

## BRAZILIAN TAX SYSTEM

An overview of the brazilian tax system and its indirect taxes

- ▶ The concept of Tax is set out in the 3rd article of the National Tax Code: "*Any pecuniary benefit, compulsory, in money or whose value can be expressed in it, which does not constitute a sanction of an unlawful act, instituted by law and charged by a fully bound administrative activity*".

In other words, a Tax is a citizen obligation towards the State, mandatory to all, that must be paid with money, established in law, due to licits acts (excluded the criminal acts, which are subject to other penalties, like fines, imprisonment and so on), whose collection should come exclusively from state actions directed at society.

## DEFINITION OF TAX

There are four main principles governing the Brazilian Tax System, in direct relation with democratic precepts:

- ▶ Equity (or Contributory Capacity, or Taxable Capacity): means that the collection of taxes should respect equity between citizens, analyzing their social and economic differences. This goes beyond the classical concept of fairness, usually linked to the equality principle;
- ▶ Legality (or Respect for the Rule of Law): means that it is not allowed to collect taxes, as well as establishing benefits and punishments, without legal provision. It is quite resemblant to the principle of Certainty in CR;
- ▶ Freedom (Prohibition of Confiscation): The State is forbidden to restrict freedom and fundamental guarantees by unreasonable and disproportionate collection of taxes;
- ▶ Anteriority: In compliance with the principle of Legality, it prevents the State from establishing the collection of taxes without observing a deadline for the start of its validity, in order to surprise the citizens.

## PRINCIPLES

In Brazil, taxes are defined as a big genre that is subdivided into three types of taxation, each one linked an administrative activity:

- ▶ Impostos (taxes): General funding of state activities. There are not specific services or other benefits for this contribution do the state budget;
- ▶ Taxas (duties): Compensation for specific and divisible public services for each taxpayer and/or resulting from police power;
- ▶ Contributions: Payments to finance specific and determined public policy (economic and social investments, general public works, etc).

Moreover, we can divide the taxes as to the economic category upon which they fall:

- ▶ Income: that is, all that is earned by doing the work;
- ▶ Patrimony: property ownership (movable and immovable);
- ▶ Economic activity: circulation of wealth.

## TYPES OF TAXES

- ▶ Since the Proclamation of the Brazilian Republic (except Era Vargas, between 1937 and 1946) it is important to note that Brazil, in theory, constitutes a Federation. Federation, by definition means the union of states that delegate their sovereignty to the Federal State.
- ▶ Differently from United States, that was not what happened. Even though in our colony history the regions were almost independent de facto, because of our huge extension and relatively small population, all the independence were delegated by the central power. It was like that until the birth of the Republic, when a Federation was formed.

## FEDERATIVE PACT

What is seen in the table is a true concentration of tax policy under the jurisdiction of the Federal Government, to the detriment of States and Municipalities.

## FEDERATIVE PACT – TAX COMPETENCES

Table 01 - Tax by economic category X Tax competence of the Federative Entities

Federative Entities / Estados Geradores	Federal government (articles 153 e 154, Federal Constitution)	States (art. 155, FC)	Municipalities (art. 156, FC)
Income	<ul style="list-style-type: none"> <li>- Income Tax (IR)</li> <li>- Social Insurance Contribution</li> <li>- Work Accident Insurance (SAT)</li> <li>- Contribution to the Public Education ("Salário-Educação")</li> <li>- Contribution to the "S System"</li> </ul>		
Patrimony	<ul style="list-style-type: none"> <li>- Tax on rural property (ITR)</li> <li>- Tax on Wealth</li> <li>- Contributions on improvement</li> </ul>	<ul style="list-style-type: none"> <li>- Tax on transmissions <i>causa mortis</i> ou donation of any nature (ITCMD)</li> <li>- Tax on the Property of Automotive Vehicles (IPVA)</li> <li>- Contribution on improvement</li> </ul>	<ul style="list-style-type: none"> <li>- Tax on urban property (IPTU)</li> <li>- Real estate transfer tax (ITBI)</li> <li>- Contributions on improvements</li> </ul>
Economic activity	<ul style="list-style-type: none"> <li>- Tax on Industrialized Products (IPI)</li> <li>- Tax on Financial Operations (IOF)</li> <li>- Importation Tax (II)</li> <li>- Exportation Tax (IE)</li> <li>- Contribution to the Social Security (COFINS)</li> <li>- Social Integration Program (PS)</li> <li>- Social Contribution over the Net Profit (CSLL)</li> <li>- Intervention Contributions in the Economic Domain (CIDDE)</li> </ul>	<ul style="list-style-type: none"> <li>- Tax on circulation of goods and services (ICMS)</li> </ul>	<ul style="list-style-type: none"> <li>- Tax on services of any nature (ISS)</li> </ul>

