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Tax Intelligence Strategy

From complexity to execution

The impact of the consumption tax reform in M&A transactions: challenges, operational shifts, and strategic considerations

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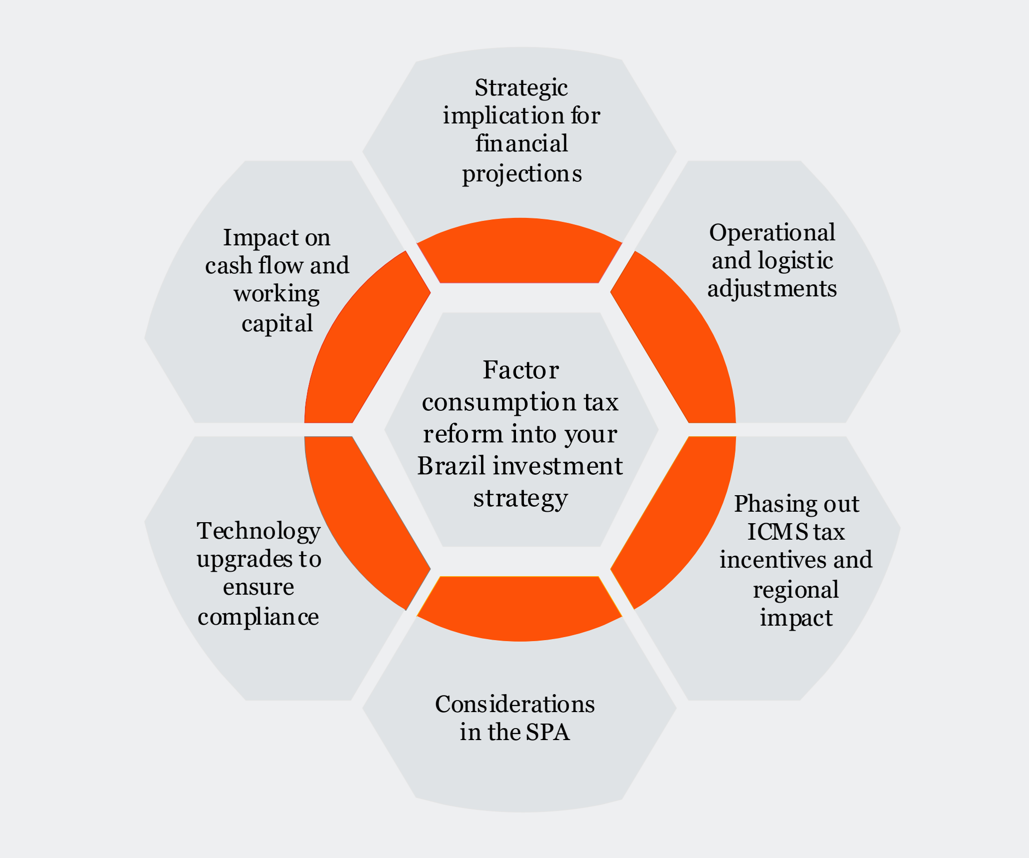
Brazilian Congress recently approved the Constitutional Amendment No. 132 (PEC 45), marking a significant reform of the country's consumption and transactional tax framework at the federal, state, and municipal levels.

Subsequently, tax reform measures were enacted through Complementary Law No. 214/2025. This tax legislation sets the stage for the gradual rollout of a new value-added tax (VAT) system beginning in January 2026.



Under the new Brazilian tax environment, four existing taxes (PIS, COFINS, ICMS and ISS) will be phased out and replaced by a dual VAT taxation (CBS - Federal Contribution on Goods and Services; and IBS - State and Municipal Tax on Goods and Services) plus an Excise Tax on certain specific sectors/products (IS - Federal Selective Tax).

The consumption tax reform, which aims to simplify Brazil's tax system, has sparked significant discussions about its real impact on businesses.

