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SPECIAL REPORT

Supreme Court Decision on Tax Methodology: A Middle Ground

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- In this report we explore the possible impact of the change in methodology for calculating tax collections following a decision by the Supreme Court (STF). **The Court's decision does not lead us to modify our fiscal scenario outlook and revenue forecasts**. The government also will maintain its fiscal numbers, as its latest estimates already consider this decision's subsequent effect on the revenue stream. Nonetheless, we believe that the decision reinforces the importance of approving a tax reform. If the revenue loss increases beyond what we forecast, we would expect lead the government to approve a tax reform.
- On May 13, the STF concluded its deliberations on the exclusion of ICMS state tax from the calculation basis for the PIS/Cofins federal taxes. The majority of Court ministers supported the rapporteur's decision that this exclusion should be valid, based on the Court's March 15, 2017 decision. That year, the STF clarified the non-cumulative nature of PIS and Cofins taxes, ruling that the ICMS should be excluded from the calculation base. The modulation of the effects of this decision was defined by the Plenary of the Court, in an eight-to-three decision. The STF also changed the methodology for calculating the compensation of tax credits.
- Moreover, the federal government will have to compensate all firms retroactively since 2017, with only those who had legal actions in the five-year period before being allowed to be compensated for tax credits from prior years. From a fiscal point of view, this time limitation was positive, if it were more retroactive (before 2017) the fiscal impact would be much higher. On the other hand, the revision of the ICMS calculation methodology should increase tax compensations and the possible impact on tax revenue.
- **Our preliminary estimate for the net fiscal impact from the tax methodology change for the federal government is close to BRL180 billion.** We note the significant uncertainty in this estimate, due to the complexity of the accounts. In addition, our forecast already considers an additional increase of BRL120 billion in compensation over the next few years (BRL65 billion in 2021). The estimative of compensations of judicial claims before 2017 is uncertain, yet we believe these should not be substantial. Most companies have already benefited from the decision since 2017, with more than BRL100 billion already used as a tax credit as of 1Q21. **Therefore, the STF's May 13 decision could potentially lead to a further government revenue reduction of BRL60 billion in our scenario (yet it would be diluted over the years).** Moreover, a portion of the total amount could also be returned to the government in the form of income tax, with the calculus that the profit would be higher as a result of a lower PIS/Cofins collections, and which may be taxed by 25% (IRPJ) and 9% (CSLL) — amounting to 34% of tax taxes and minimizing the fiscal impact. We also expect refunds to companies to be made via tax credits and not court-order debt (an additional expenditure that would be subject to the constitutional spending cap limit), which would additionally pressure for compliance with the fiscal rule.
- We further anticipate that this change in tax calculation methodology will reduce revenue flow by ~0.5% of GDP per year, though we not that this has been included in our fiscal scenario since last year, when the use of tax credits for some large companies jumped in the aftermath of the 2017 STF decision. If in the future, the decision is expanded to include municipal taxes on services (ISS), tax compensation since 2017 could reach a maximum value of BRL30 billion, with a loss in the revenue flow of 0.1% of GDP per year. Conversely, the cyclical revenue recovery and the effect of inflationary shock on the federal tax collection could also mitigate possible effects in the short term.