- ▶ The distribution of the Union's revenues to the States and Municipalities and of the States towards the Municipalities - the so-called Funds of Distribution of the Tax Revenues (art. 157 to 161 of the Constitution) - lend themselves to guarantee such independence. This is because, on the one hand, such Funds create a real bureaucracy between federative entities, generating suspicions and endless judicial discussions about their accuracy.
- ▶ In practice, the tax resources shared by the Union with States and Municipalities and States with Municipalities, before arriving at each citizen as public services, goes from hand to hand for a stupid and unreasonable bureaucracy, generating strenuous costs and the possibility of deviations along the way (legal or criminal) that clog the Judiciary with endless legal discussions.

Federative Entity	Fiscal budget	%
Federal government	737.004,43	69,83%
States	270.046,37	25,59%
Municipalities	48.356,17	4,58%
Total	1.055.406,97	100,00%

## FEDERATIVE PACT – TAX CONCENTRATION

- ▶ Brazil is known as a country that has heavy taxes on consumption, up to half of the national tax revenue, and softer taxes on income. That, among other things, means a greater social inequality when in comparison to other countries, mostly the developed ones, that go in the opposite direction.
- ▶ There are mainly five taxes that affects the prices of goods and services in Brazil, levied by the three levels of the Federation. At federal level, there are IPI, PIS e Cofins. At State level, there is the ICMS. At municipal level, the ISS. By far, the ICMS is the most important tax to the States, representing around 80% of their tax collection, and 20% of all the taxes collected in Brazil.
- ▶ Normally, the indirect taxes are levied in each level of the production chain, and the participants of the chain can deduct what was already paid as a tax to the seller from whom they purchased the product, if the tax is non-cumulative. A fiscal credit (if the input tax is bigger than the output tax) gives to the tax payer the possibility to claim this fiscal credit on another tax payment.

## INDIRECT TAXES IN BRAZIL

► **IPI - Imposto sobre Produtos Industrializados (Tax on Industrialized Products)**

Decree 7.212/2010: Art. 4o *Industrialization characterizes any operation that modifies the nature, operation, finish, presentation or purpose of the product, or perfects it for consumption.*

The tax base is the product selling price, varying a lot by product, from 0% to 45% (cigarettes), for example. The taxable event can be the custom clearance of the imported product or the selling of the industrialized product from the industrial establishment or equivalent to it (according to the law).

► **PIS – Programa de Integração Social (Social Integration Program)**

Federal Constitution: Art. 239. *The collection resulting from the contributions to the Social Integration Program (...) and the Program for the Formation of Public Server Patrimony (...) begins (...) to finance, under the terms provided by law, the program of unemployment insurance and the allowance (...).*

Also known as PIS-PASEP, this tax has as objective financing the payment of unemployment insurance, payment and participation in the revenue of organs and entities for public and private workers. The PIS is intended for employees of private companies and PASEP is destined to the civil servants.

## INDIRECT TAXES

► **COFINS - Contribuição para o Financiamento da Seguridade Social (Contribution to Social Security Financing)**

Complementary Law 70/1991: Article 1. (...) *a social contribution for social security financing is established, (...) exclusively destined to expenses with activities-ends of the health, social security and welfare areas.*

COFINS is a federal contribution, levied on the gross revenue of companies in general, intended to finance social security, which covers social insurance, public health and social assistance. Its tax base can be the monthly invoicing (gross revenue from the sale of goods and services) or the total revenue earned by the juridical person.

► **ICMS - Imposto sobre Circulação de Mercadorias e Prestações de Serviços (Tax on the Circulation of Goods and Services)**

Complementary Law 87/1996: Art. 1 *It is incumbent upon the States and the Federal District to institute the tax on operations related to the movement of goods and on services of interstate and intermunicipal transportation and communication services, even if operations and services are started abroad.*