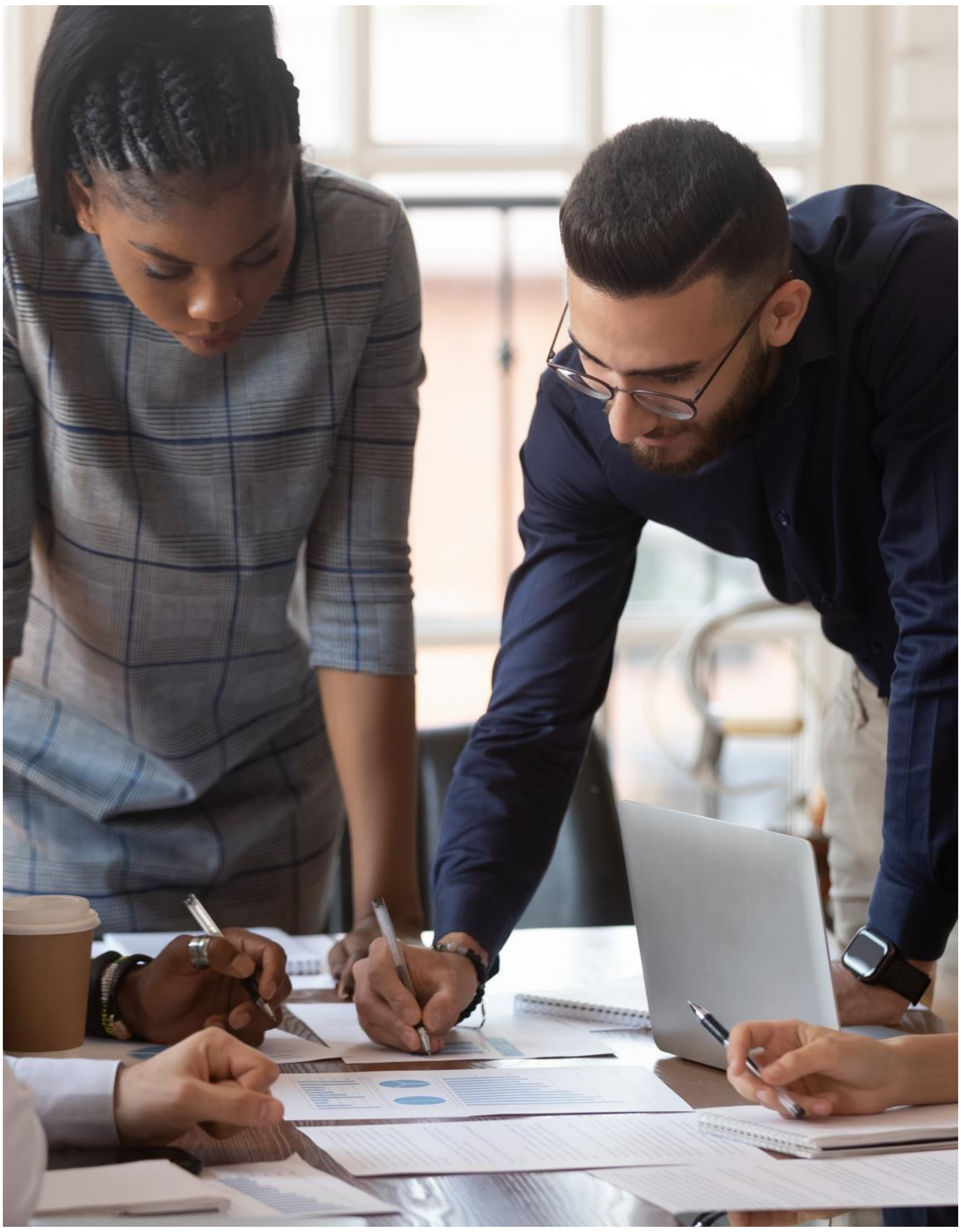
Initially presented as a measure to streamline taxation without raising the overall tax burden, the tax reform's effects are more nuanced. While some sectors may see a reduction in taxes, others might face an increased burden. As the reform takes full effect in the coming years, businesses must engage in careful strategic planning and financial projections to navigate this complex and new tax landscape.

It is no different when it comes to M&A transactions. Investors pursuing the acquisition of Brazilian companies have now to also look at their potential targets through a different perspective. This is because the application of new taxes on the present/future commercial transactions performed by the companies naturally achieves different results. Consequently, it becomes imperative to anticipate and understand the effects of the future tax environment to better assess whether the envisaged purchase price and projected financial returns justify the originally proposed deal value or whether investors may have to redesign the structure and financial conditions to be offered to the sellers.