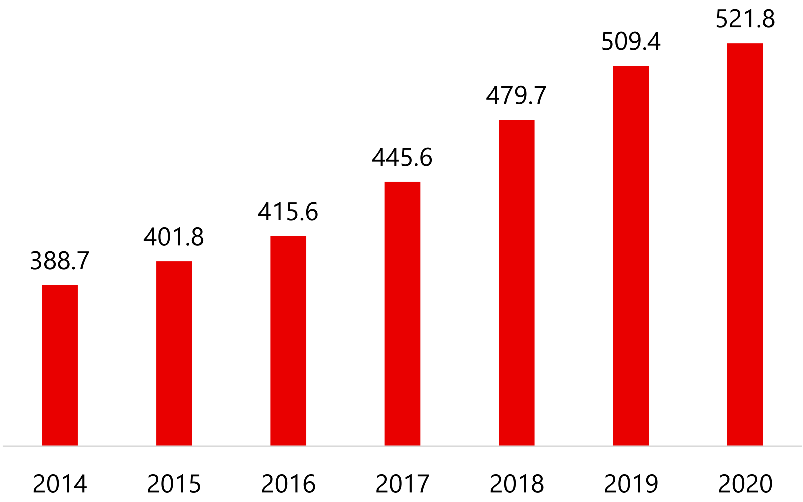
On May 13, the STF reached a final ruling on the extent of the exclusion of the state ICMS tax in the calculation of federal PIS/Cofins. Earlier in March 2017, the Court had ruled when calculating the amount that companies must pay for PIS and Cofins, what they have already paid for ICMS should be excluded. With last week's decision, the STF decided that this understanding is valid as of March 2017, and not before. However, the judicial and administrative actions and procedures filed up to March 15, 2017 are protected. Firms that appealed their tax credit prior to 2017 should be able: (i) to claim credits retroactively for five years prior to the date they started their judicial clams; and (ii) claim credit also from 2017 up to today The modulation of the effects of this decision was defined by the Plenary of the Court, in an eight-to-three decision. The STF also changed the calculation method for compensation of tax credits.

This STF's decision has be called "the ruling of the century" given its significant fiscal impact. The Attorney General's Office of the National Treasury (PGFN) estimates losses of BRL258.3 billion in five years, while the numbers in the 2020 LDO showed an impact as a fiscal risk of around BRL229 billion over five years (BRL 45.8 billion/year). We were able to reproduce the PGFN accounts with the full ICMS total collection data using the formula below. We emphasize that this would be the maximum impact, and that the effective impact would require a much more complex accounting of the entire production chain. The PGFN account shows the maximum impact of the measure in the period, considering that the rate of 9.25% is the value for companies that fall under the actual profit method *lucro real* (companies with a turnover above BRL78 million per year). Most companies are in the presumed profit basis regime[1] (*lucro presumido*), with rates of 3.25%. However, when we analyze 2018 collection data, almost 80% of the total is from companies under the actual profit method. Another point is that the PIS/Cofins rate is cumulative and not additive, which in fact raises the effective average rate.

$$\textbf{PGFN Fiscal Impact estimate} =$$
$$\left(\sum \text{ICMS from 2014-18 (adjusted by Selic rate)}\right) \text{x}$$
$$\text{PIS/Cofins rate (9.25\%)}$$

Figure 1 shows the data for the collection of the ICMS state tax of the 27 federative units. We see that the collection amounted to values above half a trillion BRL per year, possibly a good proportion is included in the PIS/Cofins calculation base.

Figure 1 – Total ICMS states tax collection - BRL billion



Sources: Brazilian IRS, Santander.

Another important aspect of the STF decision is that final ruling also mandated that the full value of the ICMS should be deducted (companies usually pay less than reported in invoices due to tax credits). PGFN estimates were based on the total ICMS tax collection. To understand the difference, the ministers voted that the ICMS to be removed from the PIS and Cofins calculation base is the "highlighted in the invoice", and not

[1] Under the presumed profit method, taxable income is calculated on a quarterly basis and corresponds to a deemed profit margin applied over gross revenue, adjusted as determined by tax law.

the "effectively paid" amount. And this has an impact on public accounts; however, it makes the calculation much more complex, it is difficult to know if there are the records to know which value was on the invoice of all past transactions. The ICMS collected is lower than the one highlighted in the invoice, due to the discount of tax credits during the productive chain. See Figure 2 for more details. Although the difference between the two accounts is more than double, some Brazil's Internal Revenue Service (IRS) studies with company data suggest that the value is about 20% higher in the ICMS "highlighted in the invoice", and this must be considered when we analyze the fiscal impact of the STF decision. In addition, the greater or the number of steps inside a productive chain, the greater the cumulative effect of such distortion.

