



Maximising the value of indirect tax credits



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Introduction

When manufacturers acquire inputs (eg, raw materials or components), indirect tax is incurred.⁽¹⁾ This indirect tax is equivalent to the tax initially paid by the supplier subsequently passed on to the manufacturer through the cost of the input. The manufacturer receives a tax credit for the indirect tax incurred during the acquisition of inputs. The indirect tax credits can later be used to offset taxes levied on the sale of the manufactured goods (ie, tax liabilities or tax debits).

However, many manufacturers do not have sufficient tax debits to offset the accumulated tax credits. This is often the case for exports, as revenue tax and value added tax (VAT) exemptions apply to export revenue.⁽²⁾

This update outlines the procedures and solutions for companies with surplus tax credits. Companies should become familiar with the details of these procedures and solutions in order to maximise the tax benefits available to them.

Indirect tax system

The Brazilian indirect taxes applicable to the manufacturing industry are levied at the federal and state government levels.⁽³⁾ Indirect taxes levied in Brazil include PIS/COFINS, IPI and ICMS:

- PIS/COFINS (revenue tax) is a federal tax levied on the gross revenue at a combined nominal rate of 9.25%.
- IPI (excise tax) is a federal tax with a variable rate that depends on the tariff classification of the manufactured goods or products.
- ICMS (value added tax) is a state tax with a rate varying in accordance to the classification of the final goods - for example, the nominal standard rate in the state of Sao Paulo is generally 18%. Rates of

between 7% and 12% exist for operations between states. As ICMS tax is governed by each Brazilian state, a proper analysis requires examination of each transaction and the state tax laws where transactions occurred.

Under the Brazilian tax system, PIS/COFINS, ICMS and IPI are non-cumulative taxes.(4) With respect to all three types of tax, tax liabilities or debits due on the sale of manufactured goods can be offset by tax credits incurred during the acquisition of inputs.

Multinational companies that export a significant amount of their production often have insufficient PIS/COFINS and ICMS tax liabilities or debits to offset their tax credits. As a result, many multinational companies accumulate credits throughout the fiscal year.

Accumulated revenue tax credits

Multinational companies that do not have sufficient quarterly tax debits may capture the value of their tax credits by making a claim for a cash reimbursement at the end of the quarter.(5) Reimbursement requires the presentation of an electronic refund claim, which is subject to the review and approval of the tax authorities. (6) Unfortunately, multinational companies often wait a long time to obtain a decision from the tax authorities; their claims are usually denied and rebates are rarely granted.

Fortunately, multinational companies can pursue rebates proactively and generally force the tax authorities to make timely decisions. In such cases it is possible to file a lawsuit in the judicial courts demanding that the tax authority issue a decision within a specified period of time. This strategy is fairly effective.

In May 2010, Ministry of Finance Ruling 348/10 gave multinational companies additional means to force tax authorities to make timely decisions regarding tax credits arising from exports.(7) Under the ruling, tax authorities must render a decision within 30 days. However, at present tax authorities often still take longer than 30 days to render their decisions. Thus, even with the new law, multinational companies must often file a lawsuit evoking Ruling 348/10 in order to accelerate the decision-making process.

Multinational companies can also file lawsuits in the judicial courts to dispute rebate claims denied by the tax authorities.

Tax rebate regime for exporting companies

One objective of the 'Bigger Brazil Plan' is to make the exports of Brazilian manufacturing companies more competitive in comparison to those from other countries. The Special Tax Rebate Regime for Exporting Companies (REINTEGRA) has been created to help achieve this objective.

Under REINTEGRA, tax costs incurred in the production and supply chain processes are eligible for reimbursement equalling 3% of the company's total export revenue.(8)

Reimbursement requests under REINTEGRA must meet the tax and trade authorities' specific procedural requirements and are limited to exports made before December 31 2012.(9)

Value added tax credits

The following applies to the tax laws and regulations of the state of Sao Paulo only.

Export activities can also result in a significant amount of PIS/COFINS and ICMS tax credits at a state level. (10) However, the ability of multinational companies to use ICMS tax credits is limited even after approval is obtained from the state authorities.

