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New Developments on REPETRO

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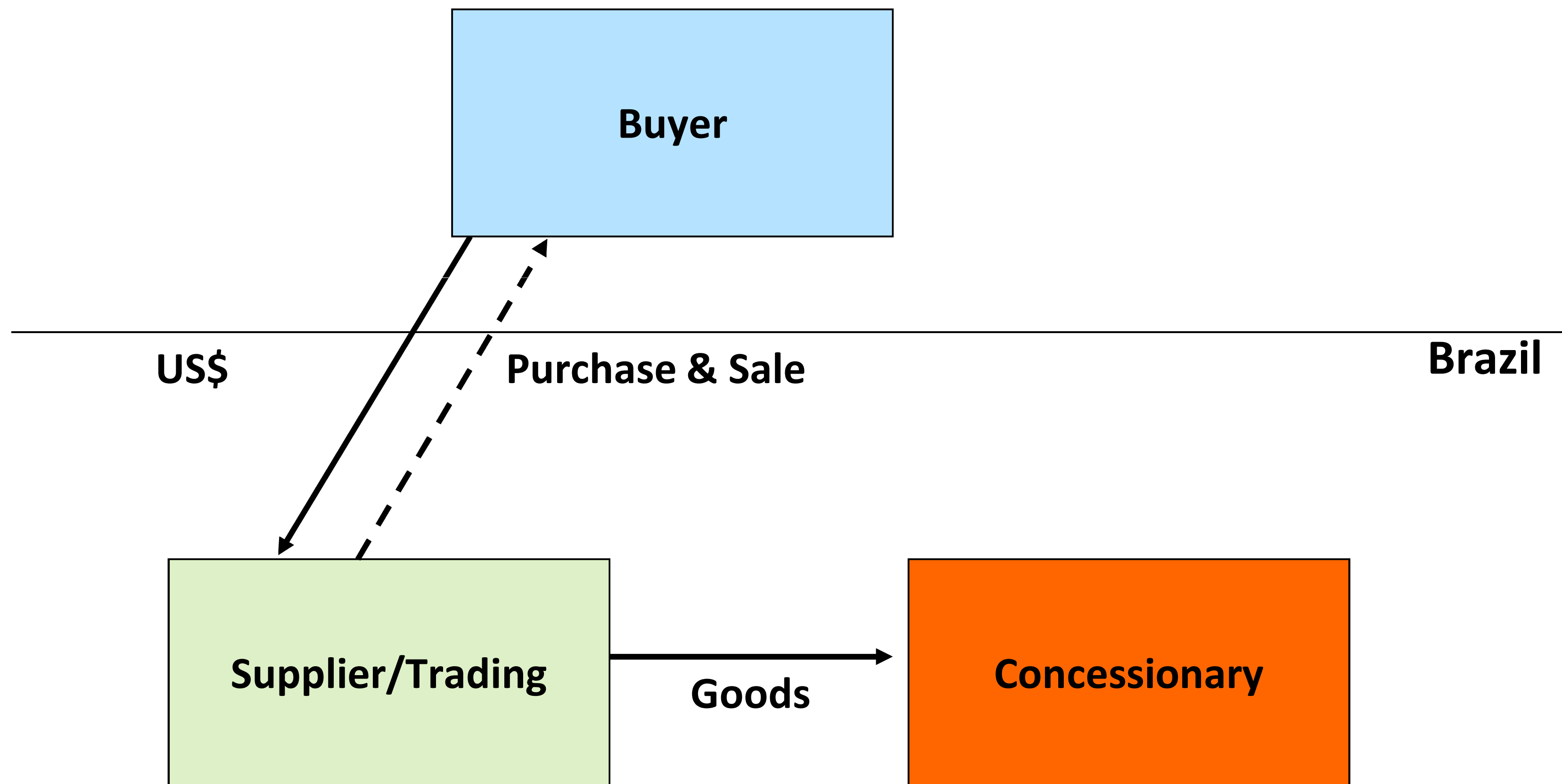
REPETRO