Furthermore, in this context, the investors must take into consideration that the implementation of the tax reform may carry significant short to medium term cost implications for companies operating in the country.

These costs, although not directly tax-payment related, may materially affect a company's profitability and operational efficiency during the tax reform transition period and beyond. Among these costs that may result in higher upfront costs and temporary inefficiencies, it is worth mentioning the following: i) Upgrading ERP and tax systems; ii) Investing in automation and on real-time reporting; iii) Changing processes and internal controls; iv) Upskilling staff across departments; v) Incurring legal, administrative and HR additional costs; vi) Reassessing supply chain and site relocations; and vii) Realigning businesses structure. Further comments in this respect are presented in the following topics.

Take a look at introductory concept of our VAT Tax Reform.



Strategic implications for financial projections and pricing

For businesses in general, and especially for foreign investors evaluating opportunities in Brazil, it's crucial to be alert to the transformative effects brought about by the country's comprehensive consumption tax reform. This reform, aimed at simplifying the complex tax landscape, will have deep implications for financial modeling, pricing strategies, and valuation of Brazilian companies' operations.

Investors should particularly pay attention to how the tax reform could impact projected returns and pricing, especially in light of shifting tax liabilities and reduced incentives, affecting the companies' margins and profitability. Detailed financial projections and adjustments to tax plannings will be necessary to ensure profitability in an environment where some sectors may face increased tax burdens, including the analysis of: i) Pass-through capabilities; ii) Margin Management; iii) Contracts repricing; and iv) Sector-specific impacts.

In 2026, Brazil will initiate a "test phase" of the new tax system. While no economic impact on the effective tax rate is expected, as both the old and new regimes will operate in parallel without an increase in overall tax burden, this phase offers a critical window for foreign investors to model dual tax scenarios and plan for strategic adjustments in anticipation of the full implementation.

From 2027 onward, major tax changes will take effect. The Contribution on Goods and Services (CBS) will be fully implemented, replacing PIS and COFINS taxes, while the new Excise Tax (IS) will apply to production, sale and importation of goods harmful to health or to the environment (e.g., iron ore in the mining sector) will be introduced. The IS may increase the tax burden on specific industries, impacting valuation models, especially in resource-heavy sectors and consumer goods. Also, IBS will be introduced with minimal rate.

From 2029, the Tax on Goods and Services (IBS) will be gradually increased, replacing the state and municipal ICMS and ISS taxes. Alongside this phased implementation, tax benefits and incentives will be reduced or eliminated, changing the investment appeal of certain regions or sectors that previously relied on tax differentials to attract capital.

The full adoption of Brazil's new Value-Added Tax (VAT) system will be completed in 2033. Investors must be prepared for ongoing adjustments in financial modeling, particularly as legacy tax incentives expire and the new tax system takes hold.

An important strategic consideration, especially for deal-making, is that while the tax reform introduces taxation on some previously non-taxable transactions, it also establishes a more comprehensive non-cumulative tax framework. This allows for broader tax credit mechanisms, enabling companies to offset taxes paid on inputs, which may partially or fully mitigate increased tax costs in some business models.

Therefore, prior to entering deals or investments, investors should thoroughly assess the net impact of these changes on each business line, and ensure that financial models, pricing structures, and valuation assumptions reflect the complexities of the new tax framework.

Proper scenario planning, stress testing, and a deep understanding of sector-specific implications will be key to successful long-term investment in Brazil.

In addition, deals already closed which contains contingent payment clauses based on achievement of future performance metrics (such as "earn-out" structures) and/or acquisition of remaining participation ("put / call options"), may be impacted depending on how the SPAs (Stock Purchase Agreements) were designed. Therefore, investors should also assess the potential impacts of the tax reform on the recently acquired companies.