## INDIRECT TAXES II

- ▶ Officially known as "Tax on Operations related to the Circulation of Goods and Provision of Interstate and Intermunicipal Transportation and Communication Services", the ICMS is a State Tax and one of the most well-known Brazilian taxes. It is a non-cumulative tax par excellence, that is, the taxpayer credits the tax paid in previous operations and collects the tax for the difference, resembling the VAT (at some degree). Its characteristic in the application of the Tax or to calculate the ICMS, one must consider several factors, such as Source-Destination, Product, Company, Client, etc.
- ▶ **ISS - Imposto sobre Serviços de qualquer natureza (Tax on Services of any kind)**
- ▶ Complementary Law 116/2003: Art. 1 *The tax on services of any nature, in the jurisdiction of the Municipalities and the Federal District, has as its tax event the provision of services listed in the attached list, even if they do not constitute a preponderant activity of the provider.*
- ▶ The tax on services of any nature (ISS) is a municipal tax, that is, only municipalities have the power to institute it. The Union, through complementary law, set a maximum rate of 5% for all services, and a minimum rate of 2%. The function of the ISSQN is predominantly fiscal; even if there is not a uniform tax rate, it can not be said that it is a selective tax. The basis of calculation is the price of the service provided. As a general rule, the ISS is collected from the municipality where the provider's establishment is located.

## INDIRECT TAXES III

Tobacco is already the major IPI tax source, beating the automotive and beverage industries. The high taxes and the regulation over the minimum price of the 20-package cigarettes, along with inefficient border control, harms both the State and the legal tobacco market.

With much lower prices than the legal ones, this contrabanded cigarettes represents around 40% percent of the Brazilian tobacco market. It is estimated that more than 1,3 billion euros will no longer be paid in taxes each year.

The chart below shows how much the taxes on tobacco contribute to the budget (approximately in euros).

- ▶ IPI: 1,1
- ▶ ICMS: 1,1 billion euros
- ▶ PIS-COFINS: 0,4 billion euros

## TAX ON TOBACCO



### ► IPI

Since 2011, two taxation systems over tobacco were established: General Regime and Special Regime. In the General Regime the tax will be calculated with an ad valorem rate of 300% applied on 15% of the sale price, which results in an effective rate of 45%. In the Special Regime, the value of the tax is obtained by the sum of two installments, one ad valorem, calculated in the same way as the general regime, and another specific according to the type of package, pack or box, according to schedule and aliquots that reached its peak in 2015: 60% ad valorem and 1,3 reais (0,35 euros) for both pack and box. Taking as an example the minimum price of the cigarette:

#### ► a) General Regime

$R \$ 4.50 \times 300\% \times 15\% = R \$ 2.02$ . That represents 45% of the sale price.

#### ► b) Special Regime

$R \$ 4.50 \times 60\% \times 15\% + R \$ 1.30 = R \$ 1.71$ . This represents 38% of the sale.

## TAX ON TOBACCO - IPI

### ► PIS-COFINS

Cigarettes producers can't choose this tax non-cumulative system and have to collect the tax for all levels of the production chain, calculating it on the forecast sale price for the product, as "tax payer substituts".

The calculation basis will be obtained multiplying the selling price of the product in retail by the percentage of 291.69%, in the in the case of COFINS, and by the coefficient of 3.42 in the case of PIS.

Quantity sold = 150

Unit Price = R \$ 4.50

Amount of Sale Total = R \$ 4.50 x 150 = R \$ 675.00

Basis of Calculation of PIS = R \$ 675.00 x 3.42 = R \$ 2.308,50

► Value of PIS = R \$ 2,308.50 x 0.65% = R \$ 15.01

COFINS Calculation Base = R \$ 675.00 x 291.69% = 1,968.91

► Value of COFINS = R \$ 1,968.91 x 3% = R \$ 59.07

Thus, we can affirm that the tax burden of the two taxes established on the industrial establishment of cigarette is almost 11%. Being 2.22% of PIS and 8.75% of COFINS.

## TAX ON TOBACCO – PIS/COFINS

► **ICMS**

For cigarettes and their derivatives, the internal rate of ICMS in the Brazilian states is mostly 25% applied over the amount of the operation (including freight and expenses). The state of Rio de Janeiro has the highest tax rate which is 35%.

► **The final price**

Using the percentages and the minimum value of sale from 2015, the total taxes levied on the sale of the cigarette may reach 91% if the cigarette industry chooses the general regime in the IPI and is domiciled in the Rio de Janeiro state. That is, 45% of IPI, 11% of PIS / COFINS and 35% of ICMS.

Considering the option for the IPI special regime where we show that the 38% from 2015 onwards, and using the average ICMS Brazilian states, which is 25%, we have reached a tax burden of 74%.

TAX ON TOBACCO – ICMS  
FINAL PRICE