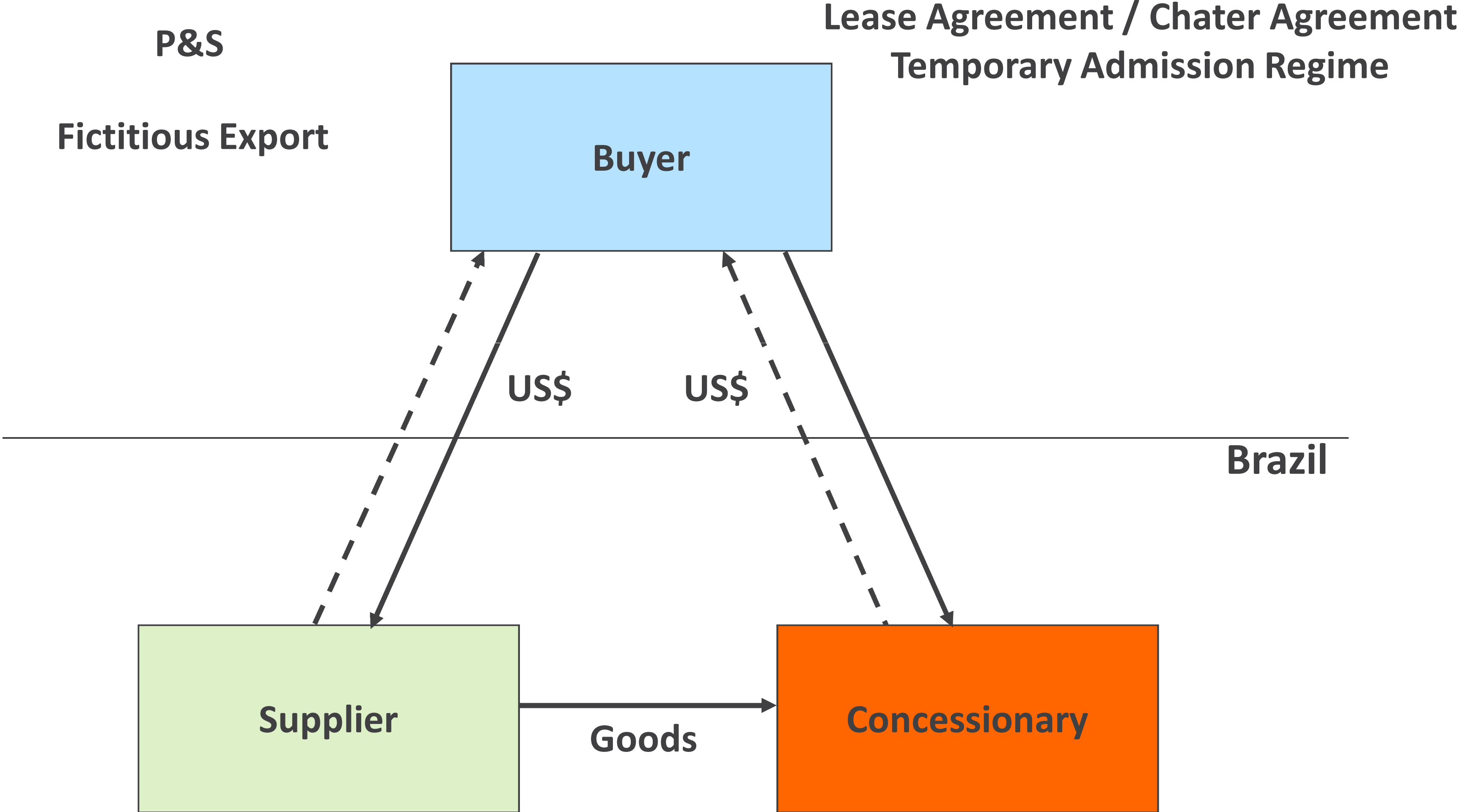
- Special Customs Regime for import and (fictitious) export of goods related to the exploration and production phase of Oil & Gas:
  - Relief of Federal Taxes due on importation of goods and national production.
- The following regimes are included in REPETRO:
  - Drawback;
  - Fictitious Export; and
  - Temporary Admission.
- Applied only to goods set forth in legislation for E&P application.
- Importer must be authorized by Brazilian Federal Revenue (previous qualification – "Habilitação").
- Legal Basis: Decree No. 6.759/2009, Normative Instruction No. 844/2008 and Ordinance No. 615/2012 (from Regional Superintendency of Brazilian Federal Revenue at 7th Fiscal Region - Rio de Janeiro and Espírito Santo).

