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Doing Business in Brazil Facing the New Oil Discoveries

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Geneva, December 5, 2008

Summary

- **Introduction**
- **Doing Business in Brazil**
 - **General guidelines**
- **Oil and gas activities in Brazil**
 - **Historic Development**
 - **Knowing the Brazilian market**
 - **A new era? The pre-salt**
 - **Typical contractual arrangements**
 - **Imports and acquisition of local content**
 - **Hiring of services**
 - **Tripartite structure issues**
 - **Local hiring**
 - **Selected taxation issues**
 - **REPETRO and ICMS Tax**
- **Questions and answers**

Introduction

- **Objective of the presentation**
 - Serve as an additional tool for foreign investors in Brazil, focusing on doing business in the oil&gas area
 - Indicate key legal and tax aspects for foreign investor in exploration and production of oil&gas
 - Explore tax issues related to the hiring of services such as drilling, supply vessels, production units, and like services
 - Clarify other legal and tax issues

Doing Business in Brazil

- **Legal Form**
 - Usually, incorporated subsidiary
 - Limitada or S.A. (sociedade anônima)
 - Seldom utilization of partnerships or unincorporated branches (permanent establishment)
- **Funding of Brazilian operations**
 - Debt and/or equity?
 - FX
 - Repatriation
 - Other forms
 - Notes/bonds
 - IPOs

Doing Business in Brazil

- **M&A usually tax free**
 - Succession issues
- **Joint ventures**
 - Consortium
- **General principles of contracts**
 - Public entities and Law 8,666 (Bidding Law)
 - Disputes
 - Judiciary Branch
 - Arbitration

Doing Business in Brazil

- **Labor aspects**
 - **Expatriates**
- **Tax aspects**
- **Import and exports**
- **IP**
- **Regulatory**
- **Other legal aspects**

Doing Business in Brazil



| Ease of... | Doing Business 2009 rank | Doing Business 2008 rank | Change in rank |
|---|--------------------------|--------------------------|----------------|
| Doing Business | 125 | 126 | +1 |
| Starting a Business | 127 | 125 | -2 |
| Dealing with Construction Permits | 108 | 105 | -3 |
| Employing Workers | 121 | 120 | -1 |
| Registering Property | 111 | 115 | +4 |
| Getting Credit | 84 | 79 | -5 |
| Protecting Investors | 70 | 66 | -4 |
| Paying Taxes | 145 | 138 | -7 |
| Trading Across Borders | 92 | 98 | +6 |
| Enforcing Contracts | 100 | 103 | +3 |
| Closing a Business | 127 | 134 | +7 |

