Brazil’s Tax Chaos and the Reform Proposals

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Dear investors,

Much of the political tension surrounding the new government has revolved around the issue of fiscal responsibility. In brief, the new government declared the spending cap law inadequate and presented a new fiscal framework that resists the idea of cutting expenditures and therefore depends on increases in tax revenue to eliminate the fiscal deficit. In turn, higher revenue can come from only two sources: either from economic growth, or from a higher effective tax rate collected by the government. Both paths are difficult, since economic growth does not depend on the government alone, and there is strong resistance to raising tax rates in Brazil, where the tax burden is already among the highest of any emerging market country.

This predicament prompted the government to reignite a longstanding Brazilian political debate: the need for a comprehensive tax reform that could simultaneously boost the country’s economic growth — through the productivity gains that simplifying our tax system would bring — and raise the effective tax rate collected, not by increasing base rates, but by eliminating a range of existing tax benefits. It is no coincidence that this agenda has been gaining momentum in recent months.

We believe this topic is of interest to all business owners and investors operating in Brazil, even if it is not one of the most engaging subjects to study, because tax reform would affect every company operating under Brazilian jurisdiction — both in how taxes are calculated and collected, and in the amounts owed. We will therefore discuss the main problems with our current tax system, the most recent reform proposals under consideration, and how we are factoring these issues into our investment decisions.

Problems with the current Brazilian tax system

Imagine that a residential condominium decides to abandon its traditional flat-fee model and “upgrade” to a fairer fee structure. A first point: units with more residents tend to use common areas more, so a fee based on the number of residents per unit makes sense. The playground is only used by children between the ages of 2 and 8, so there will be a separate charge for units where children in that age range live. Residents who receive many visitors or deliveries place greater demands on the building’s concierge service, so a small fee per visit or per parcel received will apply. To keep track of all these charges, an additional fee will be levied to maintain a team responsible for calculating and auditing what each unit owes.

If it is possible to create such confusion in an environment as simple as a residential condominium, imagine what the practice of addressing specific points — without considering the broader impact of each new rule and the cost of complexity itself — can do to an entire country. Through dynamics of this kind, Brazil has been accumulating, over decades of disorderly evolution of its tax legislation, an enormous number of specific rules and exception regimes that have turned our tax system into one of the most complex and dysfunctional in the world.

Two symptoms illustrate the scale of the problem well: a Brazilian company spends, on average, around 1,500 hours per year calculating and remitting all of its taxes. That figure is nearly 10 times higher than in the 38 OECD member countries, where companies spend an average of 164 hours per year for the same purpose. The other symptom is that the value of tax contingencies in Brazil (the amount in dispute between companies and tax authorities) represents a share of GDP roughly 60 times larger than the average of the same indicator across OECD countries — a direct consequence of the number of possible conflicting interpretations within our current tax legislation.

The main problematic features of Brazil's current tax system are:

- Multiple different taxes apply to the same tax base. For example, there are 5 taxes that can apply to a company's revenue: IPI, PIS, COFINS, ICMS, and ISS. Each is governed by a different body of law, with separate procedures for calculation and remittance. The ICMS, a state-level tax, can have different rules in each state, and the ISS, a municipal tax, can vary depending on the municipality in which it is assessed. As a result, Brazilian companies — especially those operating across multiple states and municipalities — must navigate a web of rules to determine what percentage of their revenue must be paid in taxes.
- A single tax can carry different rates depending on the category of the product or service in question. This practice creates unnecessary complexity around the classification of products whose nature is ambiguous between categories that may carry very different tax rates. There are countless multi-million-real disputes arising from these differences in tax treatment, centered on discussions that would be entirely trivial were it not for their fiscal consequences. For example, in 2022 two cases became widely known: the first concerned whether Crocs footwear should be classified as "domestic footwear (slippers)" or as "other footwear with rubber or plastic outer soles and uppers," a distinction that resulted in a difference of tens of millions of reais in import duties; the second involved Sonho de Valsa chocolates, which, following a packaging change, were reclassified from "bombons" to "wafers" and became exempt from IPI (versus a 5% rate for bombons).
- State and municipal taxes are levied based on the origin of the sale — that is, taxes are paid to the state and municipality where the selling company is located. This system has the merit of simplifying tax calculation for companies, but creates the serious problem of fiscal competition among states and municipalities. A common outcome of this so-called "fiscal war" is companies whose main market is in São Paulo relocating to cities in other states (near the border) to pay less ICMS. This kind of arrangement is clearly unproductive: suboptimal logistics increase the real cost of the product (before taxes) and that value is simply wasted. In other words, one state's government incentivizes this unnecessary cost in order to capture tax revenue that would naturally accrue to its neighbor.
- There are many tax benefits currently in force, which distorts competitive dynamics in the country. As a consequence of high rates and fiscal wars, some benefits are generous enough to make inefficient companies competitive, offsetting their operational inefficiency through reduced tax payments after applying these benefits. In some sectors, the ability to negotiate tax benefits thus becomes a more important competitive factor than being operationally efficient. This dynamic tends to crown the wrong champions — bureaucratic entrepreneurs running inefficient businesses that thrive on tax incentives and protectionist legislation shielding them from international competitors.