The decision to limit the effects of the exclusion of ICMS from the calculation of PIS/Cofins as of 2017 was positive from a fiscal point of view (even more due to the monetary correction with the higher Selic before 2017), yet this change for full ICMS was detrimental and increases the potential fiscal impact. For collection purposes, the "collected" tax is considered simpler to measure than the one on the invoice, given the complexity of the system. This final decision favored companies that received higher tax credits to receive.

Figure 2 – Taxes Added Along the Productive Chain

	Industry	Wholesaler	Retailer
Operation Value	BRL100	BRL160	BRL210
ICMS state rate	10%	10%	10%
ICMS highlighted in the invoice	BRL10.0	BRL16.0	BRL21.0
ICMS to be offset	-	BRL10.0	BRL16.0
ICMS to be collected / paid	BRL10.0	BRL6.0	BRL5.0
PIS / Cofins calculation basis *(ICMS highlighted in the invoice)*	BRL90	BRL144	BRL189
PIS / Cofins calculation basis *(ICMS to be collected / paid)*	BRL90	BRL154	BRL205

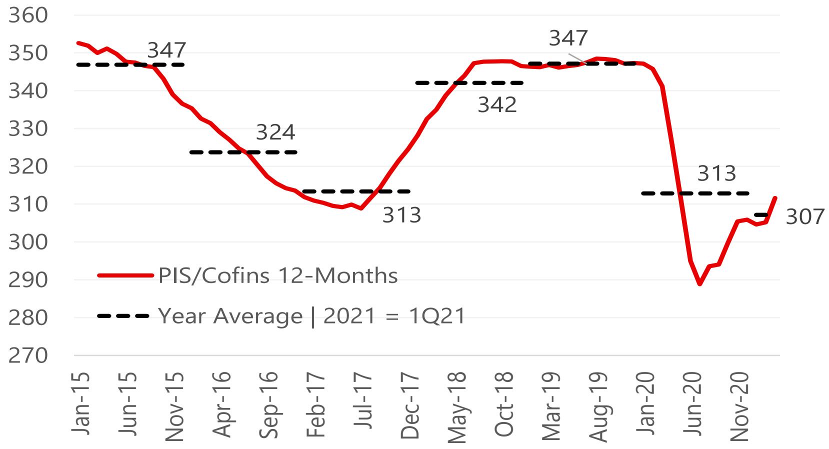
ICMS highlighted in the invoice
BRL47.0

ICMS to be collected / paid
BRL21.0

Sources: PGFN and Santander

Although the fiscal impact numbers seem frightening to the already challenging fiscal adjustment, a significant part of the collection of PIS/Cofins has already been reduced, mainly due to the effect of the Covid-19 pandemic effects and the greater use of tax credits in 2020. It will be important to see the recovery of the total collection in this specific tax; the latest data still suggest that it is a partial cyclical recovery of the economy and of an effect of inflation in the overall tax collection that affected the companies' profits, with a recovery of partial margin. We expect this change in tax calculation methodology to reduce revenue flow by around 0.5% of GDP per year; however, we note that it has been included in our fiscal scenario since last year, when the use of tax credits for some large companies jumped in the aftermath of the 2017 STF decision.

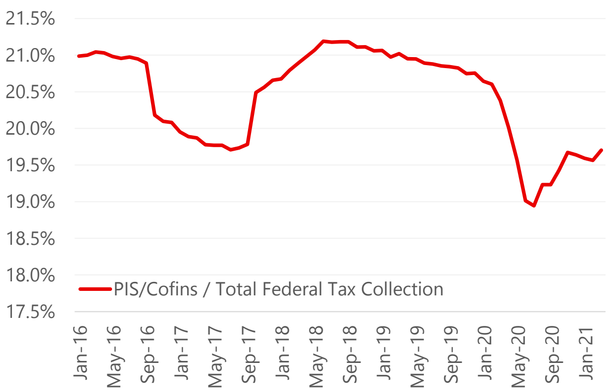
Figure 3 – Federal Tax Collection PIS/Cofins – 12-months in real terms – BRL billion



Sources: Brazilian IRS, Santander.

