The Proposal of a Digital Services Tax amid the Tax Reform Debates in Brazil

By:

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Introduction

Brazil has been a challenging environment for businesses, in great part, due to the complexity and inefficiency of its tax system. Despite some controversy about the necessity of a wide and structural tax reform, the topic has been treated as a priority by the President and Congressional leaders, but the bills that currently address the tax reform have struggled to make significant progress in the Brazilian Congress. Besides, uncertainties remain as the Federal Administration may present and endorse a proposal, which could include the creation of a Digital Services Tax ("DST").

The purpose of this paper is to provide an overview of the Brazilian tax system, addressing its basic features, some of the problems it presents, the proposals to tackle such problems in a tax reform, and the debates surrounding the

creation of a DST.

Basic features of the Brazilian tax system

Brazil is organized as a federal republic, formed by the union of Federal Union, States, Municipalities and the Federal District. The Brazilian Constitution grants administrative autonomy to each political unit. It also allocates taxing rights among them (Articles 145 to 162), which is an important aspect of the political units' administrative autonomy. The current Constitution was enacted in 1988 and preserved the general structure of a tax system that was originally established in the 1960's.

In summary, the Federal Union has the authority to tax: importations ("Import Duty" or "II"); exportations ("Export Duty" or "IE"); income ("Income Tax"); industrialized products ("Excise Tax" or "IPI"); financial transactions, currency exchange and insurance ("IOF"); rural property ("ITR"); great fortunes (never imposed); and labor and employment. It also has the authority to collect social security contributions ("PIS", "COFINS", "CSLL" and others) and contributions for intervention in the economic domain ("CIDE"). The States may impose taxes on trade on goods, inter-municipal transportation services and telecommunication services ("State VAT" or "ICMS"); inheritances and gratuitous transfers ("ITCMD"); and the property of motor vehicles ("IPVA"). The municipalities may levy taxes on urban property ("IPTU"); property transfers ("ITBI"); and services of any kind ("Service Tax" or "ISS"), except for inter-municipal transportation and telecommunication services, which are taxed by the States. Finally, the Federal District cumulates the taxing rights of the states and municipalities in its jurisdiction.

Problems of the current system

The Brazilian tax system is complex and inefficient. Not surprisingly, the Minister of the Economy referred to it as a "tax madhouse" in a reference to Augusto Becker (1963), an influential tax scholar in the 1960's. As of today, the madness once identified by Becker seems aggravated. Labor and employment taxes are charged at high rates. The costs of a lawful employment relationship may discourage formal hiring and stimulate informality. Reports from the World Bank Organization and PricewaterhouseCoopers (PWC) indicate that complying

with tax obligations in Brazil takes longer than anywhere else in the world. A relevant part of that complexity is associated with indirect taxes. Consumption taxes represent an important source of revenue to all political units and are the source of burdensome tax reporting obligations.

Furthermore, the allocation of taxing rights between the Federal Union (Excise Tax), the states (State VAT) and the municipalities (Service Tax) was based in the economic reality of the 1960's. The criteria historically applied to identify the boundaries between the tax jurisdiction of each political unit - such as the civil law concepts of an obligation "to do" or "to give" something, or the distinction between tangible and intangible assets – has been proved obsolete and insufficient in the current economic context.

The existence of different indirect taxes led to disputes between the political units for the right to tax certain activities. As a rule, the levy of the Service Tax (ISS) shall exclude the levy of the State VAT (ICMS) and the Excise Tax (IPI). However, it is not uncommon to find municipalities and states charging the ISS and the ICMS over the same activity, such as the sales of software. On the other hand, some activities may not be reached by any of those taxes, leading to an undesirable non-taxation. That is the case for certain Telecommunication Value Added Services ("VAS"), for example.

Along with the disputes for the right to tax certain activities, States and Municipalities engage in disputes to attract investment. As a rule, the State VAT and the Service Tax are due where the business unit of the supplier (seller) is located.[1] To attract new enterprises to their territory, States and Municipalities have granted illegal tax incentives. Such practice, commonly referred to as "tax war acts" created serious distortions in the State VAT non-cumulative regime and the economic conditions in which the taxpayers compete (unleveled the "playing field"). Tax incentives, by the way, even the ones not granted in the context of the "tax war", seem to be another problem, especially to the budget of the Federal Union.

Finally, because of the problems abovementioned and others, the level of tax litigation in Brazil is unprecedented. Tax disputes flood administrative e judicial courts all the way up until the Supreme Court, creating instability and

uncertainty for enterprises, while also increasing the administrations' costs and stimulating a somewhat "hostile" relationship between tax authorities and taxpayers. All those factors raise compliance costs and certainly affect the competitivity of Brazilian products and enterprises.

Tax reform proposals

The primary focus of tax reform proposals is to simplify the Brazilian indirect tax regime and tackle its problems, without compromising the public budgets. Currently, two bills, one in the House of Representatives ("PEC No. 45/2019") and one in the Senate ("PEC No. 110/2019"), concentrate the tax reform debates in Congress. The bills differ in certain aspects, such as the allocation of taxing rights between political units, transition period and the number of taxes affected by the reform, but share a common proposal in the replacement of the State VAT (ICMS), the Service Tax (ISS), the Excise Tax (IPI) and the PIS and COFINS social contributions for a new value added tax that would levy on services, transactions with goods, assets, intangibles and other "utilities", the Tax on Assets and Services ("IBS").

