INDIRECT TAX REFORM IN BRAZIL: a necessary complement to trade opening

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MAIN messages:

- **The indirect tax reform in Brazil can have a positive effect on foreign trade and support trade liberalization**

- **The VAT potential positive influences on foreign trade arises from the level of Brazil´s indirect tax system inefficiencies**

MIND THE GAP

Brazilian VAT

An ideal VAT

Broad base

Compreenhensive credit

Swift reinbursements

Small number of rates

Non tax burdens on investments and exports

Tax at destination

THE VAT genesis

Tax on sales: cumulation

- **Cumulation** is taxation without deducting the amount paid in the previous step
- **A "tax on tax“** effect
- **Increases taxation, as taxation increases with the number of stages of production**; taxes exports and investments and induces vertical integration to reduce tax payments

VAT as a "tax integration *software*"

- VAT does not differentiate locally produced and imported goods
- Imported and domestic goods are taxed at the same rate
- It is not a trade policy instrument
- No VAT incidence on exports; goods taxed at destination; avoids consumption double taxation.
- A border adjustment tax, does not tax exports and imports; sheltered from WTO resolutions

VAT helps trade integration I

Cumulative tax removal creates level playing field in competition with countries that do not have these tax anomalies by three means:

(i) the non-taxation of exports

(ii) a level playing field for competing with imported products that were not hampered, at their production phase, by cascading taxes

(iii) the elimination of investment taxation, which reduces the cost of capital and helps the economy structural adjustment

VAT helps trade integration II

- **Reduces the potential conflicts** with the WTO
- **Deductions from indirect VAT taxation are not deemed as subsidies**. VAT is a superior solution to other means used to neutralize cumulative taxes, such as rebates to the exporter, which are always subject to controversy on methodologies estimates
- **Taxes imports and crafts isonomic treatment for domestic producers** and foreign producers, respecting the non-discriminatory treatment clause of GATT Art. III.

VAT helps trade integration III

- **Removes incentives for unfair tax competition** between countries
- **Increases the overall economy efficiency** and its ability to compete by eliminating/reducing measures that distort the sectoral and geographical allocation of resources and bias on companies' size
- **Neutrality** in relation to production organization shapes; favors specialization and efficiency by not inducing verticalization, a process encouraged by taxes on revenues

BACK on track

- The remaining large countries with special faulty VATs were Brazil, India, and China
- Brazil is lagging
- China and India went through a long process to complete the distortions elimination. The reforms stressed the inclusion of taxation on services and the exports and investments burdens exemption

