establish goods to benefit from the program.

Ordinary bills require a simple majority vote in the House and the Senate, while supplementary bills, designed to detail constitutional provisions, require an absolute majority vote in both chambers.

Built-in Agenda

Congress included in the reform provisions for further changes in the tax system. In this context, once the constitutional amendment is promulgated, the Executive branch will have to meet the following deadlines:

Deadline	Action required
90 days	■ Submit to Congress an income tax reform bill, including budget and financial impact assessments. ■ Submit to Congress a payroll tax reform bill.
180 days	■ Submit to Congress all supplementary and ordinary bills required by the tax reform constitutional amendment.

Prospects

The political economy of the tax reform will continue to play out during congressional debate of all implementing ordinary and supplementary bills. This will include sectoral efforts to expand or restrict exceptions, and state and local government push to secure more resources for the newly-created funds. There will likely be a substantial debate on the dual VAT tax rates to be set by the Senate.

In parallel to this, there is an expectation from market players that the income tax reform bill to be introduced by the Executive branch will substantially change individual tax brackets to make them more progressive, reinstate a withholding tax on company dividends, and eliminate the interest on equity mechanism (JCP). There might be an opportunity to discuss the reduction of the corporate tax level, but this will likely be connected to a reduction or elimination of several existing tax subsidies.

There is also an expectation from market players that the payroll tax reform bill will reduce these taxes with a goal to spur job creation, but will likely compensate it with the recreation of a contribution on financial transactions (CPMF) that existed for more than a decade and was not renewed by Congress in 2007. Another possibility is the creation of a digital tax. Finally, the Lula administration might use the opportunity to create labor-related obligations for companies in the digital economy, including mobility and delivery apps.

If you have any questions concerning the material discussed in this client alert, please contact Diego Bonomo in our Latin America Public Policy group:

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