The IBS was designed as a value added tax with a broad base and simple rules for offsetting tax credits and debts. IBS revenues would be divided between the political units and the share of the States, Municipalities and the Federal District would be granted to the place of consumption or destination. Since the taxes that the IBS would replace represent a significant source of tax reporting obligations, the changes proposed tend to reduce compliance hours and costs. In addition, the allocation of taxing rights to the place of consumption (destination) and the enactment of simple non-cumulative rules tends to reduce litigation and "tax-war-like" disputes.

Yet the IBS proposals appear well accepted in Congress, a lot of uncertainty still surrounds the political scenario. The bills – "PEC No. 45/2019" and "PEC No. 110/2019" - were an initiative of Congress representatives and neither one has been officially endorsed, nor discouraged, by the Federal Administration. As the tax may affect the administrative autonomy and the budget of States, Municipalities, and the Federal District, the difficulty and complexity of the political negotiations required to approve such a substantial change may have

influenced the Federal Administration's approach towards the bills and the tax reform itself. The Federal Administration endorsed a parallel bill – "PL No. 3.887/2020" – that proposes the replacement of the PIS and COFINS social contributions for a new tax, similar to the IBS: the Contribution on Assets and Services ("CBS"). The CBS appears a remodeled version of the PIS and COFINS, which may provide simplification and may enable the reduction or extinction of certain tax incentives.

It is important to note that the creation of the CBS would not affect the allocation of taxing rights and revenues, since the Federal Government holds the authority to collect social contributions. In that regard, by proposing the creation of the CBS, the Federal Administration may be intentionally avoiding a protagonist role in the negotiations with states and municipalities for the creation of the IBS. The PL No. 3.887/2020 was announced as the first part of the tax reform proposal endorsed by the Federal Administration. The remaining part(s) was not announced yet, but the Minister of the Economy has shown the intention of lowering labor and employment taxes. Besides, he claims to be evaluating alternatives to balance the financial impact of such measure on the federal budget. One of the alternatives considered is the creation of a DST.

Debates surrounding the creation of a DST

As of May 2020, a congressman filed a bill within the House of Representatives – "PL No. 2.358/2020" – proposing the creation of a tax, referred to as "CIDE-Digital", which presents the general characteristics of a DST. The tax would levy on the revenues earned by large multinational technology companies ("LMTC") from (i) internet advertising, (ii) internet platforms that allow the sale of products or the provision of services between users; (iii) the transmission of data collected from Brazilian users.

The bill assumes that LMTC are undertaxed in Brazil. However, that assumption is controversial, since several of them have subsidiaries paying taxes in Brazil. Furthermore, the share of revenues that is attributed to foreign entities is also taxed at significant rates. According to the Brazilian tax law, income derived by foreign entities from services rendered to Brazilian consumers is subject to a withholding income tax at a 15% rate and a CIDE (due on technical services) at

a 10% rate. Other taxes, such as the ISS, the ICMS and the IOF may also apply.

The proposal, which has been criticized for its potential to create an exodus of digital businesses and jobs, has not made any progress in its legislative procedure so far. The PL No. 2.358/2020 has not been endorsed by the Federal administration as well. It is true that the Minister of the Economy has spoken in favor of the creation of a new tax on electronic payments. However, it is still unclear if such new tax would levy upon revenues from big technology companies, as a DST, or if it would levy on electronic payments and other financial transactions.

Brazil had a previous experience with a tax on financial transactions in the past, the Provisory Contribution on Financial Transactions ("CPMF"). The tax levied on payments and other transactions that involve the intervention of financial institutions, such as money transfers and cash withdrawals. It was widely criticized by economists and tax scholars for being disconnected from value creation and burdensome to large economic (supply) chains. It was also a very unpopular tax, felt by the population in daily activities. Nevertheless, the CPMF proved to be an efficient means to improve tax compliance and collection. Despite the references made by the Minister of the Economy to a DST or a new tax on digital payments, his real intention seems to be the creation of a (perhaps remodeled) tax on financial transactions, based on the CPMF.

Conclusions

The tax reform proposals currently debated in Brazilian Congress – PEC No. 45/2019 and PEC No. 110/2019 – tackle the problems related to the indirect tax regime by creating a new value added tax, the IBS. The Federal Administration has not endorsed the IBS bills and proposed the creation of another tax, similar to the IBS: the CBS. All proposals may merge during the legislative procedure, and the CBS may be "attached" to the IBS.

In addition, aiming at reducing labor and employment taxes, the Federal Government may propose the creation of a new tax to compensate the budget impact of such reduction. Despite referring to the potential new tax as a DST or a tax on digital payments, the Minister of the Economy seems favorable to the creation of a tax on financial transactions, based on the later CPMF, levied on

payments and other transactions that involve the intervention of financial institutions, such as money transfers and cash withdrawals. A further comprehension of the scope of a DST or new tax on financial transactions, along with other potential changes shall be possible when the Federal Government presents the remaining part(s) of its tax reform proposal.

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[1] The original design of the State VAT and the Service Tax was based on the “origin principle”. Recent changes in the law shifted taxing rights to the place of destination, in specific situations, Still, taxation at origin remains as the general rule for both taxes.

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