Tax aspects of investments in basic sanitation projects

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The New Basic Sanitation Legal Framework allows Brazil's federal government to grant tax benefits to support improvements in public basic sanitation services in exchange for achieving pre-determined operational performance targets, in addition to specific incentives designed to reduce the cost of expanding infrastructure in the sector.

This article looks at existing tax benefits for the funding of sanitation projects, and for the implementation or expansion of such projects, along with some proposed changes to the legislation.

Financing basic sanitation projects can involve the issuance of "Incentivized debentures", which must meet certain requirements: notably, they must pay interest at pre-fixed rates tied to a price index or reference rate and have a weighted average term of more than four years, they may not be redeemed by the issuer (or any related party) in the first two years, and they must follow a simplified procedure that demonstrates how the funds raised by the debentures will be used in the investment project.

Earnings from Incentivized debentures are exempt from income tax in the case of individuals resident in Brazil and foreign investors not resident in tax havens, and taxed at 15% in the case of legal entities. These tax benefits translate into a smaller cost of raising funds for the issuer in comparison with common debentures (or traditional loans).

Earning from units in Incentive Infrastructure Investment Funds (FI-Infras) also benefit from the tax treatment described above. Among other requirements, FI-Infras must invest at least 85% of the net assets of the fund in incentive debentures or in Real Estate Receivable Certificates (CRIs)/Receivables Investment Funds (FIDCs) that apply funds in the implementation of infrastructure investment projects that meet requirements set out in the applicable legislation[1].

Turning to implementation and expansion of basic sanitation projects, one mechanism for reducing tax costs that is already in place is the Special Regime of Incentives for Development of Infrastructure – REIDI. The federal government created REIDI to suspend the gross revenue taxes PIS and Cofins attaching to the acquisition of goods and services classified as fixed assets for use in infrastructure works, including basic sanitation works. The suspension is subsequently converted into zero-rate tax, when the good or service is used in the works.

Another possibility under Brazilian tax legislation for reducing the tax burden on acquisition of capital goods is the "Ex-Tariff" regime, which applies to goods that are not produced in Brazil. Ex-Tariff can reduce Import Tax – II (and IPI, the Tax on Industrialized Products) to 0%.

At the state and municipal levels, negotiated tax incentives are common, reducing ICMS (the state VAT) and ISS (the municipal service tax) on goods and services needed in basic sanitation projects.

There are thus many opportunities for investors interested in taking advantage of the opening-up of the basic sanitation sector in Brazil. These opportunities, if structured to fit the specific characteristics of each case, can represent important instruments for optimizing the costs of investments in infrastructure.

New Legal Framework for federal tax benefits to support improvements in basic sanitation services, if approved, could make it possible for service providers to apply to the federal government for a reduction in the PIS and Cofins attaching to their revenues from basic sanitation services, or even negotiate presumed PIS and Cofins credits, along the lines of the proposed Special Regime of Incentives for Development of Basic Sanitation – REISB, which, however, was vetoed.

At the municipal level, however, investors should keep an eye on Bill PLC 155/19, which is now before the Senate and has already been approved by the Legislative Commission on Economic Matters. If passed, the Bill would allow ISS to be charged on basic sanitation services, at rates varying from 2% to 5%.

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Notes:

1. These tax incentives may be broadened by Bill 2646/2020, mentioned in the article Financing Basic Sanitation Projects.

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