Operations where REPETRO is authorized

- Fictitious Export with fictitious exit of goods: further application of Temporary Admission Regime.

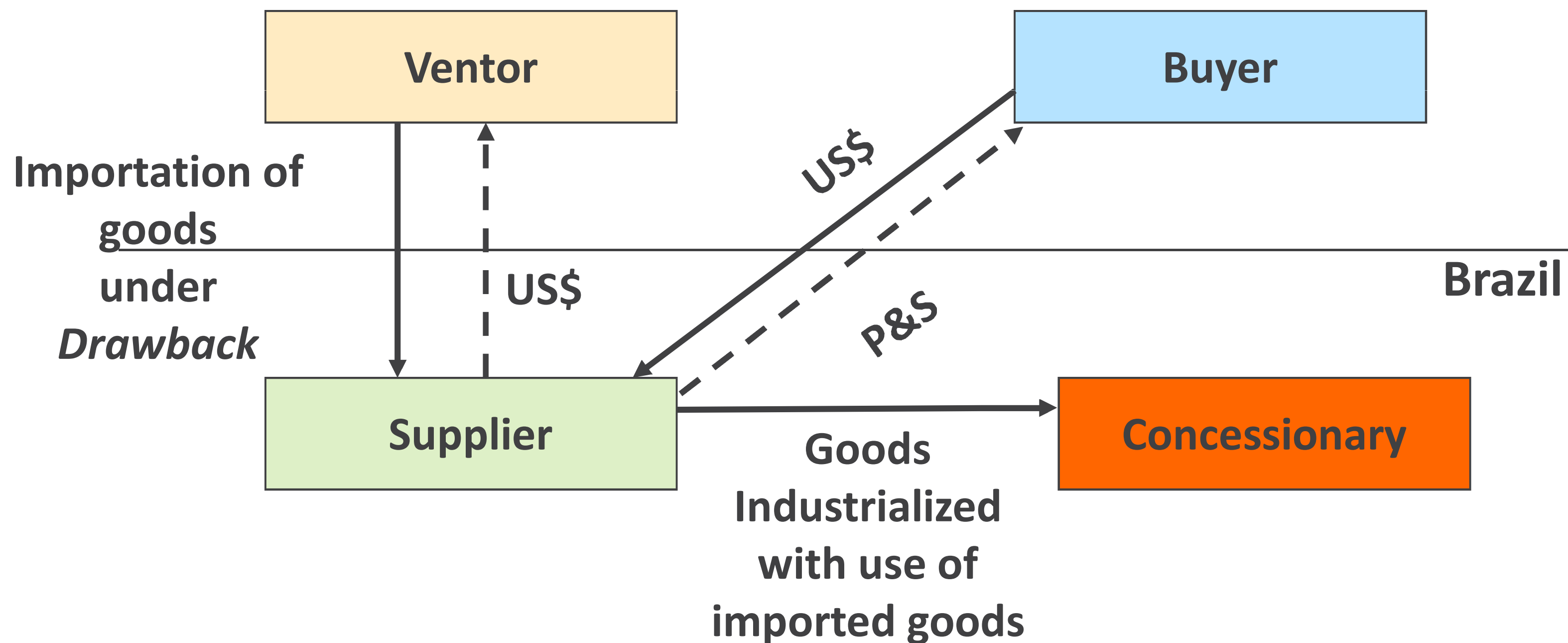


Operations where REPETRO is authorized



Operations where REPETRO is authorized

- Import of goods under drawback, with suspension of federal taxes, for production destined to fictitious exportation.



