Brazil

Recent Developments in Brazil Regarding the Indirect Taxation of Services in the Digital Economy

Marciano Seabra de Godoi[*]

Issue: Bulletin for International Taxation, 2018 (Volume 72), No. 4a/Special Issue
Published online: 26 March 2018

This article considers Brazilian indirect taxation, examines recent legal initiatives through which municipalities and states have disputed the tax basis of digital economic activities, and criticizes the Brazilian judicial system's inability to timely settle tax disputes in a legal system where nearly all tax measures sooner or later become constitutional.

1. The Constitutional Framework of Brazilian Indirect Taxation: Concurrent Taxing Powers and Long-Running Disputes

From 1891, Brazil has been politically organized as a federation.[1]1 The main difference between Brazil and other federations in the world is that the former has not two, but rather three levels of autonomous government: (i) the Union, i.e. the central Federal Government; (ii) the states, i.e. the regional governments; and (iii) the municipalities, i.e. the local governments, each with their own legislative and executive powers. Brazil has 27 states, including the Federal District, and 5,570 municipalities. The Brazilian *Constituição* (Constitution) grants each of these the power to enact its own tax laws, to monitor and/or control the taxpayers located in its territory, and to assess and/or collect the corresponding tax.

Brazil has a tradition of including lengthy and detailed tax provisions in the Constitution. It is possible that the drafters of the Constitution expected that a high number of detailed constitutional tax provisions would result in a greater level of tax legal certainty. In reality, this has proved to be false. In the Constitution of 1988, which is currently in force, this tradition became even more apparent. Instead of just setting out some general tax principles, the Constitution contains many detailed tax provisions. This has resulted in at least the two following negative consequences: (i) almost all tax questions and controversies can be litigated and legally brought before the *Supremo Tribunal Federal* (Federal Supreme Court, STF or the "Court"), using the argument that the tax provisions of the Constitution are being directly disrespected;[2] and (ii) the number of amendments to the Constitution relating to tax law is very high, which tends, in the long run, to weaken the normative force of constitutional tax law.[3]

This constitutional framework generates many conflicts with regard to taxing power between the three levels of government, especially in respect of indirect taxation, which constitutes the greater part of the tax burden in Brazil.[4] Instead of indirect taxation being the responsibility of only one level of government, the Constitution divides the taxable bases between three levels, i.e. the Federal Government, the states and the municipalities. Under the Constitution, the central Federal Government can tax both the internal supply and the import of manufactured products[5] and the states can tax both the internal supply and the import of goods in general, but only two kinds of services, i.e. communication services and interstate and/or inter-municipal transport services,[6] whereas the municipalities can tax all other services,[7] provided that these are unequivocally specified on a lengthy list of services updated from time to time by the national legislators by way of complementary federal laws.[8]

In theory, the taxing powers of all three levels of government are supposed to be exercised in harmony, according to general rules that were intended to prevent conflicts and overlaps. In practice, the situation is quite different. It is very common for some specific economic activities to be regarded, at one and the same time, by the states as a typical supply of goods and, therefore, subject to state taxation, and by the municipalities as the provision of services as indicated on the national list and, therefore, subject to municipal taxation. One

* **PhD Tax Law, Complutense University of Madrid and Master of Laws, Federal University of Minas Gerais, and Tax Law Professor, Pontifical Catholic University of Minas Gerais, and Lawyer in Belo Horizonte. The author can be contacted at m.godoi@rolimvlc.com.**

1. The first Republican Constitution was adopted in that year.
2. This helps to explain why, in Brazil, if a taxpayer uses all of the legal resources at the taxpayer's disposal, a tax dispute normally takes a decade or more to be settled definitively.
3. In the 30 years that the Constitution has been in force, it has been amended 99 times. Most of the amendments, directly or indirectly, relate to fiscal issues.
4. In Brazil, taxes on goods and services represent nearly 50% of the total tax revenue, whereas income and property taxes represent less than 25% of the total. *See Ministério Da Fazenda/Secretaria Da Receita Federal* (Ministry of Finance/Federal Revenue Office), *Carga Tributária no Brasil 2016* (2017).
5. This federal tax is referred to as the *imposto sobre produtos industrializados* (tax on manufactured products, IPI).
6. This is the most important state tax and is referred to as the *imposto sobre circulação de mercadorias e serviços de transporte interestadual e intermunicipal e de comunicação* (tax on the sale of goods and on the provision of interstate and intermunicipal transportation services and communication services, ICMS).
7. This municipal tax is referred to as *imposto sobre serviços de qualquer natureza* (municipal tax on services, ISS).
8. This legislation is referred to as *Lei Complementar* (Complementary Law).