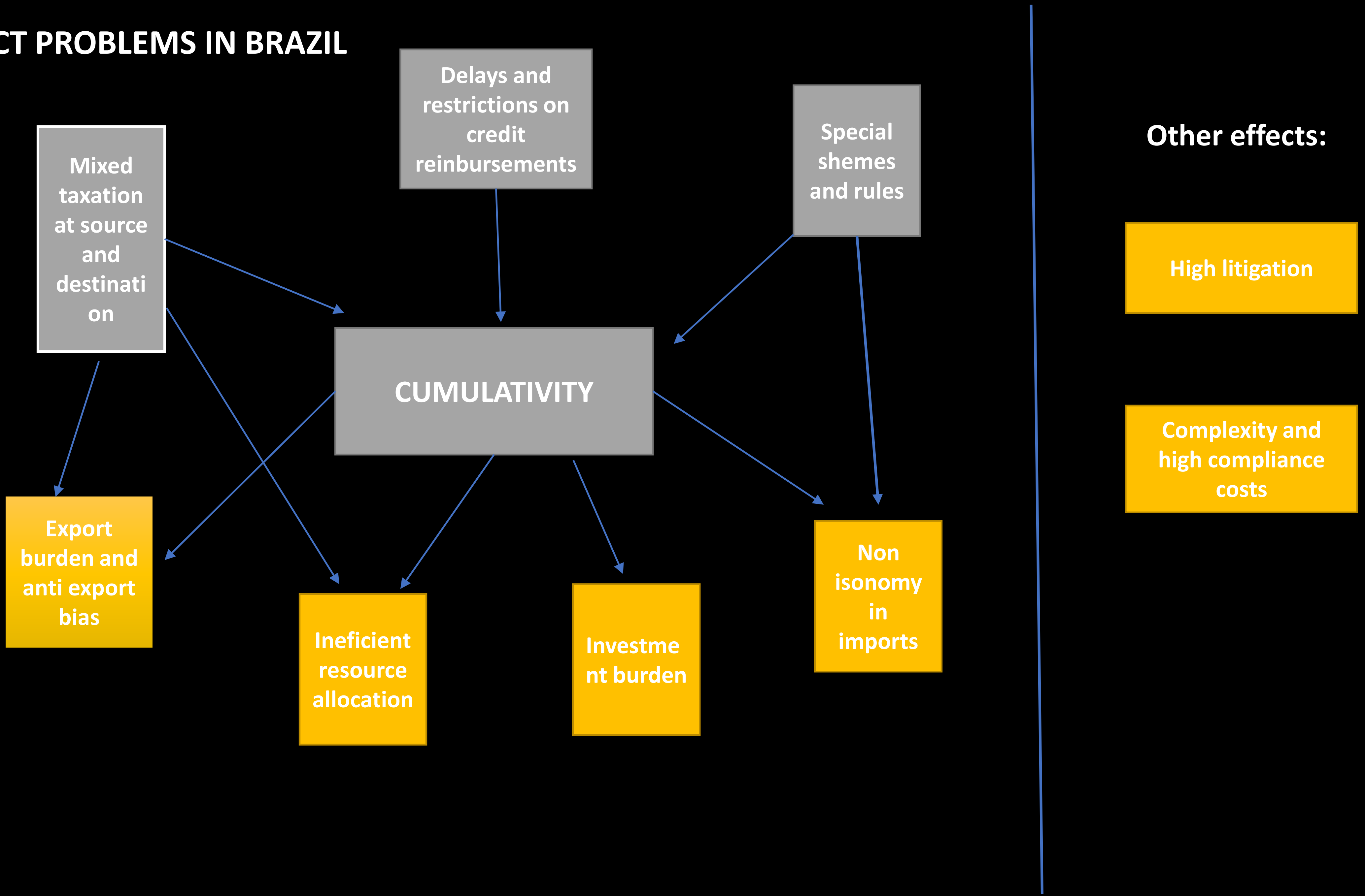
THE BRAZILIAN VAT: incomplete and imperfect

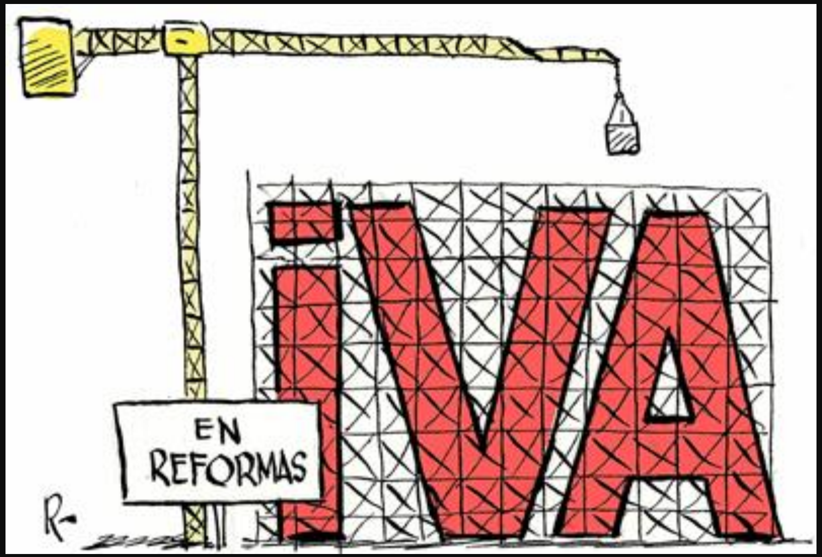
INDIRECT TAX/TAX ASSESMENT REGIMES	FEATURES AND DISTORTIONS
INDIRECT TAXES	
PIS AND COFINS	**Federal taxes.** There are two procedures: cumulative and non-cumulative, the latter with higher rate. It is in theory a border adjustment tax as taxes imports and exempt exports. There are, however, **several restrictions for credits settlement**.
IPI	**Federal tax.** A tax on industrialized products. A border adjustment tax as taxes imports and exempts exports. There are, however, **several restrictions for the credits settlement.**
ICMS	**State tax.** Rates vary in states and according to the transaction between states. The modal rate is 17%. A border adjustment tax, as taxes imports and exempts exports. There are, however, **several restraints for the reimbursement of credits. A relevant constraint is the of appropriation of investment credit only in 48 months.**
ISS	**Municipal tax.** Includes services that are not in the category of public utilities, taxed by ICMS**. Results in cumulation, without compensation.**
TAX ASSESMENT REGIMES	
SIMPLES	Unifies, in a single tax on revenues, federal, state, and municipal taxes (IR, CSLL, PIS / Cofins, IPI, ICMS, ISS and the employer's contribution to security) for companies with sales below R$ 4,800,000.00. It has variable rates. **Results in cumulation, without compensation.**
PRESUMED PROFIT **(Deemed taxable income)**	It is a federal taxation option (IR, CSLL, PIS/Cofins) for companies with revenues less than R$ 78 million. Profit is assumed according to the type of activity of the company. For the PIS/Cofins, the collection is made each month on the company's revenues (0.65% for The PIS and 3% for the Cofins). **In a parcel of these indirect taxes, cumulation is generated, without reimbursement.**
TAX SUBSTITUTION	It is a collection mechanism used in ICMS. The "tax substitute" is responsible for collecting the tax from the value chain. **The indiscriminate use has created new distortions (financial cost, arbitrary margins, reduced competition, cumulation for replaced companies)**