Impacts on purchase price

Most of the M&A transactions in Brazil have their purchase price determined as a multiple of EBITDA. Considering that taxes on consumption, object of the tax reform under implementation in Brazil, indirectly affect EBITDA calculation, it becomes necessary to understand how the current EBITDA, based on the existing tax environment, will fluctuate, along the transition period and beyond, as consequence of the application of the new taxes. Among the EBITDA impacts, we may highlight the following:

- **Increased transparency:** Non-cumulative VAT models will allow clearer separation between operating results and tax cost;
- **Temporary EBITDA compression:** Companies may experience margin pressures if unable to pass along increased tax burdens during the transition phase; and
- **Diligence adjustments:** M&A valuations must incorporate the projected impacts of CBS, IBS and IS on the target company's future margins and pricing strategies.

It is difficult today to determine such effects in EBITDA, because of the lack of certain definitions on the new tax legislation (i.e. CBS/IBS tax rates). Even though, the fact that today the parties may be using tax-related assumptions for EBITDA determination that do not correspond to future tax obligations may clearly lead to relevant discrepancies.

Therefore, the development of potential tax scenarios may be useful to help buyers better understand the position the target company will be during/after Tax Reform.

Such discrepancies may be even bigger in situations whereas the purchase price encompasses an "earn-out" mechanism based on future results that will be achieved under the new tax environment.

Therefore, it is crucial to enter into Stock Purchase Agreement (SPA) which clauses and definitions clearly determine how the agreed purchase price (including earn outs, when applicable) will/won't be adjusted as consequence of the tax reform impacts, in order to prevent future legal disputes between buyers and sellers.

Reevaluating business models

As mentioned, one of the core elements of the tax reform is the unification of taxes, such as ICMS (State VAT) and ISS (Municipal Service Tax). While this simplifies the tax system, it could lead to a higher tax burden for some sectors, particularly those in the services industry.

Pure service providers will face significant challenges in understanding and adapting to their new effective tax burden under the VAT system. Currently, ISS represents a tax rate of approximately 2% to 5% and does not allow for tax credits. When combined with PIS and COFINS, the total tax burden can reach up to 14.25%, but with the advantage of credit entitlement under a non-cumulative regime.

Under the new VAT structure, however, the total tax burden for service providers is expected to rise substantially, ranging between 26.5% and 28%. While this new system does allow for tax credits, the overall increase in nominal rates may have a significant financial impact, especially for companies with limited tax credits to offset (case of service providers).

Companies that have historically separated resale and service activities should reassess whether this division remains strategically relevant under the new tax framework. The tax reform may reduce or eliminate the tax advantages previously associated with maintaining separate operations. In this new environment, simplifying corporate structures and consolidating activities could lead to cost efficiencies, making integration a more beneficial approach than continuing to operate them independently.

Another key aspect of the tax reform is the necessity for businesses to rethink traditional operational structures. In sectors such as pharmaceuticals and cosmetics, where companies typically split their manufacturing and distribution functions for tax reasons, this division may no longer be practical. If the basis for this separation was primarily tax driven, it may now make sense to merge these functions to streamline operations and reduce costs.

As above, some industries will likely experience increased tax burdens, while others may see reductions.

Examples of sectors that may face higher tax burdens:

Healthcare services; Education; and Technology services.

Examples of sectors that may benefit from reduced/equal tax burdens:

Industrial manufacturing; Agribusiness; Logistics; and Exports.

For foreign investors, the tax reform highlights the importance of conducting thorough analysis and strategic planning before entering or expanding in the Brazilian market. Understanding the new tax implications, reassessing operational structures, and modeling potential financial impacts will be critical for investment success.

Moreover, aligning business strategies with the evolving tax landscape can help mitigate risks and uncover opportunities for greater efficiency and competitiveness in Brazil.

Phasing out ICMS tax incentives and regional impact

As A major component of the reform is the gradual elimination of ICMS and ISS tax incentives, which have long provided benefits to companies in specific regions. These incentives have been vital for maintaining competitiveness in those areas. However, by 2033, these incentives will be phased out, and businesses in incentivized regions will face a higher tax burden.

The unification of ICMS taxes across the country will have notable effects on companies that depend on these incentives for reduced operational costs. As these incentives disappear, businesses will need to adapt by reassessing their tax strategies and possibly shifting operations or locations to manage costs more effectively.