example is the activity of the manipulation of medicines by pharmacists. The Brazilian courts have not yet decided if this old and prosaic activity should be considered, for tax purposes, to be a provision of a service, i.e. as a "pharmaceutical service" according to the 2003 national list of taxable services, or a supply of goods. Following numerous conflicting decisions by the lower courts, the STF considered a relevant case in 2011,[9] but the dispute is still far from being definitively settled.

With regard to another group of unusual cases of long-lasting legal uncertainty, the question is whether a specific activity regarded as a service and explicitly referred to in the 2003 national list of taxable services, i.e. *Lei Complementar* (Complementary Law) 116/2003,[10] is really a service according to a strict and formalistic concept of service supposedly adopted by the Constitution. This is, for example, the situation of a franchise business. For decades, the legislation has considered a franchise activity to be a service taxable by the municipalities, whereas most of the legal doctrine does not consider this to be a real service. The courts are incapable of settling this dispute in a definitive manner. The STF did agreed to hear a case in 2010,[11] but, again, this is very far from being definitively decided.

2. The (Non-)Taxation of Services of the Digital Economy before Complementary Law 157/2016

As noted in section 1., this article focuses on the following three typical and significant digital economy activities:

(1) processing, storing or hosting of data, text, images, videos, electronic pages, applications and information systems, i.e. cloud computing services;

(2) providing or making available, without a permanent transfer, audio, video, image and text content by way of the internet, i.e. streaming services, such as those provided by Netflix; and

(3) inserting text, drawings and other advertising and marketing materials in the cyberspace, i.e. online advertising, which is, for example, one of Google's activities.

Until 2016, the Brazilian indirect tax law did not contain specific provisions that regarded these activities as being taxable. Alberto Macedo, tax professor and member of the Municipal tax administration of São Paulo, argues that the service of "data processing and similar", which is referred to on the first version of the national list of taxable services, could encompass cloud computing services and that the activity of "licensing of computer programs", which has been included since 2003 on the national list of taxable services, could cover streaming services.[12] This argument is an isolated one and has been rejected by most of the legal doctrine, which notes that Brazilian courts have long established that the items on the taxable services list should not be subject to such an elastic interpretation.[13]

On the other hand, a few states have tried to characterize these activities as communication services so to submit them to state taxation on communication services. Such attempts are considered to be unreasonable by all of the legal doctrine.[14]

The situation is, therefore, very unsatisfactory. Significant services in respect of the digital economy and generating remuneration of billions of US dollars a year have escaped indirect taxation due to the lack of an update to the 2003 national list, which specifies the services that are taxable by the municipalities. Following sustained political pressure on the national legislature, in 2016, the federal parliament approved an update to the national list of taxable services by way of Complementary Law 157/2016.[15]

3. Provisions and Objectives of, and Reactions to, Complementary Law 157/2016

Among other provisions, Complementary Law 157/2016[16] includes the following services on the national list of taxable services:

> Processing, storing or hosting data, texts, images, videos, electronic pages, applications, and information systems, among other formats, and similar (sub item 1.03)
>
> Providing or making available, without permanent transfer, audio, video, image, and text contents by way of the Internet, preserved the immunity applicable to books, newspapers and journals (sub item 1.09)