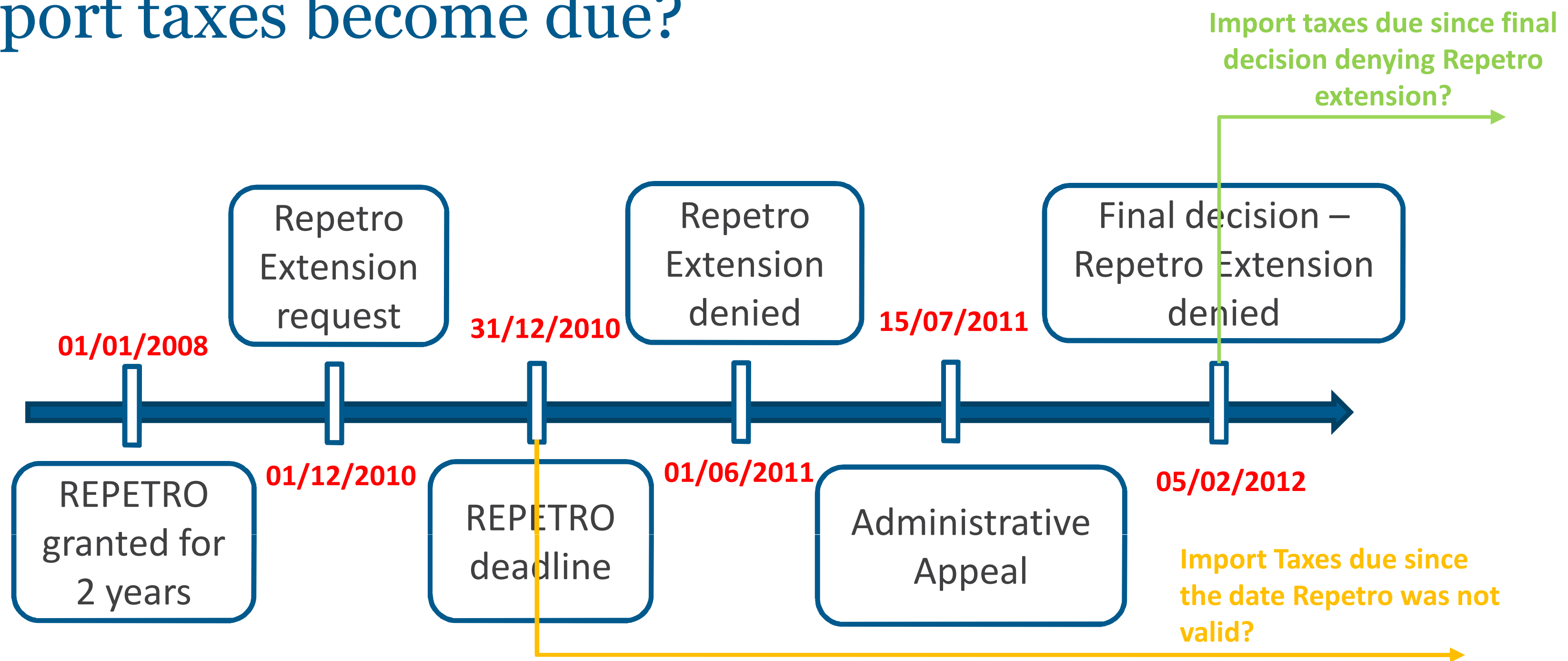
New developments and outstanding issues

- Restrictive Interpretation of Normative Ruling RFB No. 844/2008 – “The Rental of Equipments Case”.
- REPETRO extension denied – When temporary import taxes become due?
- Ancillary Obligation – Electronic Tracking System.
- Ordinance No. 615/2012 from Regional Superintendency of Brazilian Federal Revenue at 7th Fiscal Region (Rio de Janeiro and Espírito Santo).

Restrictive Interpretation of Normative Ruling RFB No. 844/2008 – “The Rental of Equipments Case”

- Change of Law and Interpretation – 7th Fiscal Region: Agreements which the scope is the rent of equipments, with ancillary services, cannot be qualified to REPETRO, because:
  - There is no express legal provision allowing the services provider to be qualified to REPETRO based on a rental/loan/lease agreement;
  - The rental/loan/lease agreements had legal provision in the past. However, Normative Instruction RFB No. 1.070/2010 excluded this provision, which resulted denial of REPETRO extension;
  - The qualification to REPETRO based on rental or loan agreements is only allowed in case of article 17, § 9º of Normative Normative Instruction RFB No. 844/2008; and
  - There must be an express provision on the agreement that goods which will be used on service agreement are owned by a foreigner company.