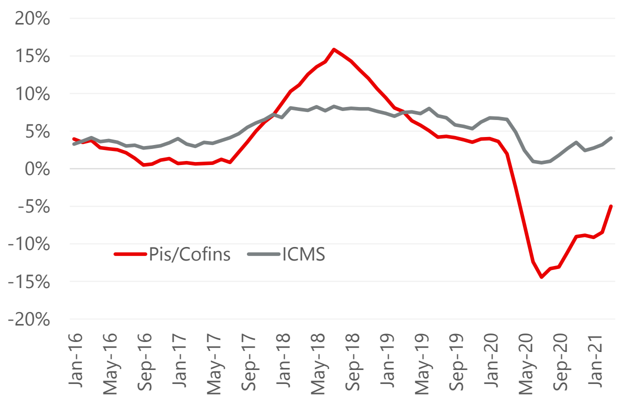
Figure 4 below illustrates how the participation of the collection of PIS/Cofins fell from about 21% of the total to below 20%, and has shown a lower growth rate since 3Q20. Figure 5 details the growth in the collection of the ICMS state tax and PIS/Cofins. It is worth mentioning that taxes such as PIS/Cofins were deferred in the past year during 2Q20 due to the pandemic's effects, but it is possible that the STF's favorable decisions for companies last year hindered its more consistent recovery, not least because a good proportion of the taxes deferred charges were paid in 4Q21.

Figure 4 – % of PIS/Cofins in Federal Tax Collection



Sources: Brazilian IRS, MCM.

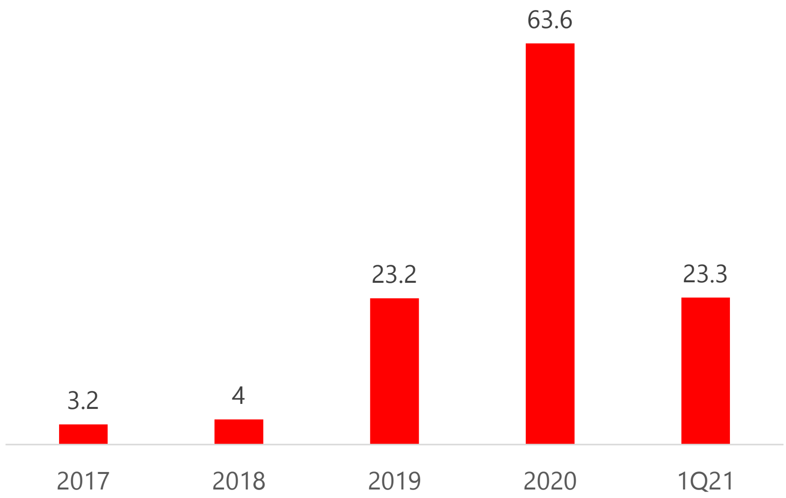
Figure 5 – Tax Collection % YoY in 12 months



Sources: Brazilian IRS, MCM.

As mentioned earlier, the STF's 2017 decision has already generated a greater use of tax credits based on the initial decision. However, its use intensified after 2020, when many companies managed to use these claims for lawsuits. This can be seen in Figure 6, and according to the PGFN, more than 92% of these decisions refer to the case of ICMS in the PIS/Cofins calculation base. It is worth mentioning that for any estimate of the fiscal impact, those tax credits already used must be disregarded.

Figure 6 – Tax Credit by Judicial Claims – BRL billion



Sources: Brazilian IRS, Santander.