Procedural to circumvent state tax authority It is also possible for multinational companies to use tax credits without the approval of the state tax authority⁽¹⁴⁾ - the state tax authority can be circumvented by filing a lawsuit in the judicial courts requesting that the court permit use of the tax credits.

Traditional uses for ICMS tax credits After approval has been granted, accumulated ICMS tax credits⁽¹¹⁾ can traditionally be used only as a form of payment to suppliers of inputs (raw materials and packing materials) or to purchase machinery and industrial equipment.⁽¹²⁾ However, these credit transfers can be used as a form of payment only between parties that have an establishment in the state of Sao Paulo.⁽¹³⁾

Alternative use for ICMS tax credits Multinational companies that do not purchase a sufficient amount from in-state suppliers may utilise a corporate reorganisation to capitalise on the value of their ICMS credits. In such cases ICMS credits are used as assets, a new company (NewCo) is incorporated and the credits are then transferred to NewCo. Later, NewCo can be sold to an unrelated party, which will be entitled to use these credits. However, there must also be a business reason connected to the sale of NewCo.

Comment

Brazilian tax laws and regulations provide mechanisms under which multinational companies can use PIS/CONFINS and ICMS tax credits. Despite the challenges, as long as certain procedural requirements are fulfilled, it is possible for multinational companies to realise the benefits of PIS/COFINS and ICMS tax credits.

Both PIS/COFINS and ICMS tax credits can be obtained on a proper application and filing with the tax authorities. While decisions from the tax authorities are often slow and unfavourable, multinational companies can proactively accelerate the approval of tax credits⁽¹⁵⁾ and appeal tax authority decisions by filing lawsuits in the judicial courts.

While a cash rebate is available for PIS/COFINS tax credits, ICMS tax credits can traditionally be used only to acquire specific goods and raw materials. Therefore, as an alternative to the traditional use of ICMS tax credits, a proper corporate reorganisation strategy may also be used in order to maximise their value.

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Endnotes

(1) The indirect tax can be defined as tax "levied... on producers in respect of the production, sale, etc of goods and services, which they charge to the expenses of production". Barry Larking (editor), *IBFD International Tax Glossary*, 5th edition, IBFD, 2005, p122.

(2) Article 5(I) of Law 10.637/02, Article 6(I) of Law 10.833/03 and Articles 3(II), 24 and 25(1) of Complementary Law 87/96.

(3) Municipal governments may also levy indirect taxes on companies that render services, which do not engage in any manufacturing business activities.

(4) Indirect taxes imposed at multiple levels of the distribution chain can be offset or deducted from the tax paid on subsequent sales.

- (5) Article 5(2) of Law 10.637/02 and Article 6(2) of Law 10.833/03; procedure of such reimbursement claim is ruled by Article 27(I) of Ordinance 900/08.
- (6) Article 28 of Ordinance 900/08.
- (7) Besides the PIS/COFINS taxes, this ruling also provides for an excise tax credit. Moreover, according to Ruling 348/10, in order to obtain a tax rebate at the amount of 50% of the applied amount, the total value of exports of the applying company should be at least 10% of its gross revenue for the year before the application, among other requirements (Article 2(IV)).
- (8) Articles 1 and 2(2) of Law 12.546/11 and Article 2 of Decree 7.633/11.
- (9) Article 3 of Law 12.546/11.
- (10) As long as most part of the revenue is driven by exports.
- (11) Sao Paulo State ICMS regulations, Article 72-B(I) of State Decree 45.490/00.
- (12) Article 73(III) and (IV) of State Decree 45.490/00.
- (13) Article 74 of State Decree 45.490/00.
- (14) There is recent High Court precedent (RE 1.252.683 dated June 21 2011) recognising that the tax credits or rebates granted to exporters cannot be restricted or conditioned by a prior approval from the local state tax authorities. It is an important precedent which will define the trend for this matter.
- (15) High Court precedent RE 1.252.683 dated June 21 2011.

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