REPETRO extension denied – When temporary import taxes become due?



- Interim period between the filing of the Repetro extension request and its deny by DIANA;
- Tax authorities have assessed import taxes (II, IPI, PIS and COFINS) considering them due at the expiration of REPETRO, ignoring the long period which DIANA (customs) authorities was analyzing the Repetro extension request;
- Violation of legal principles as the Protection of Good Faith.

Ancillary Obligation – Electronic Tracking System

- Article 6 of Normative Ruling RFB No. 844/2008: beneficiary of REPETRO must have an electronic tracking system, which must enable Tax Authorities to monitor special regime, as well as the use of goods in the activity for which it are allowed.
- Inaccurate information or lack of input may cause suspension or cancellation of REPETRO.
- Penalties are increased by repetition of infraction.
- Cases of services providers that were penalized due to non compliance with such article.

Ordinance No. 615/2012 from Regional Superintendence of Brazilian Federal Revenue at 7th Fiscal Region (Rio de Janeiro and Espírito Santo)

- The Ordinance contains rules and procedures for REPETRO qualification, on Rio de Janeiro and Espírito Santo States.
- The Ordinance defines "import agreement", "service agreement", "leasing agreement", and "REPETRO beneficiary".
- Creates a new document to be filed by the importer regarding the status of the agreement.
- It requires, prior to REPETRO qualification, that the importer request approval of the company's electronic tracking system.
- It requires the importer, prior to REPETRO qualification, to register at the Notary Office ("Cartório de Títulos e Documentos") its support documentation.
- The support documentation for REPETRO qualification must now also be submitted on digital media.

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ICMS New Issues and Developments

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ICMS – State value-added tax

- Brazilian Constitution of 1988 granted authority to the Brazilian States to collect ICMS (VAT like tax), which is the tax due on **(even when the transaction and the rendering of services initiate in another country)**:
  - The circulation of goods;
  - The supply of interstate and intermunicipal transportation services;
  - Communications; and
  - **<u>Import transactions</u>**.

ICMS – State value-added tax

- Is not a cumulative tax (tax paid in the goods price = credit for offset purposes);
- Collected by most States at the usual rate of 18%;
- Export revenues are tax exempt from ICMS, but the ICMS tax credit recorded on the acquisition of inputs and services may be kept; and
- **Incentives and tax exemptions must be established by Federal Law or pre-approved by all States (CONFAZ Conventions).**

ICMS on import transactions – Temporary Admission

- Normative Ruling No. 285/03 – Authorize import of goods for economical use with proportional payment of Federal Taxes;
- Proportional Payment of Federal Taxes – calculated based on period that goods shall stay in Brazil;
- Usually this mechanism is used when goods are not authorized to be imported under Repetro;
- Convention ICMS CONFAZ No. 58/99: if federal taxes are paid proportionally, then ICMS is also due proportionally;
- ICMS issue in Rio de Janeiro State: <u>§ 4º, item 2 of article13 of RICMS/RJ = if exporter is a related company ICMS is due 100% (not proportional);</u>

ICMS on import transactions – Temporary Admission

- Several decisions from Rio de Janeiro State Court: § 4º, item 2 of article13 of RICMS/RJ **is ILEGAL** and ICMS is due proportionally in any case when federal taxes are also collected proportionally (even if the exporter is a related company);
- **Rio de Janeiro changed the law**: Decree No. 43.232/11 – no restriction in case exporter is a related party;
- However, Rio de Janeiro continues to assess taxpayers for import occurred **before** October, 17, 2011.

ICMS on import transactions - Repetro

- REPETRO and Temporary Admission were created as a incentive mechanism aimed to relief tax import costs **ONLY** to federal taxes;
- ICMS, as a State tax, is not part of REPETRO or Temporary Admission incentives;
- In order to assure a real incentive for import transactions related to Oil & Gas Industry was issued Convention ICMS CONFAZ No. 58/1999;
- Convention ICMS CONFAZ No. 58/1999: ICMS suspended on the clearing through customs of importation of goods under REPETRO or Temporary Admission.