Our Preliminary Estimate

For our preliminary estimate, we used the ICMS values collected from April 2017 until April 2021. We multiplied the result by 20%, which is the value of a sample of companies by the IRS on the difference between the two forms of ICMS calculation. We updated the values using Selic (such as PGFN). We removed the BRL110 billion of tax credit already used, yet we included the possible the correction (+20%) in the credit already used by the change in the ICMS method showed in Figure 2. With that, we reached a fiscal impact of BRL182 billion, but it is worth mentioning that this is our preliminary estimate and that given the complexity, these numbers can change according to the refund requests by companies. The estimate of compensations of judicial claims before 2017 is uncertain, yet we believe that it should not be large. According to the PGFN, the number of judicial claims after 2017 applies to 78% of the total volume of causes related to ICMS tax methodology, only 6% before 2007, and 16% between 2008 and 2016. Most companies have already benefited from the 2017 decision, yet it is important to monitor and observe the official estimates.

$$\textit{Santander Fiscal Impact Estimate} =$$
$$\left(\sum \text{ICMS collected from Apr-17 to Apr-21 } \text{(adjusted by Selic Rate)}\right)$$
$$\text{x (Average of PIS/Cofins rate: 10.25\% in the Productive Chain)}$$
$$- \text{Tax credit already granted since 2017}$$
$$+ \text{(20\% to readjust to the new tax methodology x (Tax credit already granted since 2017))},$$

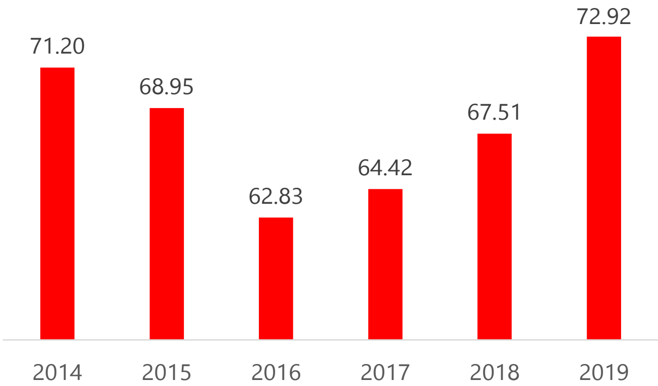
Of course, there is a lot of uncertainty in this estimate. What are the sizes of the judicial claims in the STF? How many companies will request refunds? How much of tax/social security debt will be written off? What will the timetable for the return of funds be? How big are the production chains? Given the complexity of the difference between the collected/highlighted on the invoice, the final impact could be higher or lower. In addition, not every ICMS taxpayer pays PIS and Cofins.

In our view, the impact in the short run should be limited, as some further steps would have to be taken to directly affect federal tax collection. First, the decision must be regularized by the Brazilian IRS, which will have some time to correct the tax system for all companies and then the IRS will have to define the timetable and rules for the refund of the resources, which may be diluted over the years. Moreover, part of the total amount can also return to the government in the form of income tax, with the calculus that the profit would be higher as a result of a lower PIS/Cofins collection, and which may be taxed by IRPJ and CSLL (amounting to 34% of tax taxes) — minimizing the fiscal impact. In our scenario, we have already considered BRL 65 billion in compensation related to the theme in 2021, yet considering the credit already granted. The amount may increase marginally, depending on the new estimates, timetable and implementation of the STF decision.

Therefore, considering that we considered an impact of BRL120 billion over the next years the STF final deliberation could have the potential to cause an extra reduction in government revenues of BRL60 billion in our scenario (yet it would be diluted over the years). Additionally, we believe that this change in tax methodology could reduce revenue flow by around 0.5% of GDP per year, though it is included in our fiscal scenario since last year.