Oil&gas activities in Brazil

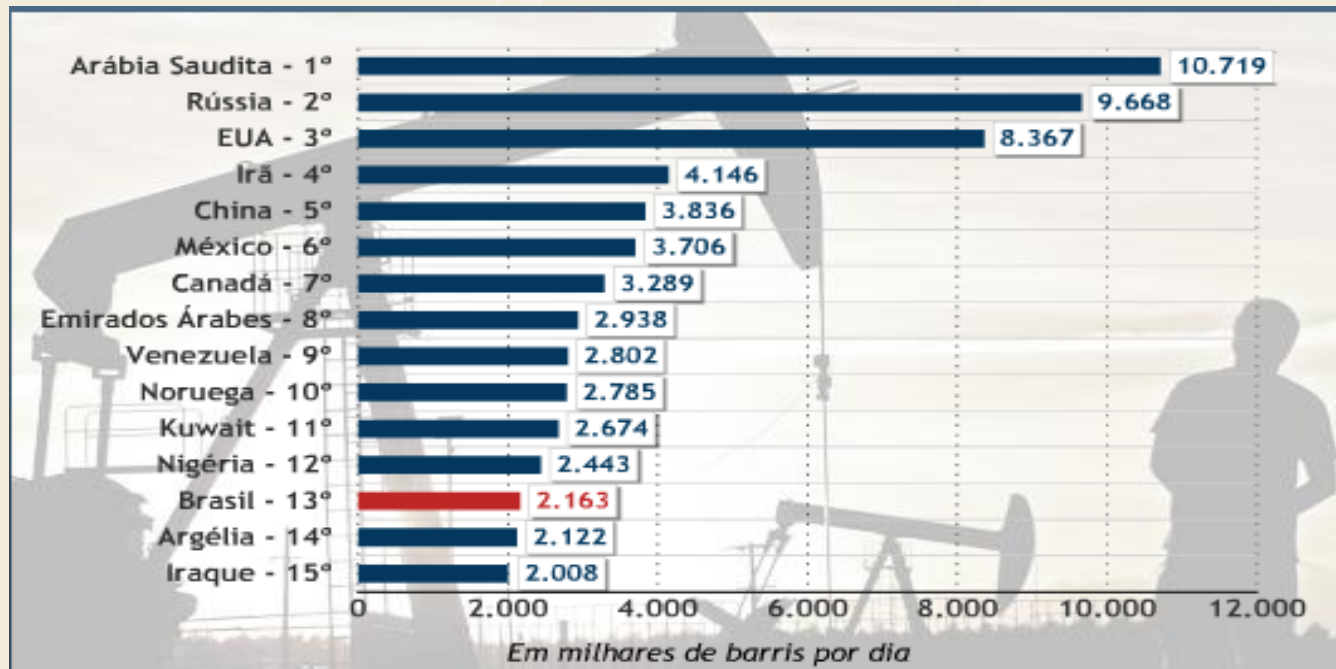
- **Historic Development**
 - Law 2.004/53: Creation of Petrobras
 - From the Risk Contract to Concession Contract
 - The Petroleum Law landmark (Law 9.478/07 and the end of Petrobras monopoly)
 - ANP Bid Rounds

Oil&gas activities in Brazil

- **Historic Development**
 - The Concession Contract (main clauses)
 - payments for the areas;
 - royalties;
 - Government take;
 - Conditions for relinquishment;
 - Effectiveness, duration, terms and conditions for E&P activities and work program;
 - Local content;
 - Minimum exploration package;
 - Responsibilities of concessionaire, including environmental damages.

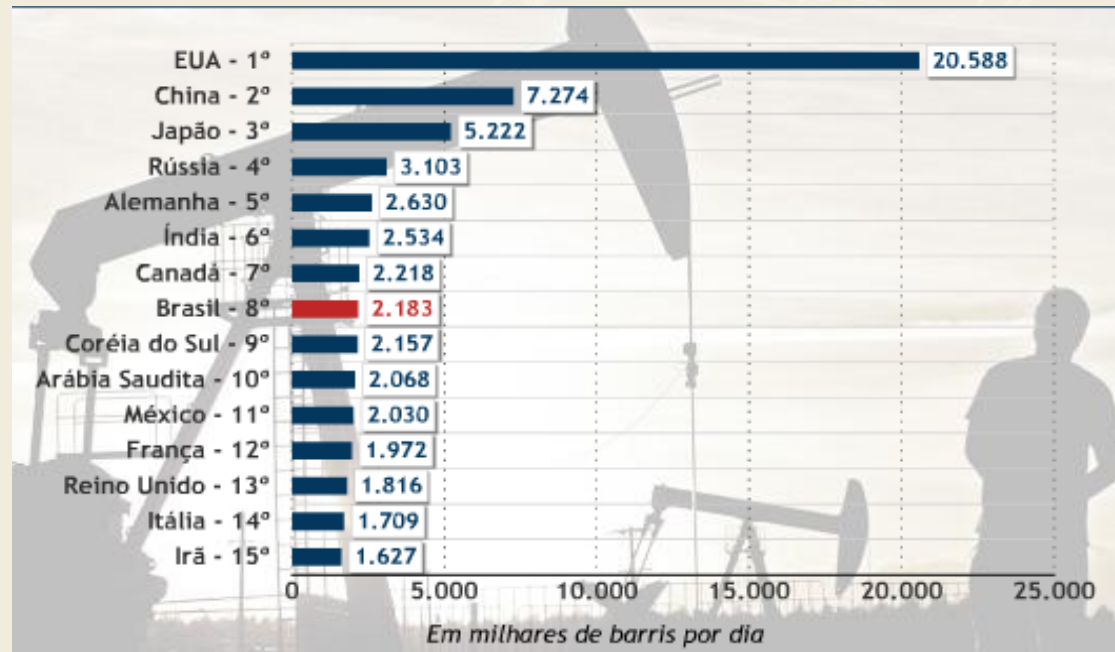
Oil&gas activities in Brazil

- **Getting to know the Brazilian Market**
 - Population of almost 200 million people
 - 13th oil producer in the world