There are countless other specific problems stemming from legislative complexity, but from a broader perspective, the central issue is the damage done to economic efficiency. Beyond the distortions introduced into free-market dynamics, millions of hours are devoted each year by business owners, accountants, consultants, tax auditors, lawyers, judges, and others to tax-related matters — activities that are inherently unproductive. This is precisely why a comprehensive tax reform could stimulate Brazil's economic growth.

Below, we discuss the current reform proposals under consideration.

Tax reform proposals under discussion

There are currently two constitutional amendment proposals (PECs) on tax reform: PEC 45/2019, from the Chamber of Deputies, and PEC 110/2019, from the Senate. Although both are recent, this reform has been on the agenda for quite some time. PEC 110/2019, in particular, was based on PEC 293/2004, drafted by a special commission nearly two decades ago. While there are differences between the two proposals, both share a very similar conceptual foundation. We will therefore focus on these common elements, given that the specifics are still likely to be modified before any definitive reform is eventually approved.

The central objective of the reform is to bring radical simplification to consumption taxation. The proposals rest on several conceptual pillars:

- Unification of the 5 taxes currently levied on revenue (IPI, PIS, COFINS, ICMS, and ISS) into a single value-added tax — the model adopted by most countries in the world. In Brazil, this tax would be called the IBS (Tax on Goods and Services Operations). Alongside the IBS, a new Selective Tax (IS) would also be created, applying to products harmful to health or the environment whose consumption is to be discouraged.
- Maintaining the overall tax burden equivalent to that of the taxes being replaced. IBS rates would be set so that total revenue collected is equivalent to what would have been collected had the existing taxes remained unchanged. The reform is therefore not about increasing or reducing the overall tax burden, but about changing the form and administration of tax collection.
- Applying uniform rates to revenues of any nature, eliminating disputes over product and service classifications or differences in the treatment of various revenue streams. Rates on the sale of services and goods would be equalized. PEC 110 would allow different rates for certain product categories, while PEC 45 proposes full unification, but both follow the principle of uniform rates as a general rule.
- Multi-stage, non-cumulative IBS collection. The new tax would be applied at every stage of the production chain on a non-cumulative basis — meaning that any inputs consumed by a business would generate credits to be offset against the total IBS due on the company's revenue. IPI and ICMS already work this way, but PIS and COFINS vary case by case, and ISS is cumulative, resulting in higher taxation when a production chain involves more service-providing links. The advantage of the non-cumulative regime is greater transparency about the total tax levied throughout production chains. Multi-stage collection (applying the tax at every sale rather than only at the point of sale to the final consumer) adds complexity but supports efficient enforcement, by providing greater visibility into each stage of the chain and requiring two parties to report the same transaction (the selling and the buying entities), enabling cross-checks.
- Payment of taxes to the destination of the sale — that is, adopting the principle that if a consumer in the city of São Paulo makes a purchase, the consumption taxes they pay should be allocated to ends that benefit them and therefore collected by the jurisdiction where they live. Beyond this principle of using tax revenue to benefit the population that paid it, destination-based taxation eliminates fiscal competition among states and municipalities, since the location of the selling company no longer matters.
- Reduction of tax benefits. PEC 45 prohibits any form of benefit involving the IBS, and PEC 110 limits them to a small number of product and service categories. Both

proposals aim to drastically reduce the number of tax benefits currently existing in Brazil, making the tax burden more equitable across companies.