ICMS on import transactions - Repetro

- Convention ICMS CONFAZ No. 112/07 (from October, 3, 2007): States of Ceará, Pernambuco, Rio de Janeiro and Rio Grande do Norte **authorized to revoke** benefits set forth on Convention ICMS CONFAZ No. 58/1999;
- States authorized to collect ICMS (100%) on the importation of goods destined to Oil & Gas Industry;
- **ALTERNATIVE:** Convention ICMS CONFAZ No. 130/2007, from November, 27, 2007; and
- **New Regime** for taxation under ICMS of import transactions related to Oil & Gas Industry.

Convention ICMS CONFAZ No. 130/07 -Rules

Situation / Legal Basis	Calculation Basis Reduction – Cumulative System	Calculation Basis Reduction – Non-Cumulative System	Exemption	ICMS credit Situation
Importation of goods Unique Annex (**REPETRO**) – Exploration Phase (clause 2)	1,5%	n/a	Yes	-
Importation of goods Unique Annex (**REPETRO**) – Production Phase (clause 1)	3%	7,5%	n/a	-
Operations before Fictitious (paper) Export - Exploration and Production Phase (clause 3 and 5)	3%	7,5%	Yes	In case the State adopt the exemption tax credit recorded on the acquisition of inputs and services cannot be kept
Importation of goods ***NOT REPETRO*** (clause 6)	1,5% (items I and III)	n/a	Yes	-

Rio de Janeiro – Decree No. 41.142/08 - Rules

Situation / Legal Basis	Calculation Basis Reduction – Cumulative System	Calculation Basis Reduction – Non-Cumulative System	Exemption	ICMS credit Situation
Importation of goods Unique Annex (**REPETRO**) – **Exploration Phase** (article 2)	n/a	n/a	**Yes**	-
Importation of goods Unique Annex (**REPETRO**) – **Production Phase** (article 1)	**3%**	**7,5%**	n/a	n/a
Operations before Fictitious (paper) Export - **Exploration and Production Phase** (article 3)	n/a	n/a	**Yes**	Tax credit recorded on the acquisition of inputs and services cannot be kept (cost)
Importation of goods ***NOT REPETRO*** (article 5)	n/a	n/a	**Yes**	-

São Paulo – Decree No. 58.388/12* - Rules

Situation / Legal Basis	Calculation Basis Reduction – Cumulative System	Calculation Basis Reduction – Non-Cumulative System	Exemption	ICMS credit Situation
Importation of goods Unique Annex (**REPETRO**) – **Exploration Phase** (article 2)	n/a	n/a	**Yes**	-
Importation of goods Unique Annex (**REPETRO**) – **Production Phase** (article 1)	**3%**	**7,5%**	n/a	n/a
Operations before Fictitious (paper) Export - **Exploration and Production Phase** (article 3)	**3%**	**7,5%**	n/a	Tax credit recorded on the acquisition of inputs and services cannot be kept (cost) **Deferral – NEW REGIME**
Importation of goods ***NOT REPETRO*** (article 4)	n/a	n/a	Yes	-

*New! From September, 15, 2012

New Regime created by Convention ICMS CONFAZ No. 130/07: IMPORTANT POINTS

- Impact on the structures and projects in course in Brazil in 2007, as ICMS was not included in the price - Discussion with Operators for price adjustment continues;
- More attention to tax compliance, specially in order to exclude tax credits not allowed;
- Annex list of goods authorized to be imported – different from Normative Ruling RFB No. 844/08;
- Services Providers facing difficulties to operate, due to differences of rules in each of the States;
- Classification of the concept of previous/prior operations;
- Discussion related to unconstitutionality remains valid.

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Charter and Service Contracts with Petrobras

Tax structures and transaction flows

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Why should the scope of the contract be split between charter (lease/loan) and services?