Oil&gas activities in Brazil

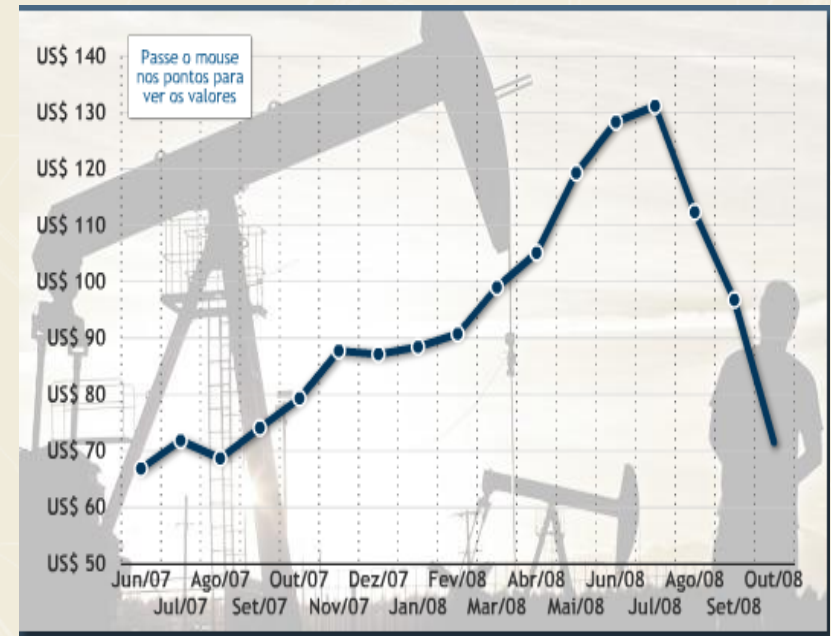
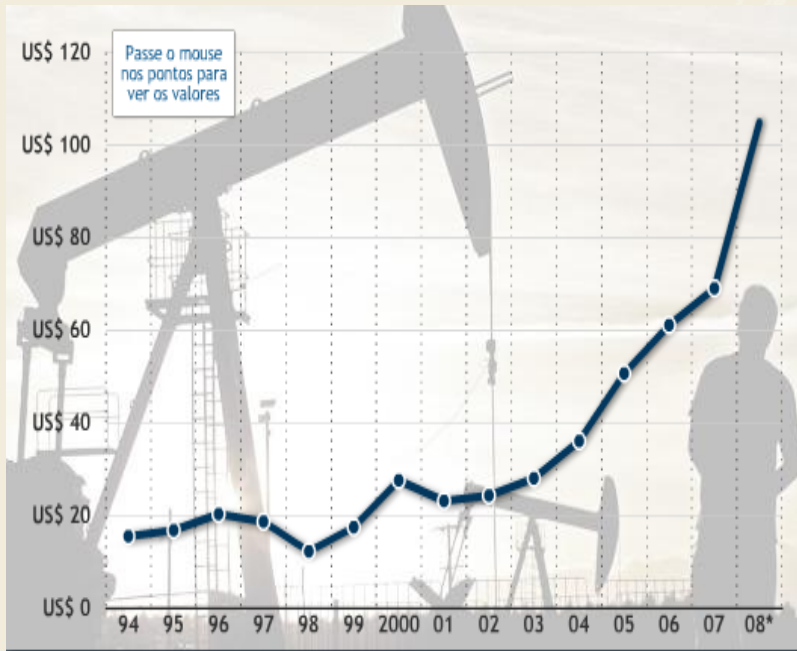
- **Getting to know the Market**
 - Ranks 8th in consumption



