Brazilian Government announces new tax measures

In an effort to avoid a budget deficit, Brazil’s Executive branch proposed a number of tax and administrative measures that would reduce the forecasted 30 billion Reais (R$) deficit for 2016. The proposal has been met with opposition as it would significantly increase taxes by reducing tax incentives and increasing the withholding tax on capital gains, as well as re-enacting the CPMF, a social contribution used to fund the public health and social security systems.

Continuing its efforts to fight a budget deficit, last week the Brazilian Executive branch announced a proposed set of new tax and administrative measures to reduce the R$30 billion deficit forecasted for 2016.

The proposal would increase tax revenue by creating new taxes, reducing tax incentives and raising existing tax rates. The administrative proposal would reduce the Government’s direct costs. Government officials estimate an additional R$39.7 billion in tax revenue, and R$26 billion in cost cuts. If the proposal is enacted, instead of a budgetary deficit of R$30 billion, there would be a surplus of R$34.4 billion (0.7% of GDP), and that takes into account a R$5.5 reduction in tax revenue due to the economic downturn.

Tax incentives

The proposal would reduce REINTEGRA, which is a tax incentive for export companies. It is a tax refund of the taxes paid on the production chain of exported products. The refund rate varies from 0.1% to 3%. Under the proposal, the rate would be limited to 0.1% in 2016, 1% in 2017, 2% in 2018, and return to 3% in 2019. The proposal is estimated to raise R$2 billion in revenue.

The proposal would cut in half the REIQ, a tax incentive for the chemical industry that aids in funding innovation and new investment through tax incentives. The proposal is estimated to raise R$800 million in revenue.

Additionally, the proposal would limit the deduction for interest on net equity (INE). The proposal would limit the interest rate applied to net equity to 5%, and increase the applicable withholding tax (WHT) on INE from 15 to 18%. This proposal is estimated to raise R$1.1 billion in revenue.
There is currently one new project aimed at limiting the INE in Congress.

The proposal also would allow a deduction from the amount due to the “S” system for the amount of corporate income tax (CIT)/payroll taxes related to the R&D incentive. The “S” system provides social support to workers and it is managed by private organizations. Basically, under the proposal, funds from the “S” system would be used to fund the R&D incentive. In addition, part of what today is paid to the “S” System would be redirected to the social security system, approximately 30% of the total. The proposal is estimated to raise R$2 billion in revenue.

In total, the reduction of these tax incentives would increase revenue by R$5.9 billion.

From a legal perspective, the Executive Branch plans to implement these measures by enacting provisional measures, except REINTEGRA, which would require a decree. Although simple and easy from a technical perspective, since last week all concerned entities and the Congress have expressed concerns and little support for these proposed measures.

So far the Government has not taken any concrete steps to implement these proposed measures.

New tax revenue

Two main measures were presented to increase tax revenue via a new tax (CPMF) and the increase of the WHT burden on capital gains.

**WHT on capital gains**

Currently, a 15% WHT applies to capital gains earned by individuals. Under the proposal in Provisional Measure (MP) 692, capital gains earned by individuals would be subject to new WHT rules and rates as follows:

<table>
<thead>
<tr>
<th>Capital gains range</th>
<th>WHT rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to R$1 million</td>
<td>15%</td>
</tr>
<tr>
<td>R$1 million to R$5 million</td>
<td>20%</td>
</tr>
<tr>
<td>R$5 million to R$20 million</td>
<td>25%</td>
</tr>
<tr>
<td>Above R$20 million</td>
<td>30%</td>
</tr>
</tbody>
</table>

It is unclear whether this measure would also affect capital gains earned by nonresidents on the sale of assets located in Brazil. Further regulations and analysis would be required to determine whether nonresidents would be affected by this proposal.

These new provisions would be effective 1 January 2016, and the Congress has to approve MP 692 within 120 days. MP 692 would raise R$1.8 billion in additional tax revenue.

**Tax on financial transactions (CPMF)**

CPMF was a social contribution used to fund the public health and social security systems. It was in force until 2007 when it was repealed. The proposal would re-enact CPMF.

On 22 September 2015, the Executive branch sent to the Congress a project to amend the Brazilian Constitution (called PEC 140), allowing the CPMF to be reinstated.

PEC 140 would establish a 0.20% rate for CPMF, which would fund the federal social security system only. PEC 140 also would re-enact Law 9.311/1996, which regulates CPMF.

In a nut shell, the 0.20% rate would be levied on every banking transaction (deposits and withdrawals). Certain transactions and entities would be exempt.

The next step should be a Presidential Decree to reduce IOF rates, which were increased to 0.38% when CPMF was terminated in 2007. This reduction would not eliminate all of the effects of the new CPMF, as IOF does not apply as broadly as CPMF.

Because CPMF caused a severe reaction from almost all relevant sectors in the country, it should face a delicate approval process. It is difficult to determine the likelihood of the CPMF being approved. The state governors have also proposed a higher CPMF rate of 0.38% (as it was in the past), and the revenue would be split between federal (0.20%) and state (0.18%) governments.
The Chamber of Deputies has just started to analyze PEC 140, and it is sure to be a complex task, especially because it requires a “qualified quorum” (3/5) for approval in both houses, Senate and Chamber of Deputies.

It is estimated that the CPMF would increase revenue by R$32 billion.

Cost cuts

On the cost front, the Government proposed the following nine measures, which would be a savings of R$26 billion for 2016:

<table>
<thead>
<tr>
<th>Measure</th>
<th>Impact R$ B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Postponement of the inflationary adjustment for federal employees' salaries and benefits to October 2016 (instead of March 2016)</td>
<td>7.0</td>
</tr>
<tr>
<td>Prohibition on hiring new Federal employees in 2016</td>
<td>1.5</td>
</tr>
<tr>
<td>Elimination of bonuses paid to employees qualified for retirement who continue to work</td>
<td>1.2</td>
</tr>
<tr>
<td>Implementation of a salary ceiling for federal employees</td>
<td>0.8</td>
</tr>
<tr>
<td>Several operational cost reduction actions</td>
<td>2.0</td>
</tr>
<tr>
<td>Change of funding source related to social investment programs, social housing programs</td>
<td>4.8</td>
</tr>
<tr>
<td>Change of funding source related to priority investment projects (PAC)</td>
<td>3.8</td>
</tr>
<tr>
<td>Change of funding source for public health system expenditures</td>
<td>3.8</td>
</tr>
<tr>
<td>Reduction in projected expenses with price guarantees for agricultural products</td>
<td>1.1</td>
</tr>
<tr>
<td><strong>Totals</strong></td>
<td><strong>26.0</strong></td>
</tr>
</tbody>
</table>

These proposed measures received a severely negative reaction, especially from unions that represent public workers. The Executive Branch will face a complex process to approve and implement the adjustments, which all need to be approved by Congress.
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