

# Disputes over tax benefits and the position of Brazil's Supreme Court



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Under Brazil's federal constitution of 1988, the states of the federation and the federal district are entitled to establish tax on the "circulation of merchandise, on interstate and inter-municipal transportation services, and on communication services". The states' powers over this value-added tax, or *Imposto sobre Operações relativas à Circulação de Mercadorias e Prestação de Serviços de Transporte Interestadual e Intermunicipal e de Comunicação* (ICMS), are not unlimited, however. One limitation is found in article 155 §2 (XII) (g), which provides that a specific type of federal legislation known as a complementary law is required to grant ICMS exemptions and other benefits.

Complementary law 24 of 1975 (CL 24/1975) provides that the states must enter into agreements, at meetings attended by representatives of a majority of the states and federal district, to establish (i) exemptions, (ii) reductions, (iii) partial or full reimbursements, (iv) presumed tax credits, and (v) any other tax incentives or advantages based on the ICMS that result in a direct or indirect reduction or exclusion of the tax.

The legislator's purpose in requiring the states to arrive at an agreement on the grant of tax benefits is to prevent tax wars between states that offer incentives designed to attract business to their territories. These incentives can include not only tax breaks of various kinds, but also financial and infrastructure benefits.

According to CL 25/1975, if ICMS tax benefits are granted without following the procedure established in the legislation (i) the act by which the benefit was granted will be null and the any tax credit attributed to taxpayers will be ineffective, and (ii) any unpaid or reimbursed tax will become subject to collection, and the legislation or act that granted remission of the corresponding tax debt will be ineffective.

Despite the express provisions of the constitution, however, over the last few years various Brazilian states have granted ICMS tax benefits without entering into a multi-lateral agreement pursuant to CL 25/1975.

States that believe they have been victims of these tax wars have challenged the constitutionality of the legislation creating ICMS tax benefits under Direct Actions for Declaration of Unconstitutionality (*Ações Diretas de Inconstitucionalidade*, or ADIs) brought before Brazil's highest court, the Supreme Federal Tribunal (*Supremo Tribunal Federal*).

In a recent judgment, the Supreme Federal Tribunal examined various pieces of state legislation that purported to create ICMS tax benefits and declared, by unanimous decision, that 14 state laws were unconstitutional for failure to comply with the provision under the constitution that imposes the requirement for a multilateral agreement between states in order to create ICMS exemptions and reductions benefitting businesses or economic sectors. The unconstitutional legislation had been enacted by the states of Rio de Janeiro, Mato Grosso do Sul, São Paulo, Paraná, Espírito Santo and Pará and by the Federal District.

The Supreme Federal Tribunal also held that tax benefits granted without a multilateral agreement under CL 25/1975 in connection with goods and services traded between Brazilian states and on imported goods (in some cases these benefits were granted by state decree) were unconstitutional.

As a result of the Supreme Federal Tribunal's decisions, all the ICMS tax benefits that were declared to be unconstitutional will be annulled, and the taxpayers that joined the tax incentive programmes may become subject to collection of the amounts corresponding to the unconstitutional benefits.

The judgment does not apply, however, to tax benefits that were granted contrary to the constitution and CL 25/1975 but were not specifically contemplated in the ADIs.

Nevertheless, although the Supreme Federal Tribunal's decision relates only to the tax benefits at issue in the 14 ADIs, it is now clear that ICMS benefits cannot be granted except pursuant to a multilateral agreement within the terms of CL 25/1975, and the other ADIs on the matter still pending before the Tribunal will doubtless also be granted.

The big question that the Supreme Federal Tribunal's decision raises is the loss that will be suffered by taxpayers that, in good faith, made use of the tax benefits granted by the states and will now be subject to collection of the amounts of tax that were exempted or reduced.

In light of the repercussions for taxpayers, many states have mobilised efforts to negotiate a multilateral agreement that would legalise the ICMS benefits declared to be unconstitutional by the Supreme Federal Tribunal.

Such an agreement would protect the interests of taxpayers that were encouraged by ICMS incentive programmes and other benefits to set up their businesses in certain states, by ensuring that they will not called upon to pay ICMS retroactively, at the full rate.

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