Source: Estadão

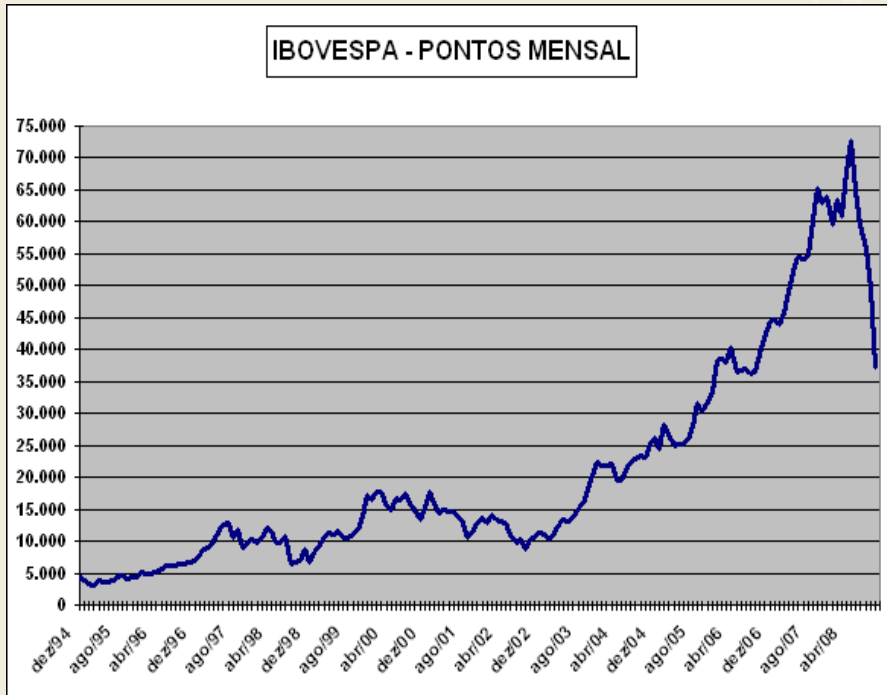
Oil&gas activities

- **Evolution of the price of the barrel**
 - Since 1994
 - Last 12 months



The market

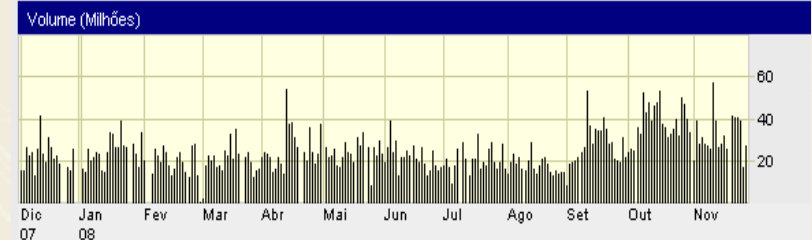
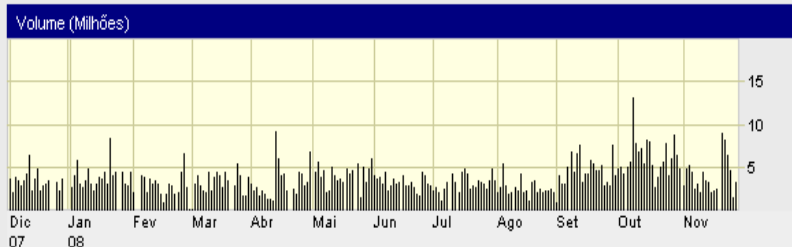
- **Evolution of the IBOVESPA index**
 - Since 1994
 - Last 12 months



Source: Bovespa and Invertia

Oil&gas activities in Brazil

- Evolution of Petrobras stock in last 12 months



Oil&gas activities in Brazil

- **The pre salt: a new era**
 - **Scenario pre and post market turmoil**
 - **Reserves of up to 100 billion barrels**
 - **High exploratory costs involved**
 - **Lots of speculations and uncertainties; regulatory risk**
 - **Decisions biased by political factors**