9. BR: STF, 5 May 2011, Case RE 605.552 RG.
10. BR: Complementary Law 116/2003.
11. BR: STF, 1 Oct. 2010, Case RE 603.136 RG.
12. A. Macedo, *ISS – O conceito econômico de serviços já foi juridicizado há tempos também pelo direito privado*, in *XII CNET – Direito Tributário e os Novos Horizontes do Processo* pp. 1-79 (A. Macedo et al. eds., Noeses 2015).
13. J.E.S. de Melo, *ISS Teoria e Prática* (Saraiva 2017).
14. H. Ávila, *Veiculação de material publicitário em páginas da Internet. Exame de competência para a instituição do imposto sobre serviços de comunicação. Ausência de prestação de serviço de comunicação*, 173 Revista Dialética de Direito Tributário, p. 153 (2010) and A.M. Moreira, *A tributação dos serviços de comunicação* (Noeses 2016).
15. BR: Complementary Law 157/2016.
16. Id., at art. 3.

> Inserting texts, drawings and other advertising and marketing materials, in any media (except books, newspapers, journals, broadcasting services, and sound and image broadcasting services free of charge of reception) (sub item 17.25)[17]

The objective of this change was to make it possible for Brazilian municipalities to tax the digital services provided by enterprises, such as Apple, Google and Netflix.

Some Brazilian lawyers and scholars[18] argue that streaming service could not be considered to be so taxable, as there is no performance of any intellectual or physical activity by the provider; rather, there is only a transfer or an assignment of rights from the provider to the consumer. According to this opinion, the Constitution only permits real services, which are supposed to only cover the onerous obligations by which the provider renders intellectual or physical activities to the benefit of someone,[19] to be taxed by the municipalities.

The author does not agree with this position, which overly attaches a constitutional interpretation to a strict and formalistic concept of services. The Constitution explicitly states that the municipalities have the power to tax services "of every kind".[20] Although the STF did adopt a strict and formalistic concept of taxable services in a precedent case of 2001,[21] in more recent years the Court has upheld the municipal taxation of at least two activities, i.e. leasing operations[22] and private healthcare plans,[23] which in no way correspond to such a strict conception of service. In the recent private healthcare plans case, the STF stated that:

> the Supreme Court, when upholding the taxation of financial leasing and leaseback, admitted a broader interpretation of the constitutional text regarding the concept of "services", [and that] the concept of the rendering of services does not have as its premise the private law configuration.[24]

In contrast to most tax lawyers and scholars, it should be noted that Netflix did not publicly challenge the validity of the taxation of its services. In a public declaration, the enterprise stated that:

> Netflix charges and collects taxes in all markets where it is legally bound to do it. Regarding the present version of the tax on services, Netflix will not transfer its cost to consumers.[25]

4. Municipal Statutes Enacted in 2017 following Complementary Law 157/2016

Under the Constitution, the taxation of a specific service by a municipality requires the satisfaction of a number of conditions. These are that the activity is a real service and not a supply of goods, a rental or other economic activity not covered by the constitutional concept of taxable services as held by the STF, that the service is not a communication or interstate and/or inter-municipal transport service, which falls under the exclusive taxing power of the states, that the service is unequivocally specified on a national list approved and periodically updated by the federal parliament, and, finally, that the municipality in question has enacted a statute providing for the taxation of that service.

With regard to the three kinds of digital services considered in this article, i.e. cloud computing, streaming and online advertising, the federal legislation, by way of Complementary Law 157/2016, included these on the municipal taxable services list in 2016. In 2017, most municipalities adapted their own legislation to the new legal context. In this context, this article focuses on the Municipalities of São Paulo, Rio de Janeiro, and Belo Horizonte, the three largest cities in Brazil in terms of economic activity.

São Paulo[26] and Rio de Janeiro[27] included all three of these activities in their list of taxable services. In Belo Horizonte, the taxation of the three digital activities was included in the bill sent by the executive power to the parliament, but the municipal legislators repealed the measure, in arguing that the taxation of the activities "would discourage new projects and investment and ultimately cause the migration of enterprises and start-ups to neighbouring cities".[28]

