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Brazilian Federal Supreme Court unravels the levy of taxes on software licensing

Ricardo Marletti Debatin da Silveira and Rogério Gaspari Coelho of Machado Associados discuss a Supreme Court decision about the taxation of software licensing in Brazil.

On February 24, 2021, the Brazilian Federal Supreme Court (STF) delivered a final decision related to the taxation of software in Brazil, defining that the transactions with software are deemed as services and therefore shall be taxed by the municipal service tax (ISS), with rates that vary from 2% to 5%.

This judgment puts an end to a long discussion started in 1999, when Direct Action of Unconstitutionality (ADI 1945) was filed against a law of the state of Mato Grosso that established the levy of the state-VAT (ICMS) on the download of software. Another Direct Action of Unconstitutionality (ADI 5965) also challenged a similar matter, but related to the state of Minas Gerais, and was judged together with ADI 1945 by the STF.

Since the time software was sold by means of physical media and mainly after the internet allowed for its acquisition via download, the Brazilian states (competent to charge the ICMS) and municipalities (competent to charge the ISS) have been competing for tax revenues of an industry that has grown exponentially over time.

In a nutshell, states historically taxed the sale of software via ICMS, deeming it as goods due to the existence of the floppy disk and, afterwards, the compact disc. Not surprisingly, the states wanted to reaffirm this nature of 'goods' when the physical media was no longer necessary.

When this discussion arose more than 20 years ago, the STF decided that off-the-shelf software should be taxed by the ICMS and customised software by the ISS. However, things have significantly changed since then.

If, on the one hand, both states and cities tried to tax transactions with software, lots of taxpayers, on the other hand, claimed that neither the ICMS nor the ISS should be levied, as the amounts paid for software licensing were theoretically not related to the sale of goods or the rendering of services.

In 2003, however, Supplementary Law 116/2003, which sets mandatory guidelines for the cities to charge the ISS, included "software licensing or the grant of right of use software" in the list of taxable services.

For years, therefore, states and cities were rattling sabres and taxpayers were caught up in the midst of the quarrel.

The STF eventually decided that transactions with software shall be taxed by the ISS. Nevertheless, as the prolonged discussion made several different factual situations arise for taxpayers, the court also decided to adjust the effects of the judgment. The court unusually established eight hypotheses of application of its decision as regards the past and the right to recover unduly paid taxes, as summarised below:

1) Taxpayers that only paid the ICMS: the ICMS will not be refunded to taxpayers; municipalities must not charge the ISS regarding the same tax triggering events (to avoid double taxation);
2) Taxpayers that only paid the ISS: the payments are legally valid, and states must not charge the ICMS regarding the same tax triggering events;
3) Taxpayers that did not pay the ICMS nor the ISS: the ISS may be charged by the municipalities, since they respect the five-year statute of limitations applicable;
4) Taxpayers that paid both the ICMS and ISS but did not file lawsuits requesting any refund. The refund of the ICMS will be granted (to avoid double taxation), and the ISS payments made will be deemed as valid;
5) Ongoing lawsuits filed by taxpayers against states challenging the levy of the ICMS, including requirements for its refund: the STF's understanding that the ISS is the tax levied shall prevail in such lawsuits, and the ICMS may be refunded;
6) Ongoing lawsuits filed by states, including tax executions, aiming at collecting the ICMS: the STF's understanding that the ISS is the tax levied shall prevail in such lawsuits, and the ICMS collection shall be dismissed;
7) Ongoing lawsuits, including tax executions, filed by municipalities, aiming at collecting the ISS: the STF's understanding that the ISS is the tax levied shall prevail in such lawsuits, except for the cases in which the ICMS was already paid (please see item 1 above); and
8) Ongoing lawsuits filed by taxpayers against municipalities challenging the levy of the ISS. The STF's understanding that the ISS is the tax levied shall prevail in such lawsuits.

The effects of the STF's judgment were hence adjusted by the court to try to balance outcomes and aftermaths for states, municipalities, and taxpayers.

Although belated, the definition that the ISS is the tax to be applied is positive for the software industry in Brazil, bringing tax and legal certainty for the taxpayers, tax savings depending on the concrete situation, and more simplicity for businesses in the IT sector.

It is interesting to note that this decision may impact the understanding of the tax authorities about the levy of other taxes in transactions with software, such as the federal social contributions PIS-import and COFINS-import.

Tax in a digital world is one of the main challenges everywhere on the planet. It is no different for Brazil.

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