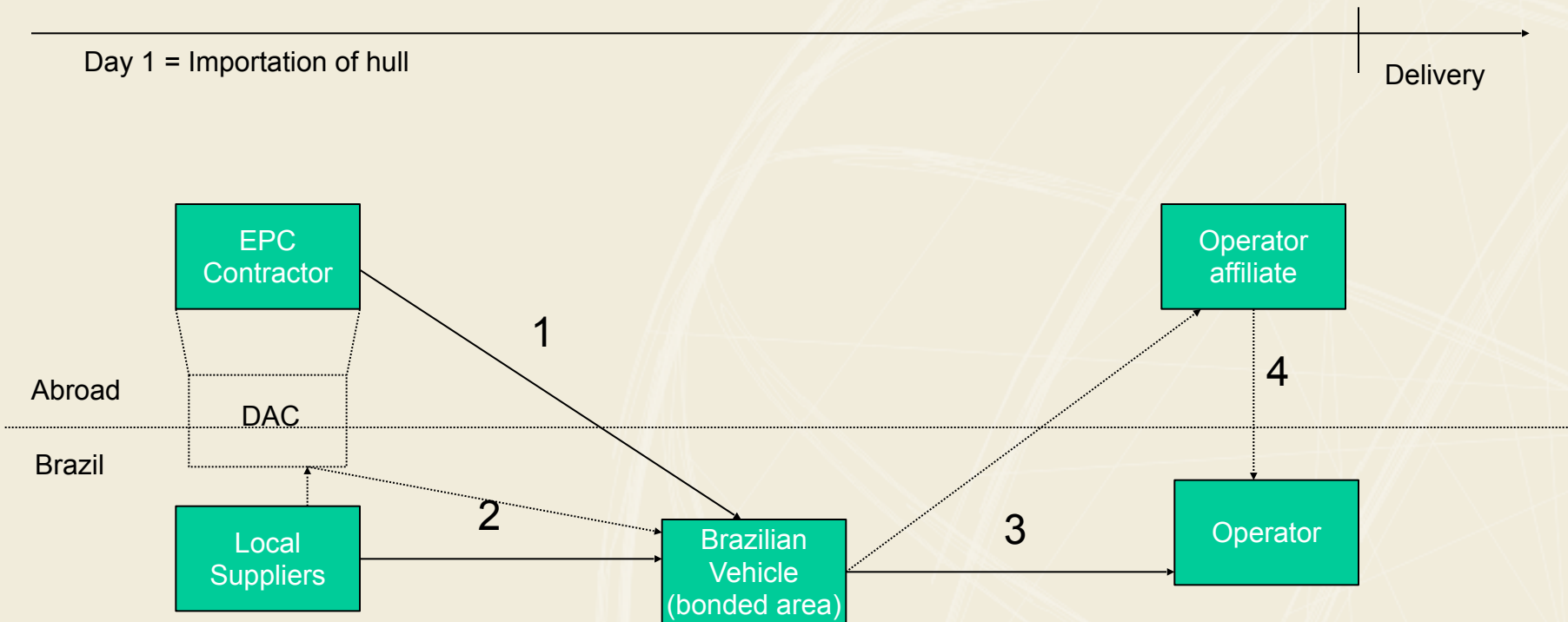
Oil&gas activities in Brazil

- **Typical contractual arrangements**
 - **Doing business with Petrobras**
 - **Usually based on Petrobras model contracts as made available in the public bids**
 - **Public bids subject to special rules crafted for Petrobras**
 - **Tough negotiation to change clauses**
 - **High standards and pre qualification required**

Oil&gas activities in Brazil

- **Typical contractual arrangements**
 - **EPC contracts for the supply of drilling rigs, production units**
 - **Utilization of customs regimes and REPETRO**
 - **Hiring of services**
 - **Utilization of the so-called tripartite structure**
 - **Other contracts, installation projects and supplies**

Timeline of a typical construction / conversion project in Brazil



Where:

- 1. Importation of Hull/ foreign supplies
- 2. Local purchases
- 3. Delivery of final Unit

- 4. Importation of Unit by Concessionaire under REPETRO temporary admission

Hiring of Services

- As a general rule, services retained from non-residents (imported services) are more expensive tax wise than local purchases
- Introduction of several new taxes on imports of services since 2001 (CIDE, PIS/Cofins, ISS)
 - Nominal tax burden reaches 40% / 50% (gross-up)

Payment of services fees abroad

TAXATION OF THE IMPORTATION OF SERVICES

| Premises | |
|--------------|------------|
| Base price | R\$ 100,00 |
| IRRF: | 15% |
| CIDE: | 10% |
| ISS: | 5% |
| PIS/COFINS*: | 9,25% |

*Tax bases of PIS and COFINS including the ISS.

| SUMMARY | |
|--|------------------|
| Tax Cost of Brazilian Company: | R\$ 21,08 |
| Tax Cost of Foreign Company: | R\$ 20,00 |
| Global Tax Cost of the Operation: | R\$ 41,08 |

| Importation of Services - IRRF, CIDE, ISS, PIS, COFINS and CPMF | |
|---|---------------|
| | R\$ |
| Base price | 100,00 |
| IRRF (R\$ 100,00 x 15%) | 15,00 |
| ISS (R\$ 100,00 x 5%) | 5,00 |
| Amount remitted to the foreign company (net) | 80,00 |
| CIDE (R\$ 100,00 x 10%) | 10,00 |
| PIS - Importation (R\$ 115,70 x 1,65%) | 1,91 |
| COFINS - Importation (R\$ 115,70 x 7,6%) | 8,79 |
| IOF (R\$ 100 x 0,38%) | 0,38 |
| Total Cost of the Brazilian Company | 121,08 |

Hiring of Services

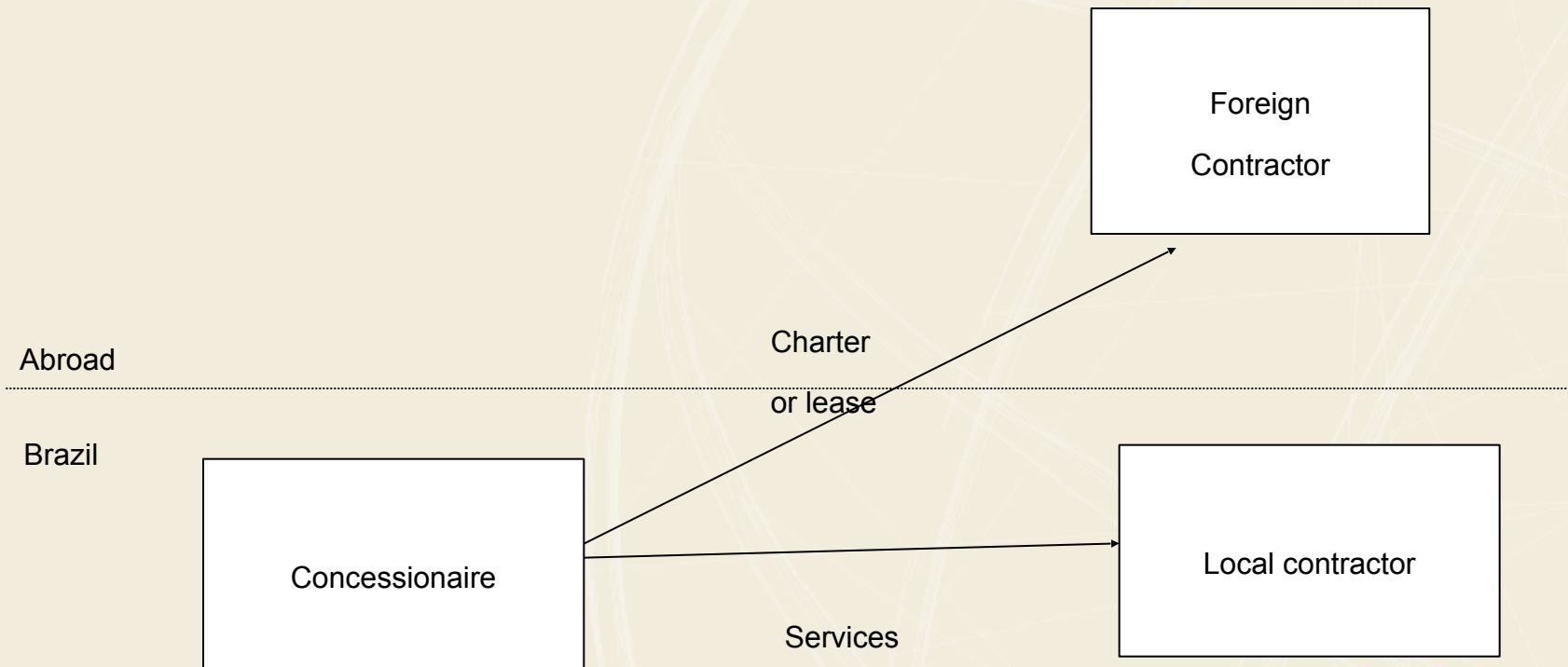
- **Effective tax burden**
 - Local company
 - PIS/Cofins credits
 - Other taxes as deductible costs/expenses
 - Foreign recipient
 - Withholding income tax (WHT) credits
 - Tax Sparing
 - Tax treaties may reduce WHT rate to 10% (Belgium, Spain, Israel, South Africa, Korea)
 - No tax treaty with the Switzerland