The Belo Horizonte legislators initiated what has been referred to in Brazil for some time now as *Guerra Fiscal* ("Fiscal War"), i.e. the practice of harmful tax competition between the states and municipalities, or a form of tax "race to the bottom", to attract businesses and enterprises to their territories. In order to prevent this practice in respect of the municipal taxation of services, the Constitution authorizes federal legislation, i.e. complementary laws, to be issued to establish a minimum tax rate that every municipality should follow.[29] Federal legislation then set the minimum tax rate at 2%[30] and determined that, in the case of infringement of this rule, the responsible

17. This and all subsequent translation from Portuguese into English are the authors' unofficial translations.
18. *See*, for example, B. Grupenmacher, *Incidência de ISS sobre streaming é inconstitucional* (CONJUR 2016.
19. *See*, for example, D. Castro, *The Digital Economy and Indirect Taxation: The Brazilian Perspective*, 71 Bull. Intl. Taxn. 6, sec. 3.2.3. (2017), Journals IBFD.
20. BR: *Constituição Federal* (Constitution), 6 June 2017, art. 156, III.
21. BR: STF, 25 May 2001, Case RE 116.121.
22. BR: STF, 5 Mar. 2010, Case RE 547.245.
23. BR: STF, 26 Apr. 2017, Case RE 651.703.
24. Id., at para. 4-5.
25. IDGNOW!, *Netflix diz que não irá repassar ISS aos assinantes no Brasil Netflix says that will not transfer the burden of tax services to its consumers in Brazil* (8 Nov. 2017), available at http://idgnow.com.br/internet/2017/11/08/netflix-diz-que-nao-ira-repassar-iss-aos-assinantes-no-brasil.
26. BR: Municipality of São Paulo, *Lei* (Statute) 16.757/2017.
27. BR: Municipality of Rio de Janeiro, *Lei* 6.263/2017.
28. According to the official report of the municipal parliament of Belo Horizonte of 24 Oct. 2017.
29. Art. 156, para. 3, I Constitution.
30. Art. 8.º-A Complementary Law 116/2003.

municipal authorities could be sued in respect of the practice of administrative improbity, which can result in significant financial and political sanctions.[31] Federal legislation also established that, as a consequence of any infringement of the rule regarding the minimum tax rate, with regard to a service provided for consumers located in another city, the municipality in which the consumer is established has the right to tax the service and not the municipality where the provider is established.[32]

In this context, it was questionable that none of the Belo Horizonte legislators warned their peers of, or at least brought to the attention of the legislature in debate, these federal norms that sanctioned and neutralized any municipal infringement of the federal rule regarding the minimum rate of service tax. Here, it should be noted that the Municipality of São Paulo has established an ad valorem rate of 2.9% in respect of all of the three digital services considered in this article, whereas the Municipality of Rio de Janeiro has established an ad valorem rate of 2% in respect of streaming and online advertising and a rate of 5% in respect of cloud computing services.

It should also be noted that, as a general rule that applies to these three digital services, the municipality which has the right to tax the services is that in which the provider of the service has its real establishment and not where the consumer is domiciled.[33] As Netflix has only one establishment in Brazil, which is located in São Paulo, it is the Municipality of São Paulo, and not the municipalities in which the clients of Netflix live, that has the right to tax Netflix's streaming services.

With regard to certain specific services, such as the provision of private healthcare plans, federal legislation, i.e. complementary laws, determines that the tax is payable to the municipality in which the consumers have their domicile,[34] but this special rule does not apply to the digital services considered in this article. In spite of the clarity of the relevant legislation, it is very likely that the municipalities in which consumers are domiciled consider themselves entitled to collect the service tax. Unfortunately, the most likely scenario is a judicial dispute regarding this question and one that will probably take decades to be definitively settled. A similar dispute, i.e. which state is entitled to collect tax on the ownership of automobiles, being the state where the automobile is registered or the state where the automobile is used, has been before the STF for many years now and is far from being settled.[35]

5. States' Strategy in Attracting Digital Services to Their Taxing Jurisdictions: Uncertainty and Disputes

As stated in section 1., the taxable bases in respect of indirect taxation in Brazil are divided between the three levels of government, i.e. the Federal Government, the states and the municipalities. If an activity is identified as a supply of goods, a communication or transport service, it is taxed by the states and not by the municipalities. The precise boundaries between such activities are constantly subject to endless litigation before the courts, especially at the STF.