- Special taxation on “Services” in Brazil – Municipal Tax (“ISS”) and Withholding Social Contribution on rendering of services (“Advance payment of Payroll Social Contribution”);
- Strict “Services” concept in Brazil – “Human performance upon demand”;
- Exemption of Withholding Income Tax on outbound payments related to the Charter provided by foreign companies; and
- State VAT Tax (ICMS) applies only on transactions that entail transfer of title.

General concepts in Petrobras and IOC's "services" contracts in Brazil and their effects

- Scope of the contract is split into two contracts – "service" for strict human performance and "lease/charter/loan" for assets used in the provision of services with bulk of payment (70% to 95%) under "non-service" contract.
- Effects:

a) Payment of the Service Tax (ISS) and occasional Withholding of Social Contributions only on the "Services" contract; and

b) Exemption of Withholding Income Tax on outbound payments related to the Charter provided by foreign companies.

Recent questions raised by Tax Authorities regarding the tax planning.

- Lack of substance in the Contracts' split:

a) "Mirror image" Contracts;

b) Asset value not compatible with the lease/charter/loan Contract total amount;

c) Lack of sufficient revenues for the Brazilian Company to maintain its regular operation (when the charter/loan/lease contract is executed with the foreign company and the services contract with the Brazilian subsidiary); and

d) Impossibility of Contracts' split due to the link of human performance and operation of the asset.

Possible Effects of Tax Authorities disregarding the Contract scope split

- ISS Tax Assessments filed against the service provider on the charter/lease/loan Contract amount (from 2% to 5% plus monetary correction, interest and penalties);
- Withholding Social Contribution Tax Assessments filed against the retainer of the services over the [charter/lease/loan] Contract amount (11% of Services Provider charter/lease/loan Contract invoices plus monetary correction, interest and penalties) – can be cancelled if the service provider proves to have paid the full amount of Social Contribution on Payroll;
- Income Tax (15%) / Social Contributions on Profits (9%) / PIS and COFINS (Tax on Revenues – 0,65% and 3%); and
- Tax Assessments filed against Brazilian subsidiaries on the charter payments made by Petrobras or IOC's to foreign companies based on the assumption that part of the amount should have been paid to the Brazilian subsidiary.

Possible measures to mitigate risks of split contracts being disregarded.

- Better Contract wording:

a) Clear division of use of assets (charter/lease /loan) and human performance (services); and

b) Clear division of companies' duties if charter/lease/loan and services contracts are executed by two different companies of the group;

- Evaluation of the split percentages according to asset value.

- Providing sufficient revenue through different split percentages or intercompany arrangement for the Brazilian subsidiary to either break even or to be profitable.

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Withholding Income Tax on Importation of Services

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COSIT Act No. 01/2000

- COSIT (General Coordination of Taxation of the Brazilian Internal Revenue Service) Act No. 01/2000: outbound payments relating to international services provided by foreign companies, which does not entail transfer of technology, are taxed by withholding income tax (WHT);

- Since 2000, such rule has been applied by Brazilian Internal Revenue Service (BR IRS), even in cases where Brazil signed International Treaties to avoid Double Taxation. BR IRS deny the Treaty classification of such revenues as “Business Profits” to classify it as “Other Income”.

OECD Model Convention

- Article VII of OECD Model Convention – Business Profits - service fees are a component of the business profits of the enterprise (unless such services are attributable to a PE located in Brazil),. Thus, such amount can be taxed in the country where the service provider is resident;

- This classification ratifies the main goal of International Treaties to avoid double taxation;

OECD Model Convention

- Article XXI of OECD Model Convention – Other Income- as originally provided by OECD model treaty, such article confer exclusive taxing rights over the so-called "Other Income" to the residence country of the recipient, tax treaties executed by Brazil have not adopted this rule. The article 21 has been negotiated by Brazil with treaty partners in order to confer cumulative taxing right to the source state.

Prevalence of Tax Treaties over Internal Law

- Pursuant to the provisions of the article 98 of the Brazilian Tax Code, tax treaties are not overridden by domestic rules. Accordingly, tax treaties may revoke or modify domestic law and must be observed by any supervening law.