- An IBS refund mechanism for low-income taxpayers. To offset the social impact of eliminating tax benefits — which are often defended as a way to reduce the final cost of essential goods for low-income populations — both proposals include a mechanism to reimburse the IBS paid by low-income consumers. This way, the subsidy would be better targeted at its intended beneficiaries, and the social impact question would be separated from the discussion of benefits for specific companies or sectors.

If the reform is so beneficial, why has it taken so long?

Although the reform proposals represent clear improvements over our current tax system and are beneficial to the country as a whole, that does not mean they are beneficial for every taxpayer — especially in the short term. There are therefore several political factors that complicate their approval and implementation. The main ones are:

- By unifying rates, half of taxpayers will pay more taxes. Because the reform's concept is for everyone to pay the same rate while keeping total revenue unchanged, taxpayers who were previously paying an effective rate above the average will see their tax burden reduced, while those paying below the average will pay more. In other words, half of all taxpayers — when assessing the immediate impact on themselves — have an incentive to oppose the reform.
- Unification would also reduce revenue for some government entities (the federal government, states, and municipalities), which join the resistance. Analogously to the previous point, by equalizing rates and shifting from an origin-based to a destination-based tax regime, many municipalities and states would experience revenue losses. To mitigate this problem, the current reform proposals include rules for distributing IBS revenue among government entities and elaborate restitution mechanisms for those negatively affected, which would remain in force for extended periods in order to soften the reform's impact and reduce political resistance from these entities. In any case, this discussion adds yet another layer of complexity to the approval of the new tax system.
- The elimination of tax benefits puts several influential companies against the reform. As a rule, those who hold the most tax benefits are the economic groups with the greatest political influence — the very influence needed to secure those benefits in the first place. As a result, the reform would hurt precisely those groups with the greatest political power to resist its implementation.

Amid these conflicts of interest, and now 19 years after the first PEC on tax reform was introduced, no proposal has yet managed to gather sufficient support to be approved by the National Congress.

How to make investment decisions in this context?

It is difficult to know when a tax reform will be implemented in Brazil. The priority the new government is placing on this agenda may mean that, this time, it is approved by Congress in the near term — but given that this discussion has been ongoing for two decades, it would be imprudent to rule out the possibility that the issue remains unresolved for several more years.

Despite the uncertainty around approval, the shape of the reform is reasonably well developed, so it is plausible to adopt the premise that, if passed, the reform will preserve the founding principles of the proposals contained in PECs 45 and 110. The exact impact that the new tax system would have on each company's valuation is difficult to calculate, but it is possible to determine whether that impact would be positive or negative, and to have a reasonable sense, in relative terms, of which businesses would be most affected. In summary, in a scenario where the reform is approved, there are two factors we can use as guides to interpret the impact on each company:

- Companies that currently pay below-average consumption taxes will be disadvantaged, while companies that pay above-average consumption taxes will benefit. This effect is the direct result of the principle of unifying rates across all revenue types. The clearest case is that industrial businesses, subject to IPI and ICMS, should see their effective rates reduced, while service businesses, subject to ISS, should see their effective rates increase.
- Tax benefits should lose their value. Since the existing benefits are tied to the 5 current taxes, as those taxes are replaced by the IBS, the benefits will lose their worth. For example, a 70% exemption on ICMS due will have no value once ICMS ceases to exist.

To prevent these impacts from being too abrupt — which could cause price shocks and frustrate investments made under the assumption of the existing tax regime — both proposals include transition periods (of 6 or 7 years, in the most recent drafts). However, softening the impact does not change its direction.

When evaluating new investment opportunities, a practical rule of thumb is: the lower the effective consumption tax rate a given company currently pays, the greater its risk of being negatively affected by the tax reform. Conversely, the higher the effective rate paid by a company, the more it stands to benefit from the reform.

The complexity surrounding this topic is a good illustration of why the Brazilian stock market is a challenging environment for individual investors, who generally cannot dedicate the time required to analyze issues of this kind — which, extensive as they are, represent only a small fraction of everything that must be evaluated before making an investment with appropriate diligence.

Despite the additional challenges these issues create for investment analysis, we view the tax reform proposals favorably. Their approval would represent a tremendous step forward for the Brazilian tax system, one that should generate productivity gains, stronger economic growth, and consequently, greater appreciation potential for publicly listed companies.