We further note that in the future it is possible that the decision will be expanded to include the tax calculation methodology also for municipal taxes on services (ISS) based on the same thesis in the ICMS decision (i.e., removing the ISS municipal tax from the PIS/Cofins calculation basis). For municipalities, the data and the parameters to calculate the potential fiscal impact is even more difficult to obtain. Besides that, we tried to obtain a possible estimate for the fiscal accounts. For this, we have used a similar methodology from the calculus for the ICMS case, and also used the ISS tax collection for municipalities from an IPEA (2020)[2] study, as shown in Figure 7.

Figure 7 – Total Municipal Taxes on Services (ISS) – BRL billion



Sources: Brazilian IRS, Santander.

The maximum effect for fiscal accounts with tax compensations may reach BRL30 billion in total since 2017, with a loss in the revenue flow of 0.1% of GDP per year. As with the ICMS case, the ISS calculation has even more uncertainties, and probably lower requests by companies to the STF for a governmental refund.

An important conclusion of this overall discussion, which would be even more pertinent if the ruling has a greater than expected fiscal impact over the next months and years, is the importance of approving a tax reform. According to the government presentation regarding the tax reform[3], PIS/Cofins judicial claims represents 25% of the total in which the PGFN needs to review in the Superior Court of Justice (STJ)[4]. In addition, there are more than 56,000 cases in the STF regarding the ICMS case, showing the elevated number of tax litigation cases and the significant complexity. The end of PIS/Cofins would imply in no more differentiated taxes for sectors and more than a hundred special regimes. We believe that the CBS tax regime (which unifies PIS/Cofins aka PL 3887/2020) considered in the law sent by the government to Congress proposes a single rate and would, in our view, not only mitigate the problems discussed in this report but also improve the efficiency of the tax system.

Conclusions

We estimate a potential net impact on fiscal accounts of around BRL180 billion following the May 13 decision on the exclusion of ICMS state tax from the calculation basis for the PIS/Cofins federal taxes. It is difficult to specify and estimate what the final real effect will be, given the uncertainties even in the assumptions considered in the attempt to estimate the impact. However, in our scenario, we have already included an impact of BRL120 billion in tax compensation over the next few years, considering the increase in tax credit

[2] IPEA (2020) "*Estimativas anuais da arrecadação tributária e das receitas totais dos municípios brasileiros entre 2003 e 2019*". Acess in Portuguese on: http://bit.ly/ipea_tax_2020
[3] *Acess it in Portuguese on:* http://bit.ly/Tax_reform_brazil
[4] STJ is the last instance of the Brazilian Justice for infra-constitutional causes

by judicial claims. The tax credits used by firms totaled more than BRL100 billion since the STF's initial decision in 2017.

In other words, considering the change in the tax accounting methodology and use of full ICMS in the calculus, we anticipate a maximum impact from reduced tax revenue of BRL60 billion in our estimates (but this is also diluted over time). Part of the total amount can also be returned to the governmental revenue in the form of income tax, with the highest profit, as a result of a lower PIS/Cofins tax, and which will be taxed on the IRPJ and CSLL (which partially minimizes the impact). The possibility of extending the decision to municipal taxes should increase the impact on BRL30 billion, but this estimate carries even more uncertainty. Finally, we maintain our fiscal scenario outlook considering the STF's decision (as it should not cause a fiscal crisis directly, in our view), yet it reinforces the need for approving a tax reform.

We reiterate that the decision currently does not modify our fiscal scenario outlook and revenues forecasts, considering that a significant part of the effect was already included in our numbers, yet it will be important to monitor its evolution and developments, as the estimates carry a lot of uncertainty. The government also maintains its revenues estimate, as the effect on the revenue stream has already been considered in the latest estimates. Finally, the STF's decision highlights the importance of approving a tax reform. If the loss of revenue increases beyond our forecasts, we would expect the government to fast-track tax reform approval. We believe that the approval of the government's CBS law (PL 3887/2020), which proposes a single tax would be a positive sign and mitigate all future impacts of the STF decision, while greatly simplifying the tax system.

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