For industries that previously benefited from specific tax incentives, such as those located in incentivized regions, this increase in the tax burden will not be uniform across all sectors. Some industries, especially those that have relied heavily on these tax breaks, could face significant challenges.

As a result, companies will need to reassess their operational models and determine whether they can maintain their previous tax structures or understand when would be the more suitable moment to start a transition of its production, utilizing the tax benefit while possible and at the same time preparing a transitional period to migrate its production to a more favorable location (from an operational standpoint, no longer tax driven).

For service companies that enjoy ISS tax incentive granted by certain municipalities, the same rationale would apply. Instead of moving all your infrastructure to a more distant municipality or maintaining different structures in two municipalities just to enjoy a lower taxation in one municipality, with the tax reform this would no longer be applicable not only due to the end of the incentives themselves but also as the payment will be made to the location of the consumer.

Further tax analysis will help investors estimate the potential value of lost tax incentives. While the net effect, considering both the elimination of tax incentives and any resulting increase or decrease in overall tax burden, remains uncertain, a preliminary analysis should be conducted to provide a rough estimate of the financial impact.

Operational and logistic adjustments: evaluating the viability of current site locations

With the end of regional tax incentives and the unification of taxes, where tax payment will be made to the destination of good/service, businesses must reconsider their operational strategies, particularly when it comes to choosing site locations. Factors like labor costs, real estate prices, and logistics expenses will become more critical in decision-making.

The proximity to consumer markets will become more important as companies look to minimize logistic costs in the absence of tax incentives (expected to be reduced/eliminated under IBS, diminishing the tax advantages tied to specific locations).

Some companies may consider relocating their sites (production plants, warehouses and offices) closer to key markets to optimize efficiency. However, these decisions will need to be carefully made, factoring in the timeline for the end of incentives and the associated transition costs.

If on the one hand, a post-acquisition site relocation could result in cost efficiencies as above, on the other hand it will represent an additional implementation cost which must be considered by the potential buyers on their investment plans.

Impact on cash flow and working capital

The tax reform could also affect the timing of tax payments, which has significant implications for cash flow management. With changes in payment schedules and the implementation of split payments, companies will need to assess how these shifts will impact their working capital. This mismatch between the tax payment schedule and the collection period for sales (which can often range from 30 to 90 days) could create financial strains.

As businesses adjust to the new payment timelines, they will need to update their financial planning strategies to ensure they can more effectively manage cash flow in this new environment.

In summary, the new VAT framework will have significant consequences for working capital management, as follows:

- **Credit accumulation:** During the transition period, companies may accumulate excess tax credits that are not immediately monetizable;
- **Cash Flow mismatches:** Delays between the collection of output taxes and recovery of input tax credits could strain liquidity; and
- **Increased need for financial stress-testing:** Buyers must model the effects of delayed credit utilization and higher gross cash outflows on target's working capital cycles.

Likewise, cash flow forecasting will require substantial recalibration, as below:

- **Higher gross tax remittances:** The VAT system will demand higher upfront cash payments, even if later offset by input tax credits;
- **Deferred monetization of tax credits: :** Particularly in sectors with long production of service cycles, cash tied up in tax credits could impact liquidity; and
- **Pressure on covenants:** Deterioration in operational cash flow could affect debt service coverage ratios and other financing conditions.

Therefore, the necessary working capital and cash flow analysis should take into consideration the effects of the tax reform to determine the new appropriate level of cash the target companies must have in order to run their businesses looking forward.

Additionally, investors will need to assess the potential impacts of the tax reform over the purchase price adjustment mechanism in the SPA, specifically when the Completion Accounts method is adopted, and purchase prices are adjusted based on the working capital variation between signing and closing dates.

Technology upgrades: ensuring compliance with new tax regulations

The tax reform requires the need for businesses to update their technology infrastructure. Companies will need to invest in new ERP or to enhance existing systems to comply with the new tax regulations. This includes automating tax calculations, issuing invoices in the new format, and generating reports that meet legal requirements.