Hiring of Services

- **Wide utilization of tripartite structure**
 - A.k.a. “split structure” or “Petrobras model”
 - Split of revenues between charter and services contract
 - Usual ratio leasing/charter and services: 90/10 for offshore, 40/60 for onshore
 - Charter portion subject to regulatory (Navy, ANTAQ, etc) regulations
 - Potential tax risks

Hiring of Services

- **The tripartite structure**



Hiring of Services

- **Tripartite structure - tax risks**
 - 3 main risks
 - Recharacterization of bareboat charter as a time charter
 - Challenging of application of WHT zero rate on charter
 - The split structure concept itself – tax authorities claim that services revenues are being built up into charter contract

Hiring of Services

- **Tripartite structure - tax risks**
 - Recharacterization of bareboat charter as a time charter
 - Specially relevant in case of foreign crew
 - Possible allegation that part of the charter revenues shall be taxed as services
 - **Risk lies on concessionaire**

Hiring of Services

- **Tripartite structure - tax risks**
 - Challenging of application of WHT zero rate on charter
 - Petrobras landmark precedent on drilling rigs of 2003 (1999-2002)
 - Strict interpretation that drilling rigs are not vessels
 - Even narrower rationale that exemption only applies to vessels destined to transportation of cargo and people
 - **Risk lies on concessionaire**

Hiring of Services

- **Tripartite structure - tax risks**
 - Challenging of the split structure concept itself
 - tax authorities claim that services revenues are being built up into charter contract
 - Possible consequences:
 - Application of PE concept
 - Rejection of tax losses of contractor subsidiary
 - Attribution of charter income to contractor subsidiary
 - **Risk lies on contractor subsidiary**

Local Hiring of Services

- **Issues**

- Social Security Contribution (INSS):
11% withholding
- ISS tax issues:
 - Certain services require withholding
 - Municipality that may claim taxing power:
place of provision or place of residence?
- Some services (mainly outsourcing like cleaning, security, etc.) subject to withholding of federal taxes

Oil&gas activities in Brazil

- **Selected taxation issues**
 - **REPETRO and ICMS is maybe the most controversial issues in the last 10 years, when E&P activities in Brazil showed constant growth**

REPETRO and ICMS Tax

- **Importation / temporary admission of E&P equipment (1)**
 - REPETRO regime is in place since 1999 and grants full suspension/exemption of federal indirect taxes for the time of the concession (until 2020)
 - REPETRO applies to a large range of products listed by customs authorities
 - REPETRO applies to Brazilian subcontractors

REPETRO and ICMS Tax (1)