What have the states done to remove the digital services tax bases from the municipalities? Immediately after federal legislation had placed digital services on the service tax national list by way of Complementary Law 157/2016, the executive powers of the states enacted legislation, i.e. *Convênio ICMS* (States Agreement) 106/2017,[36] which characterized digital services as digital goods. As goods, and not services, digital activities could be exclusively taxed by the states.

The States Agreement 106/2017 has its origins in an old judicial dispute, as usual, one that has not yet been definitively resolved by the STF, regarding the question of whether the acquisition of a computer program should be considered to be an acquisition of goods and/or merchandise or a service. As expected, in order to protect their tax base, the states argue that software must be considered to be digital goods and the municipalities hold that software must be considered to be the provision of services. Software enterprises, in their turn, argue that what they are selling is neither a service nor goods and/or merchandise, but rather a licence for the use of intellectual property (IP), and that this is an activity that the Constitution does not allow to be taxed.

As usual with Brazilian tax law, the judicial dispute in question has lasted for decades without being properly resolved. The STF has pronounced twice on the problem. In the first decision, in 1998, justices from one of the two branches of the STF held that software can be either a service or goods.[37] It is a service if it is customized to the specific needs of the consumer and it is goods if it is standard, commercial off-the-shelf software.

This first decision of the STF in 1998 did not take into consideration whether the states could tax, as digital goods, the downloading of standard software and applications. In 1999, in another case, the STF initiated procedures to decide, among other things, whether a specific statute of a state, which provided for the taxation of software sold by "electronic transfer of data", was lawful.[38] The plaintiff

31. BR: *Lei ordinária Federal* (Federal Ordinary Law) 8.429/1992, art. 10-A.
32. Art. 3.º, para. 4.º Complementary Law 116/2003.
33. Id., at art. 3.
34. In confirming the author's previous statement that, in Brazil, nearly all tax rules, even the most prosaic ones, can be challenged as being unconstitutional before the STF, Complementary Law 157/2016, i.e. the provision stating that, in respect of some activities, the payment of the service tax is to be made to the municipality where the consumers have their domicile, was recently challenged by a political party before the STF as being in violation of the constitutional "principle of reasonableness". *See* BR: STF, 18 Dec. 2017, Case ADI 5.862. By exploring the vagueness of this "master key" legal principle, it is possible – and this is what happens all the time in Brazil – to challenge every new tax as being unconstitutional.
35. BR: STF, 1 Aug. 2014, Case ARE 784.682 RG.
36. BR: *Convênio ICMS* (States Agreement) 106/2017.
37. BR: STF, 1 Dec. 1998, Case RE 176.626.
38. BR: STF, 14 Mar. 2011, Case ADI 1.945.

in the case, a political party,[39] argued that no form of software, i.e. standard or customized that was transferred to the consumer by physical support or by download, could be taxed by the states as it constitutes simply licensing rights and not a supply of goods and/or the provision of service. The case has already run for 12 years and has still not been definitively decided. According to the provisional decision of the STF, which was given in 2011, the states can tax the selling of software by way of downloads and the fact that, in such circumstances, physical and/or corporate goods are not being transferred is irrelevant, i.e.:

> The Court cannot take the support of outdated legal premises to refrain itself from embracing new situations, concrete consequences of real world. The adherence to these legal guidelines weakens the Constitution because it does not allow its rules to be adapted to new times [...].[40]

As the provisional decision of the STF in 2011 authorized the states to tax standard and/or not customized software that was sold either physically or download, many states joined together and agreed, in 2015, by way of States Agreement 181/2015,[41] to do this in such a manner that the total tax burden on these operations would be set at a minimum 5% ad valorem. Until then, the states had been taxing software in a very limited way, as the legal tax base was only the physical support provided in respect of the software, i.e. compact disks, diskettes, etc., and not the total cost of the operations in question. In 2015/16, when some states started to impose tax on the total amount of standard software operations, downloaded or not, the dispute was once again taken directly to the STF.[42] To date, these new cases have not been decided, which means that, for the time being, the collection of the tax can be enforced.

