

# Initial views on tax reform proposals and sectoral impacts

July 2020

The debate on reforming Brazil's tax system is not new, and the topic is now back on the spotlight of the political and economic scenario. On July 21, Minister Paulo Guedes presented the first part of the government's tax reform proposal, which is now being discussed as part of a joint committee in Congress.

## The tax system in Brazil and the importance of reforming it

Since the 1988 Federal Constitution, every Brazilian President has tried to implement a wide-ranging reform to the country's tax system – and each one of them failed. Product of a system globally known for its complexity, Brazil currently features as the 184<sup>th</sup> worst country in the World Bank's Doing Business report when it comes to paying taxes. It's worth noticing that the weight of the tax burden is not compounded on the result (currently at 33% of GDP), which is measured based on the number of hours spent complying to tax obligations. In Brazil, a company spends, on average, a total of 1501 hours per year “literally” paying taxes. This compares to 256 hours calculated for the emerging peer Colombia, and 139 in “red tape” France.

### World Bank Doing Business Report (2020)



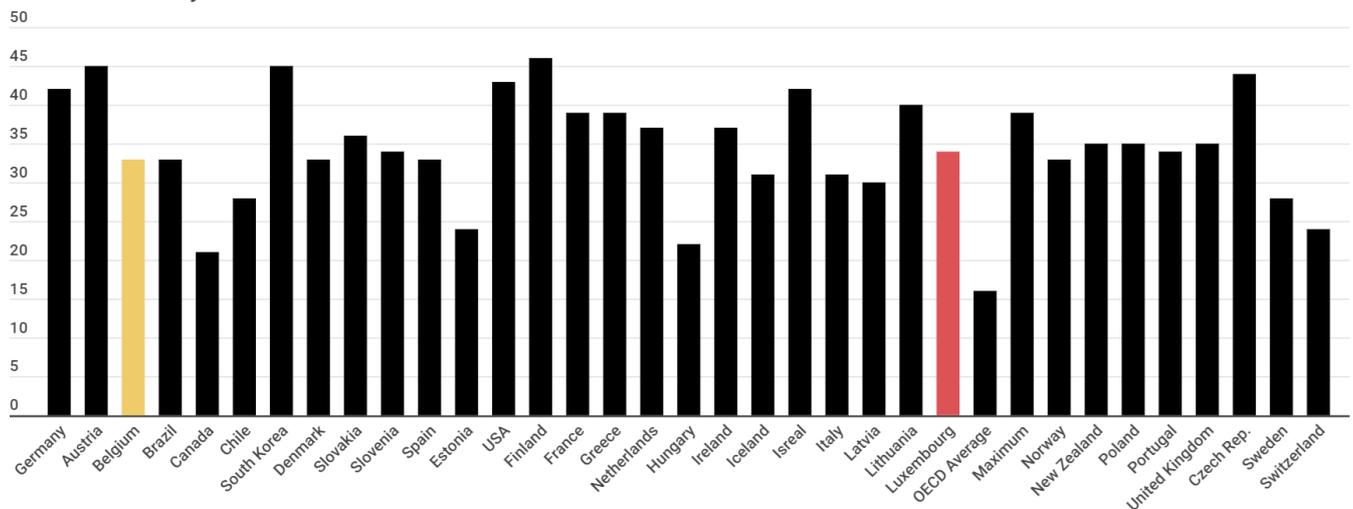
Focusing only on taxes applicable to goods and services, the more than 12 different taxes totaled from federal, state and municipal levels represent a key constraint to productivity and competitiveness of Brazil's productive sector. Featured by different rates and heavy subsidies, the system leads to misallocation of resources not only between sectors but also amongst regions. It also contributes to a piling amount of litigation and, in some cases, to making businesses financially inviable given the high costs of tax compliance. Finally, the cumulative nature of the current system weights relatively more on production, making the system more regressive as lower income households dedicate proportionally more of their income to final goods – whereas the wealthier population tends to spend more on services.

In this context, three main projects proposing changes to the current tax system are currently in discussion at a special Joint Commission in Congress. All of them have the main (and common) objective of simplifying the tax system through the implementation of a wide-ranging Value-Added Tax (VAT), with a unified rate applicable to all goods and services. For now, the proposals don't include any changes to the current income tax framework.

While the government's first proposal encompasses only federal level taxes (in a new VAT named CBS, with a 12% rate), both the Lower House and the Senate proposed a more amplified VAT – including both federal, state and municipal level taxes. The transition period, potential exemptions to the common rate and other details feature as diverging points between the proposed projects.

### Tax burden in OECD countries and in Brazil (% GDP)

Source: OECD. By: XP Investimentos.



## The proposals in progress

There is a favorable political environment for the discussion, which mainly stems from the efforts of Rodrigo Maia, the President of the Lower House, for the discussions to proceed - but there are several hurdles ahead. The first concerns the scope of the debate in Congress, since the government intends to send new stages of the proposal in August, which would encompass income taxation (so far, not included in any proposal) and the creation of a tax on transactions, which could offset payroll tax cuts. It is still unclear in Congress whether these issues would be dealt with within the same debate, or separately.

As it concerns a reform by stages, there are sectorial resistances that become clear when looking at a particular phase. For instance, the service sector defends the payroll tax cuts as a way to offset the increase in the VAT rate. However, should a complete package be introduced, there would be resistance from political groups, for instance to discussions about changes to the income tax.