EMPIRICAL STUDIES show the economic effects of an imperfect VAT for competitiveness:

- **Cumulation** in the transformation industry exports, measured for the PIS/Cofins and ISS, is **2.75%** on net revenues
- **The tax cost of investment** in Brazil, deducted of tax incentives, is about **6%** and, with the financial costs, **11%**
- **These tax costs are,** according to Ernst & Young, **1.7%** for Australia, **1.6%** for Mexico and **0.4%** for the United Kingdom

TAX INDIRECT PROBLEMS IN BRAZIL





INCOMPLETE VAT: the taxes on revenues persistence and services exclusion

- VAT operational improvements does no make a dent on the competitiveness problems
- The challenge is to build a comprehensive VAT that allows the removal of taxes on revenues
- There are many issues to be handled: from the cumulative taxation of PIS/Cofins and ICMS to the ISS tax.
- The ISS inclusion on VAT reform is essential for the foreign trade agenda

SERVICES TAX is also a trade issue

- VAT problems linked to services taxation also extend to the services tax treatment of imports and exports

- In the case of taxes on imports of services, the problems result from a series of distortions in the method of calculating taxes in which the weight of taxation on income stands out. There are also issues associated with indirect taxation of Pis/Cofins

- Subject to the calculation method, the tax incidence can vary between **41.1%** and **51.3%** of the operation value (CNI study)

IMPERFECT VAT: the debt-credit system shortcomings

VAT operations faces malformations at state and federal levels with impacts on the economy and foreign trade:

- The credit recovery system presents both **structura**l (the predominance of physical credit instead of financial credit, as explained below) and **operational** (the delay in returning credit balances)
- **These dysfunctions lead to recurrent legal battles**, in which exporting companies refer to the constitutional precept of not taxing exports and submit petitions to the court to claim expenses recognition that are not recognized by the tax authorities

BRAZIL SOLO: the physical credit concept

- **Companies can only take credit for expenses incurred in the production process**, i.e. it does not allow the recovery of credits that do not physically enter the product or are consumed in the production process. In the financial credit system, all taxable transactions generate credit, regardless of their nature

- The physical credit concept is applied in ICMS, IPI and PIS/COFINS

Electricity used in produciton → ~~Electricity used in the office~~ → Credits

THE PHYSICAL CREDIT SYSTEM leads to less credits, bureaucracy and litigation:

- **Companies credit themselves with lower expenses** than their competitors and end up exporting taxes. Administrative, marketing, transportation, research and development expenses are not creditable

- **Increases compliance costs**. Examples: The energy used in production entitles the company to credit; used in the administration it does not entitle. Similarly, a screw used in the office chair does not generate credit; if it is used on a machine in industrial operation, it will be credited

- Competitiveness is distorted and neutrality is reduced. Companies that rely more heavily on marketing, transportation and research and development actions are most affected

- **The level of taxation is affected by the nature of the technological and production processes**. There are production systems that have greater attachment to the concept of physical credit and, despite having non-recoverable credits, get less credit than in other production processes

