The Consumption Tax Reform, the End of ICMS Incentives, and New Competitiveness Challenges

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ICMS tax incentives granted by Brazilian states have long played a strategic role in attracting investment and promoting regional development, despite the fiscal strain they place on state budgets.[1] ICMS (*Imposto sobre Circulação de Mercadorias e Serviços*) is a state-level value-added tax on the circulation of goods and certain services, and one of Brazil's most significant sources of tax revenue.

Historically, many of these incentives were granted unilaterally, without complying with the requirements of Complementary Law 24/1975 or the rules issued by the National Council for Fiscal Policy (CONFAZ). This led to disputes, especially when goods benefiting from the incentives were sent to other states that refused to recognize the incentives. The resulting tension became known as the "tax war."

To resolve the conflicts stemming from the tax war, Complementary Law 160/2017 was enacted. Subject to certain formalities, the Law validated the incentives the states had granted, and established deadlines for their expiry. Still, aside from posing problems in the division of powers among the states and federal government and their taxation authority, the tax war exposed deeper structural problems in Brazil's consumption tax system, especially in the design and administration of the ICMS.

That landscape is now shifting. With the approval of Brazil's consumption tax reform and the planned transition to a dual VAT system – one federal and one subnational – ICMS incentives are set to expire by 2033. The reform replaces Brazil's fragmented consumption tax structure with two new value-added taxes: the CBS, at the federal level, and the IBS, administered jointly by states and municipalities. This shift brings a significant – and often overlooked – consequence: the direct economic impact on companies that rely on these incentives as part of their accounting and financial strategies, with effects that can materially alter their bottom line.

In many sectors, companies allocate ICMS incentives to shareholders' equity to avoid triggering corporate income taxes and to strengthen their financial position. Others recognize the incentives as revenue, converting subsidies into profit, reducing accumulated losses, and improving financial indicators.

The way these subsidies are treated reveals how their elimination could trigger significant changes in companies' capital structures. Presumed ICMS credits are typically recorded as positive revenue which, if not allocated to shareholders' equity, will directly affect taxable income.

The end of ICMS subsidies could also have an impact profitability and liquidity indicators, which in turn will affect how companies are valued and assessed: share prices, fundraising capacity, and the acquisition and disposal of assets are closely tied to financial and accounting metrics.

Key indicators may be directly affected. EBITDA (earnings before interest, depreciation, and amortization), used to identify valuation multiples, and ROE (return on equity), used to assess capital structure, could both be impacted, revealing operational challenges that were previously less visible.

With the end of the ICMS incentives, companies that rely on them to support their financial indicators will have to reassess their business models and improve operational efficiency. In some cases, even the decision to locate operations in areas with limited infrastructure – previously justified by tax advantages – may need to be reconsidered.

Structures built around subsidies will need to be rethought. Tax planning, supported by smart accounting and operational improvements, will become even more critical. More than a technical adjustment, Brazil's consumption tax reform signals a shift in how businesses must approach tax strategy. In a more uniform and transparent tax environment, results will depend less on tax engineering and more on operational efficiency and competitiveness.

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NOTE

1. DINIZ, C. C. "A nova geografia econômica do Brasil". In: VELLOSO, J. P. R. (Org.). Brasil 500 anos: futuro, presente, passado. Rio de Janeiro: José Olympio, 2000, p. 343.

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