*It is also worth noting that the discussion is taking place at a time when representatives and senators are already highly influenced by the debate on the succession to the presidency of the Lower House and the Senate, in February 2021, which may have consequences to the day-to-day discussions.*

*The rapporteur for tax reform, Representative Aguinaldo Ribeiro, intends to present his report by the end of September. After that, the proposal still needs to be considered by the Special Committee of the Lower House and by the floor of the House, to then proceed to the Federal Senate.*

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## **Potential impacts on different sectors**

*The potential impacts of a tax reform would certainly be different between sectors, depending also on the nature of the regime finally approved by Congress and Executive.*

## **Financials**

*On financials, the impact so far would be minimal, but we still expect further changes. Based on the government's first proposal, there would be a 1.15 pp difference to 5.8% on the implementation of a new VAT (the CBS), which would replace current taxes of PIS/COFINS. As CBS is a tax deducted from net revenues and not from profit, it may impact banks' operational leverage and, according to our estimates, should deteriorate Banks' Net Income by 3% in 2021.*

*Nonetheless, we understand the most relevant impacts would derive from further changes, should a second phase of the government's proposal be introduced, namely: i) introduction of dividend taxation, as banks are mostly evaluated by DDM; ii) removal of IoC benefits, which represents an important tax benefit for banks; and iii) introduction of taxation on digital transactions, which would impact banks' revenues from fees.*

## Malls and commercial properties

*On Malls and Commercial Properties sector, we estimate a moderate initial impact with the unification of the PIS and COFINS into a new single tax (CBS), as suggested in the government's first proposal. The magnitude of the impact would also be contingent on the percentage of tax payment made through the non-cumulative or the cumulative regimes (which in turn depends on which tax regime between "Lucro Real" or "Lucro Presumido" they adhere to). Companies that operate with a mix that is more skewed towards the cumulative regime are expected to be more directly impacted at first.*

*As for the airline industry, a greater share of revenue is currently under the cumulative tax regime (3.65% tax rate), and therefore the impact of the tax unification could be more relevant at first. Azul's Cargo and international revenues, for instance, are registered under the non-cumulative regime, but they represent a smaller share of revenues.*

*On the Car Rental sector, most of the tax payment is made through the non-cumulative regime (tax rate of 9.25%), and therefore companies are granted tax credits. Despite the negative initial impact of a potential increase in the tax rate (from 9.25% to 12%), the main question lies around future treatment of such tax credits. We note, however, that other potential changes under discussion, such as the payroll tax and other taxes exemptions, could offset the initial downside effects to some extent.*

## Homebuilders

*Also considering the first proposal sent by the Executive, we understand that the impact in the homebuilders segment would be limited. However, as seen with other sectors, further possible changes such as the taxation of dividends, would have a greater impact on the industry.*

*For homebuilders focused on the mid and high-income segment under the special tax regime ("RET"), the tax rate would increase to 4.12% of the monthly revenue from the current 4.0%, which represents a slight increase of 0.12 p.p. As for homebuilders focused on the low-income segment, the current tax rate remains unchanged.*

## Food & Beverages

*Also based on the proposal submitted by the government so far, there would be no material change in market dynamics for companies such as JBS, Marfrig and BRF. The potential unification of the PIS/COFINS rates should not significantly impact food prices, specifically, protein prices, according to the sector's top companies. Meanwhile, exports should remain exempt from said taxes.*

*Nonetheless, it is worth mentioning that there is still no consensus regarding the accrual of tax credits. The meatpacking industry acts as an intermediate link in the protein sector's supply chain, collecting PIS/COFINS from rural producers to be passed on to the government on behalf of the final consumer. However, as most of the meatpacking companies' final products belong to the food basket category, they do not pay PIS/COFINS. Thus, companies accrue tax credits that can be later used in other tax obligations or monetized.*

*A potential change in the food basket taxation model, be it complete exemption or a zero rate, could also impact the sector, as it would likely open other paths for the industry. Finally, another point of discussion is the potential unification of the ICMS tax between Brazilian states, which could impact the raw material's origination dynamics and should favor less verticalized industries with greater geographical coverage.*

## Metals & Mining and Pulp & Paper

*Regarding the Metals & Mining and Pulp & Paper sectors, we understand the impacts of the proposal submitted by the Executive appear to be limited. Nonetheless, given the complexity of the issue, members of the industry remain alert to the ongoing discussions.*

## Expectations on a wide-ranging reform

*As discussed, the potential approval of a tax reform would lead to permanent welfare benefits to Brazil. In a context where tackling this issue was for long disregarded by policymakers and politicians for the challenges it poses, one can see positive impacts surfacing even at the dawn of a discussion. A reflection of this are the prospects of greater investments. A simpler and more predictable tax framework provides legal and regulatory certainty, key for any business or investment decisions – be that foreign or domestic.*

*Finally, it's worth noticing that there is still a long way to go before one can see a completely reformed tax system in Brazil. In this first phase, for example, none of the proposals touch on the rules for "special regimes" such as the Simples Nacional, the Manaus Free Trade Zone and others. They also don't cover subsidies to the staple food basket, the exemption for philanthropic institutions or the tax on financial transactions (IOF) – what could pose a potential barrier to Brazil's adherence to the OCDE's Code of Liberalization of Capital Movements.*

*The progress made at the Joint Commission in Congress will be key to understand the "real face of the reform". As these become clearer, so will the likely impacts of the changes on the different sectors and the overall economic reality in Brazil.*

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