THE REINBURSEMENT nightmare

- **It happens in companies that have more credits than tax debts.** A regular problem in all indirect taxes in Brazil
- **This problem affects profitability and engagement in exporting activities**. In many cases, the delay of credit is equivalent to the denial of the credit existence
- **Increases pressure on working capital.** In Brazil, this pressure is worsened by high level of the domestic interest rate and the fact that the tax authority does not pay late interest for delays.
- **The delays in return are meaningful and can take up to several years**
- **State and federal tax authorities generate protocols limiting the use of credits**, restricting the principle of non-cumulation and also hindering the use and transfer of accumulated balances

THE ROAD to litigation

Companies file lawsuits requesting the immediate right to credit, without restrictions, based on Constitution articles on cumulation

Sample: 30 largest brazilian publicly traded companies listed on the stock exchange

Disputes: 31.8 billion reais, equivalent to 21.7% of the total disputes identified in the survey

Thee most common issue: credit-giving operations and the input concept, with disputes around 12.6 billion reais

Source: Lopes, Ana Teresa Lima Rocha,2017

THE PHYSICAL INPUT CONCEPT as a source of litigation

Each indirect tax legislation has an input definition

The consensus on the input legal concept is greater in ICMS and IPI regulations

Repeated disputes linked to production process properties

Appeals to the Supreme Court

Average trial time: 12-17 years

Solution: a credit-invoice method based on financial transactions

THE STATES COALITION AGAINST EXPORTS

A byproduct of a mixed source/destination tax system

Source taxation: the taxation revenues are kept in the producing state and not in the destination state of the inputs

The exporting state does not receive these claims, but incurs in payments of creditor and debtor balances gap

As imports may not come directly to the state ports in which the investment is located, indirect taxation takes place at the provenance port of the import

This reinforces the anti-export atitude

A tax system with several “incentives" against foreign trade

TAX REFORM, TRADE OPENING and the demand for sectoral policies

Tax distortions have upshots in other policy areas that end up crafting a fertile environment for policies that induce low productivity

Claims for special indirect taxation treatments

Requests of a "normal" tax system by the demanding sector

Preferential solutions erode the coalition needed to drive pressure for a more horizontal and less discretionary system

INCENTIVES FOR TAX ENTROPY

The special tax regimes case. Reidi (infrastructure), Reporto (ports), Repes (service export platforms) and Recap (exporting companies) have a common element: **PIS/Cofins deferral for machinery and equipment purchases in the domestic and international markets acquisitions**

The deferral is not neutral . The equipment manufacturer loses a tax that would be part of the reduction of taxes paid for inputs and accumulates credits difficult to be recovered or imperfectly recovered. **It creates a demand for solutions that end up increasing the system entropy for the sake of equal conditions to compete**

This shapes a demand for an industrial policy that "molds" the tax system and distances IP from agendas aimed at increasing productivity and developing ecosystems favorable to innovation

THE TAX SYSTEM DISFUNCTIONS fuel the protection demands:

The burden on exports, due to restrictions on the credit of expenses and difficulties in receiving the credits due

Tax on investments, due to non-recoverable taxes and restrictions on the use of credits in the operational phase

Competition with imported products, without the same tax recordings and, in some cases, ICMS deferred due to state policies to attract investments

The joint action of these distortions reduces the country's ability to fully benefit from the effects of a trade opening, intensifies negative impacts and limits responsiveness

TAX DISTORTIONS IMPACTS ON PRODUCTIVITY

Tax burden *on* investments	**Tax burden on exports**	**Verticalization (cumulation) and deverticalization (credit ficto)**
Counter productive incentives to SMEs growth	**Compliance costs**	**Litigation and legal uncertainty**
Different product taxation without economic logic	**Tax informality**	**States fiscal war**

THE MESSAGE: tax reform as complement to a successful trade liberalization

The incomplete and imperfect VAT

reduces the exporting sector profititability

increases legal uncertainty

distorts competitive conditions

reduces companies´s ability to react to pressures to move towards structural transformation

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The VAT reform priority is recognized by international institutions such as IMF, OECD and World Bank, Congress, experts, and economic operators

Competitors do not have tax systems with similar distortions. China and India, the other laggars, are accomplishing their reform processes

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It is promising that trade liberalization and tax reform are in a corresponding time agenda

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