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Consumption tax in Brazil, digital economy and the VAT experience

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The purpose of my speech is to talk about the Brazilian experience of consumption taxation and show the connection with the international VAT experience, especially with regard to digital economy.

Brazil is a nation state composed of 26 states, the Federal District and more than 5,000 municipalities. Brazil has considerable experience in taxing consumption and one thing that is interesting to point out is that much of the debate concerning consumption tax in Brazil reflects today's discussions surrounding VAT in other parts of the globe.

Unfortunately, at the end of my presentation, we will be able to see that the Brazilian experience had more downs than ups. But the lessons that can be learned from the Brazilian experience not only can help Brazil improve its own tax system but it may also serve as a warning for other countries in a time of constant remodeling of tax systems – to some extent due to the exponential growth of digital economy.

Truth is that for a number of historical and political reasons – which are beyond the scope of this presentation – consumption taxation in Brazil has not followed some cardinal principles widely accepted by

other countries. And we are paying a high price for having disregarded such cardinal rules. We will talk about some of these word-wide basic principles underlying consumption taxation, which Brazil chose not to apply.

First, international fiscal federal theory has traditionally asserted – and great names such as WALLACE OATES confirms – that highly mobile taxes should be allocated to the central government so to avoid conflicts between sub-central governments. Brazil has not done that at all. In Brazil, consumption is taxed at the three levels of federated entities, i.e., by the central government, by state governments and by local – or city – governments. The central government charges taxes on industrialized products, state governments charge taxes on the sale of goods and city governments charge taxes on the provision of services. It would be logical to assume that federated entities are bound to compete with each other for the authority to tax under such circumstances. In fact, many concrete cases confirm that logic.

Second, Brazil also chose not to conform to another rule which is based on the international VAT experience, that is, the rule that says that taxation must be guided by the principles of broad application and limited exemptions. In other words: every legal transaction that ultimately adds value must be subject to consumption tax. But what Brazil does is to tax consumption based on the *type* of legal transaction, which is a complex process that may even lead to unintended non-taxation.

For consumption taxation purposes, Brazil divides legal transactions into two categories, namely: circulation of goods – which is

subject to a state tax known as ICMS – or provision of services – which is subject to a local tax known as ISS.

Classifying legal transactions as either circulation of goods or provision of services is almost artificial and frequently raises doubts about which tax is to be levied. For example, the leasing of personal assets is subject to neither ICMS nor ISS in Brazil. According to the Brazilian Supreme Court (STF), the leasing of personal assets cannot be considered a pure provision of services or a pure circulation of goods. In digital economy, which is based on intangible assets – and where new businesses are created every second – using a taxation methodology based on type of transaction is even harder.

Third, Brazil has also disregarded another principle that stems from the international VAT experience: that taxation should follow the destination principle. Until today, in Brazil, the state tax on the circulation of goods and the local service tax still follow the origin principle. In other words, the ICMS and the ISS taxes are paid to the government authority where the provider is located. When origin-based taxes are used, local governments will inevitable engage in fierce competition since taxation is used as a mechanism to attract investment. The international literature usually defines this situation as either tax competition or harmful tax competition. In Brazil, where federated entities follow no loyalty standard when competing with each other, no such expression is used. Here, this phenomenon goes by a different name: tax war.

Having no clear definition – origin v. destination taxation – with respect to consumption taxes may lead to severe consequences for the market. This is not hypothetical; this is a reality; this is based on real facts. Let us see a case in Brazil that is based on empirical data: For

years in Brazil, there has been no definition as to which local government was to tax lease-purchase agreements (particularly, on vehicles) – the one in the bank's jurisdiction or the one in the consumer's jurisdiction. It took a while until the issue was settled in Court and, even then, the data show that the number of lease-purchase agreements signed for the finance of vehicles dropped significantly in virtue of such legal uncertainty.