In 2026, the “Test Phase” will begin, during which the IBS and CBS will apply at minimum rates, with corresponding deductions for PIS and COFINS purposes. While the initial economic impact is expected to be very low, it is essential to ensure that the company is already assessing and preparing for the operational effects these changes may have on their daily activities.

These costs, while potentially beneficial in the long term, represent an upfront capital expenditure that can temporarily reduce their margins. Large companies have already begun making the necessary investments to prepare themselves for day-one (Irrespective whether companies may have their tax and accounting functions internal or outsourced). However, the same level of readiness is not as clear among small to medium-sized businesses which seem, in certain cases, to be still waiting to take the relevant decisions and therefore may have more difficult to comply with, which in a worst-case scenario may temporarily interrupt their business activities.

As a result, upfront discussions are necessary to assess the effort level required to ensure compliance with the new taxation model.

In addition, companies may face increased personnel costs related to training and upskilling. Finance, tax, legal, and operations teams will need to be fully equipped to understand and apply the new rules, especially during the period in which the legacy and new tax systems operate simultaneously (2026–2028). This learning curve may lead to temporary inefficiencies and increased reliance on external advisors, further inflating operating expenses.

In a nutshell, despite the goal of simplification, the transition period will bring substantial operational risks:

- **Dual compliance regimes:** Companies will need to manage simultaneous reporting obligations under previous and new tax environments;
- **ERP and technology upgrades:** Significant investment will be required in tax engines and ERP systems, and reporting infrastructure; and
- **Higher litigation risk:** Transitional uncertainties may give rise to disputes over tax credits, tax computations and interpretation of the new legislation.

Impact on M&A contracts: SPA, TSA and legacy agreements

Given the relevant tax changes, M&A-related documentation must also be reviewed to address tax reform risks/impacts, mostly in connection with the following:

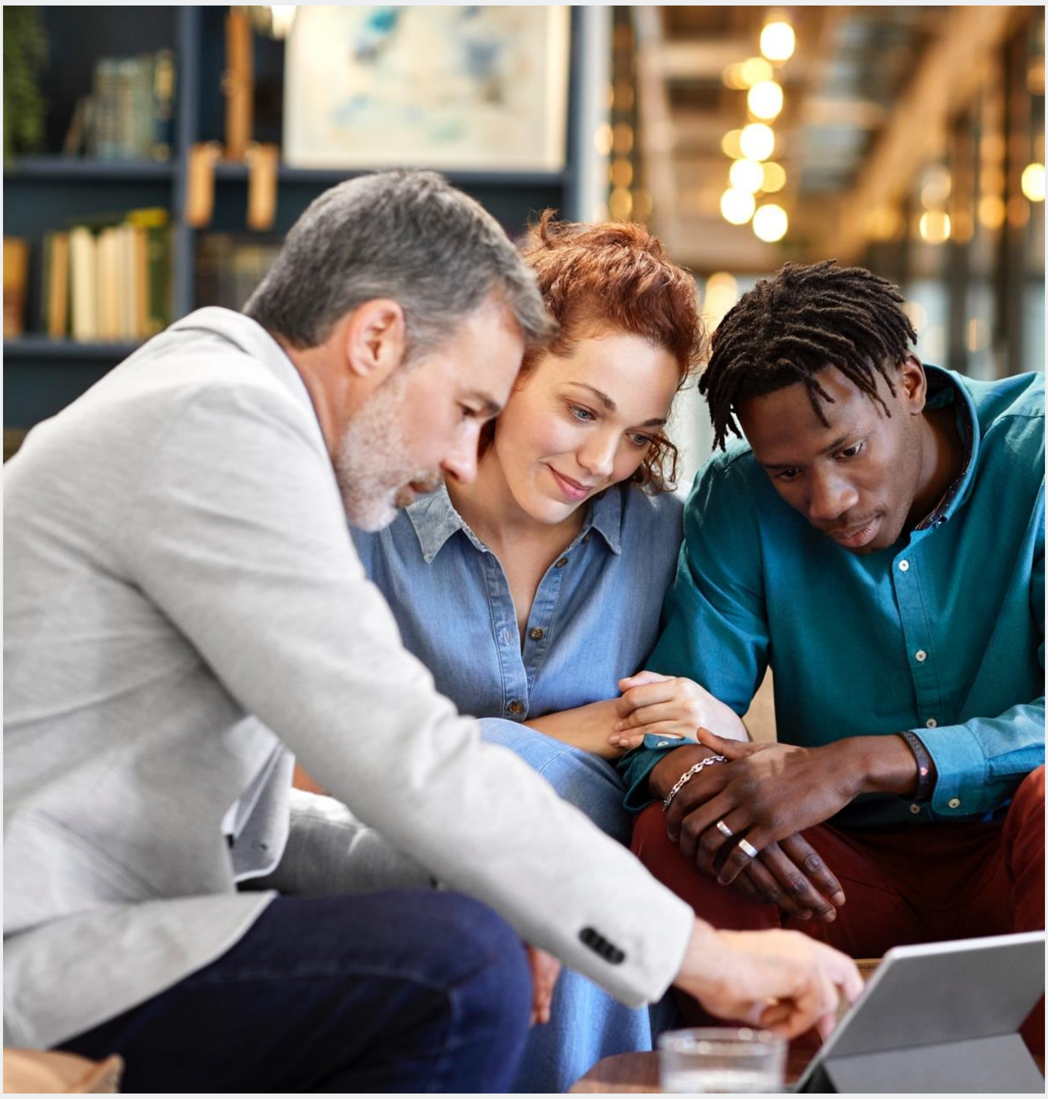
- **SPA:** Future SPAs should include detailed tax reform-related provisions, such as specific representations and warranties, covenants regarding transitional tax compliance, and indemnities covering unanticipated tax liabilities arising from the tax reform;
- **TSA (Transition Services Agreements):** TSAs must account for dual tax system compliance, adjustments to service pricing due to tax cost differences, and possible changes in tax treatment of services provided during transition period; and
- **Review of existing contracts:** For transactions closed without contemplating tax reform, a review of SPA indemnity clauses, earn-outs, tax covenants, and working capital adjustments is critical. Hidden liabilities or financial impacts could emerge as the new tax system phases in, potentially affecting earn-out payments, escrow releases, or even triggering post-closing disputes.