The novelty of the States Agreement 106/2017, which is a provision agreed by the executive powers of the states involved and not by national legislature, is that the states are trying to widen their tax base to encompass not only standard computer programs, such as software, but every kind of "digital goods commercialized by electronic transfer of data". The purpose of including the business of Netflix, for example, within the tax net appears to be clear, given legislative fragment, i.e.:

> The tax will be collected on internal operations and imports via electronic sites or platforms that sell or make available, even by means of periodic payment, digital goods and merchandises via electronic transfer of data.[43]

In this respect, it should be noted that one of the provisions of States Agreement 106/2017 affirms that liability to tax can be attributed to credit card companies.[44] There is no such rule in the legislation of the services tax of the municipalities. On the other hand, there is an old decision of the *Superior Tribunal de Justiça* (Superior Court of Justice, STJ), according to which this liability of credit card companies is void, as these companies do not have a sufficient link with the provision of services by their clients, such that they cannot be held to be responsible for the tax levied on the provision of the services.[45]

This judicial position, which does not have the binding force of a precedent, is likely to be reassessed. The reason for this is, when a digital service provider does not have any establishment in the territory of Brazil, which is often the case, it appears that the liability of credit card companies in this respect is the only way to enforce the rule,[46] according to which, with regard to imported services, the exclusive right to tax lies with the municipality in which the consumer is domiciled.[47]

6. Conclusions

The global challenges and difficulties of adapting international and domestic tax systems to the digital economy are well-known and much studied.[48] However, in Brazil these challenges and difficulties are even more problematic given the long-standing legal tradition of over-subjecting complex tax law in a three-level federation to the Constitution, the complete lack of specialized tax courts, and, most importantly, the chronic incapacity of the STF to resolve the large and growing number of tax disputes in a timely manner.

With regard to the indirect taxation of three significant digital activities, i.e. cloud computing services, online advertising and streaming services, the federal legislators closed a legislation gap in 2016 and put these within the taxing power of the municipalities. However, as expected, the states have been trying to obtain this large tax base from the municipalities by exploring the ambiguities of an outdated constitutional framework that shares, according to concepts that have never been sufficiently clarified by the case law of the STF, the consumption tax base among these three levels of government.

In the author's opinion, the attempt by the states to remove the digital services taxable base from the municipalities is illegal. Under the Constitution, conflicts of taxing power between the three levels of the government in Brazil must, in principle, be settled by federal complementary legislation. This has already been done with the updates to the national list of municipal taxable services that explicitly placed the digital services, including the licensing of computer programs, customized or not, under the tax power of the municipalities. On the other hand, it is a mistake, as appears to have been appreciated in recent rulings of the STF, to interpret the constitutional tax

---

39. In Brazil, it is common for national political parties to be used by powerful lobbyist to try to prevent tax impositions directly before the STF.
40. Case ADI 1.945 (2011), *supra* n. 39.
41. BR: States Agreement 181/2015.
42. BR: STF, 18 Aug. 2016, Cases ADI 5.576 (State of São Paulo) and BR: STF, 15 Feb. 2017, ADI 5.659 (State of Minas Gerais).
43. Third Clause States Agreement 106/2017.
44. Id., Fifth Clause.
45. BR: STJ, 12 Feb. 1996, Case REsp 55.346/RJ.
46. Art. 3, I Complementary Law 116/2003.
47. R.V.S. Garcia, *Tributação do ISS na sociedade da informação*, LLM Dissertation, São Paulo University (2013).
48. *See*, for example, OECD/G20, *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report* (OECD 2015), International Organizations' Documentation IBFD.

expression “service of every kind”,[49] according to an outdated and formalistic concept of services that unduly restricts the taxing power of the municipalities.

For the sake of legal certainty strictly necessary to safely operate private businesses and public budgets, the apparently conflicting legislative developments of 2016/17 regarding the dispute in respect of digital services tax bases between states and municipalities should be interpreted and applied by the courts, as presided over by the STF, in a timely manner according to clear and unified legal criteria. This, however, unfortunately appears to be very unlikely.

49. Art. 156, III Constitution.