It is a fact that the destination-based principle has been increasingly used in Brazil, especially due to a significant increment in digital economy. And the reason for that is the same as what we see in the international experience: digital economy allows for the provision of services and goods to many recipients without the provider having a physical presence. Because the place of destination is where the money is, paying taxes at the place of origin would not be fair.

But the conflict between origin v. destination, besides touching upon the fiscal justice issue, also raises a serious problem: how to simplify tax payments in a destination-based regime. In fact, it is not fair that, in the name of fiscal justice, a company that used to pay taxes to one single local government – according to the origin principle – is now obliged to pay taxes to dozens of different local governments – according to the destination principle. Such a change is especially harmful to small companies, for whom compliance costs will increase significantly.

In this sense, the European Union's VAT Mini One Stop Shop (MOSS) is an example. Under the MOSS Scheme, companies selling to different countries do not have to register with tax authorities in every single jurisdiction they sell. Every VAT payment is made to the country

of origin. At the end of the month, the country of origin will transfer the amounts paid to the corresponding countries of destination.

In Brazil, when dealing with the local service taxes, the origin v. destination conflict involves an even more complex element: there are over 5,000 cities in Brazil with authority to tax.

Take as an example a company that operates a transport app. Imagine that this company has only one office and this office is located in a large city like São Paulo. This company provides transport services in several Brazilian cities from one single place. Today, this company has to pay service tax to only one local government – São Paulo's. But there are some tax proposals currently with the Brazilian congress intending to change the origin-based rule to the destination-based rule. In our example, the company would have to start paying taxes to every single city it serves.

Luckily, there are also certain legislative proposals of a uniform national system to simplify the payment of such local taxes. In this case, a company based in São Paulo could opt to pay local taxes to different local tax authorities in a simplified manner, similarly to the European Union's MOSS Scheme.

Along the same lines are the 2017 OECD International VAT/GST Guidelines, which repeatedly state the need for the application of the destination principle in line with a simplified registration regime, so that non-resident remote sellers – principally small companies – are not imposed excessively burdensome charges.

The concern over a simplified taxation regime when the destination principle is used was also addressed by the US Supreme Court in *South Dakota v. Wayfair, Inc.*, in 2018.

There, the Supreme Court ruled that states could require out-of-state online retailers to collect sales taxes on purchases made within the state, even if the retailer does not have a physical presence in the taxing state.

This decision overturned the Supreme Court's 1992 decision in Quill *Corp v. North Dakota,* which considered physical presence a requisite for the state's authority to collect taxes. In fact, as the Court stated, when it decided *Quill Corp. v. North Dakota*, the Court could not have envisioned a world in which the world's largest retailer would be a remote seller.

With respect to the simplified regime, the Supreme Court pointed out that South Dakota laws afford small merchants a reasonable degree of protection, since they require a merchant to collect the tax only if it does a considerable amount of business in the State.

Finally, I must say that a comprehensive tax reform is currently under discussion in Brazil. One of the major proposals of this reform is to replace the many different consumption taxes by one single VAT – the tax on goods and services, or IBS (*Imposto sobre Bens e Serviços*). The IBS is intended to have a broad tax base and follow the destination principle, similarly to the VAT.

For many, adopting one single tax in Brazil – one that resembles the VAT – is the only way to solve the problems I presented here. But the political obstacles to such a significant change in tax laws are enormous. To impose one single VAT in Brazil – in the same way as

European countries – means to heavily modify the fragile and unbalanced Brazilian fiscal federalism, which is currently controlled by the central government. Many fear that depriving sub-central governments of their full tax authority to collect consumption taxes would mean rendering fiscal federalism even more fragile than it already is and it could be a step forward absolute centralization.

To conclude, it may well be argued that in Brazil we have been faced with practical problems arising from the non-observance of certain well established principles underlying the European Union's experience of VAT. This only proves the importance of events such as this one, where we have the opportunity to share experiences and knowledge on entirely diverse tax systems that, despite their differences, share a common goal: to achieve fiscal justice with maximum efficiency, with the highest degree of certainty and in the most simplified manner.