- **Federal indirect taxes suspended under REPETRO imports (goods/equipment)**
 - **Import tax (II)**
 - Imposed on the CIF price
 - Variable rates (average 14%)
 - **Excise Tax (IPI)**
 - Imposed on the CIF price plus II
 - Variable rates (average 5%)
 - **PIS/COFINS (9.25%)**
 - Goods: imposed on the sum of the CIF price plus II, ICMS and the contributions themselves (issue regarding the ICMS tax base – “circular effect”)
 - **AFRMM**
 - Imposed on freight costs (25%)
 - Levies on imports through Brazilian ports

REPETRO and ICMS Tax (1)

- **However, ICMS tax has become problematic over the life of REPETRO**

➤ **ICMS**

- Imposed on the sum of the CIF price plus II, IPI, PIS/COFINS, and the ICMS itself
- Rates ranging: 17%, 18% or 19% depending on State; lower rates may be applicable

REPETRO and ICMS Tax (1)

- ICMS is a tax levied by the States and works like a VAT (credits and debits, passed along to final consumer)
- “Inside calculation” mechanism on “sales to final consumer” and imports: calculation on a grossed-up basis

REPETRO and ICMS Tax (1)

- ICMS exemptions, tax holidays, incentives and the like shall be accorded by a national panel composed of representatives of all States (CONFAZ) and released through a Convênio
 - Incentives and “Fiscal Reform”: a long lasting problem in Brazil

REPETRO and ICMS Tax (1)

- In the past, States of Rio de Janeiro, Espírito Santo, and São Paulo exempted transactions with oil platforms assets and related assets and goods (“race to the bottom”; “Fiscal War”)
- Incentives were suspended by the Supreme Court on grounds of unconstitutionality, as challenged in cases filed by the State of Minas Gerais (CONFAZ violation)

REPETRO and ICMS Tax (1)

- **Several trends observed in the last 10 years**
 - Full exemption – Decree 26,005/00 (suspended)
 - Taxation of imports of finished E&P assets or parts – Law Valentim and attempt to overrule Convênio 58/99
 - Taxation on fictitious export, but only the local delivery and not the fictitious import – Resolution 45/03

REPETRO and ICMS Tax (1)

- **Recent rules brought in by CONFAZ as to oil&gas transactions:**
 - Convênio ICMS 130/07** (and Convênio 112/07):
 - Overrules Law Valentim regime in RJ State
 - Changes focus of taxation
 - RJ State Decree 41,142, published on January 24, 2008:** regulates the application of Convênio ICMS 130/07 along with Resolution SEFAZ 119, published on January 28
 - Regulations available in other States

REPETRO and ICMS Tax (1)

- **Main features of new regulations**

(i) Choice between the cumulative 3% or non-cumulative 7.5% on imports destined to the production phase;

(ii) Exemption of or a reduced 1.5% (non-cumulative) ICMS tax on imports destined to the exploration phase;

(iii) Authorization for the States to exempt the fictitious export transaction as well as the preceding transactions of the chain (national 1st tier supplier but **not 2nd tier supplier**);

REPETRO and ICMS Tax (1)

- **Main features of new regulations**

(iv) Fictitious export accepted as a compliance with drawback also for ICMS purposes;

(v) 24-month “carryforward” period for the utilization of the ICMS paid under a 7.5% rate and utilization on a pro rata basis for 48 months;

(vi) Goods listed under REPETRO (exploration phase) are exempt as well as hulls, modules, and inputs for production units constructed or assembled in Brazil, production rigs that are in transit only, and goods interconnected in both exploration and production phases that remain in the country for up to 36 months.

REPETRO and ICMS Tax (1)

- **Main features of new regulations**
 - **Pros**
 - Streamlines federal and state tax treatments
 - (Partial) recognition of fictitious export – reversal of local content credits
 - Single payment for exploration of movable assets
 - Possibility of transferring accumulated credits
 - **Cons**
 - Taxation, although reduced
 - “Carryover” of import credit
 - Rules are still somewhat confusing and allow States to provide different treatments

Questions and Answers

Thank you!

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