Conclusion: navigating the evolving tax landscape

While Brazil’s consumption tax reform aims to simplify the country's complex tax system, it introduces a range of challenges and operational shifts for businesses. These include changes to the overall tax burden, the elimination of ICMS and ISS incentives, and the need for significant operational and technological adjustments. Companies must proactively plan for these changes, as they could materially impact valuation, EBITDA, working capital and cash flow.

It should therefore be thoroughly assessed before deal signing and the relevant aspects need to be clearly addressed in the relevant SPA and other deal agreements (i.e. TSA).

Post-signing, it will be critical to revisit business models, pricing strategies and location decisions to align with the new tax landscape. By anticipating these shifts and implementing the necessary changes, businesses may minimize disruption and best position themselves for sustainable, long-term growth in the reformed tax environment.



Key Takeaways

- **Enhanced Due Diligences:** Corresponding analysis must encompass beyond the historic tax performance/risks to assess other aspects such as tax credit utilization; loss of tax incentives, compliance awareness and readiness and pricing strategy risks.
- **SPA adjustments:** Negotiations need to include mechanisms to reflect working capital risks, expected cash flow impacts, transitional tax liabilities and potential tax reform effects.
- **Post-closing strategies:** Integration plans must prioritize tax compliance, corporate restructuring steps, pricing redefinition, contracts renegotiation and working capital/cash flow monitoring.
- **Strategic Planning:** Buyers must assess if asset relocations or corporate restructuring simplifications may enhance value creation.

For such challenges, PwC has developed a new solution to assist companies understand the changes of the VAT tax reform taking as a starting point the current tax obligations delivered by the companies. To learn more about this topic, please check our Tax Intelligence 33rd Edition.

Want to understand more about how this subject can impact your business?
Contact PwC.

Leila Fernandes
leila.y.fernandes@pwc.com

Marcela Carvalho
marcela.carvalho@pwc.com

Rodrigo Bastos
rodrigo.bastos@pwc.com

Durval Portela
PwC Brazil Tax Leader
durval.portela@pwc.com

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