Income x Gross Revenue

- **Discussion:**
  - outbound payments related to importation of services cannot be classified for tax purposes as income;
  - outbound payments related to the importation of services are part of gross revenue, which is a component of the business profit of the enterprise

Income x Gross Revenue

- **Taxpayers' arguments:**
  - Taxation by WHT on payments related to services provided by foreign companies violates the concept of "income" established by Brazilian Federal Constitution, since the price paid by the Brazilian company to the foreign service provider **is not income, but gross operating revenues** that is considered upon the computation of the company´s taxable profit in its resident country;
  - The revenue of the foreign company (service provider) shall only be taxed in Brazil if such services are attributable to a PE located in Brazil.

Decisions of Federal Courts in favor of taxpayers

- Regional Federal Courts have already rendered decisions in favor of taxpayers* - the definition of Real Profit as set forth in the Brazilian Income Tax Rule has been used to avoid the application of the WHT.
- Taxable income means the total proceeds from all sources (operational and non operational activities). The Real Profit is, therefore, the result of all revenues minus cost of services/sales, operating expenses, and taxes, over a given period of time, which represents the taxable amount.
- the actual income of the foreign enterprise can only be calculated in its residence country, taking into consideration the total amount of business revenues and the respective costs and expenses, and thus it shall governed by the Article 7 of the OECD model treaty.

* Lawsuits Nos. 2002.71.00006530-5 and 2004.50.01001354-5

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Service Tax Levied on Special Offshore Field Services

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Services Tax (ISS) Basics

- Municipal Tax (Over 5,500 Municipalities in Brazil);
- 2% to 5% calculated over value of services provided;
- Strict list (Complementary Law No. 116/03) containing all types of services allowed to be taxed;
- Tax benefits may not reduce the tax rate below 2%;
- Monthly payments;
- Exemptions for Export of Services (Article 2, item I, of Complementary Law No. 116/03); and
- Taxation of Import of Services (Article 1, paragraph 1 of Complementary Law No. 116/03).

Material Issues of Services Tax in the Energy Industry

- Municipality with jurisdiction to charge ISS:

a) General Rule – Municipality where the services provider is regularly established – Article 3 of Complementary Law No. 116/03;

b) Offshore Services – Municipality where the services provider is regularly established - Article 3, 3rd paragraph of Complementary Law No. 116/03;

c) Imported Services - Municipality where the services retainer is regularly established - Article 3, item I, of Complementary Law No. 116/03 – services retainer is responsible for the payment;

d) Superior Justice Court precedents – Municipality where the service provider is regularly established: discussion regarding concept of "place where the service provider is established";

e) Some Municipalities request register for non-established companies to render services within their territory.

Material Issues of Services Tax in the Energy Industry

- Issues connected with the Import and Export of Services:

a) No legal concept regarding the characterization of export or import of services;

b) Scholars defend characterization of Import and Export according to "the where the service's outcome takes place" – broad concept;

c) Municipality to charge services import - Municipality where the retainer of the services is established x Municipality where services were rendered (Superior Justice Court precedents).

Material Issues of Services Tax in the Energy Industry

- Offshore Services
  - Performed within territorial waters (12 miles from coast):

i. service rendered within Brazilian territory, although not within Municipalities territory; and

ii. Should ISS be paid to the Municipality where the services provider or services retainer headquarters (in the case of import of services) is established (Article 3, item I of Complementary Law No. 116/03) or to the Municipality to which territorial waters projects – discussion that a establishment of the service provider is located there?

Material Issues of Services Tax in the Energy Industry

- Offshore Services
  - When performed in contiguous zone (12 to 24 miles from coast) or Exclusive Economic Zone/Continental Shelf (up to 200 miles from coast):

  i. service rendered outside the Brazilian territory, although in a area that Brazil still maintain some sovereign rights.

  ii. Should ISS tax be paid? Do the sovereign rights over the area include taxations rights? (Supreme Court ADIN No. 2.080 MC and Superior Court of Justice precedents).

  iii. Should ISS be paid to the Municipality where services provider or services retainer headquarters (in the case of import of services) is established (Article 3 and 3, item I of Complementary Law No. 116/03) or to the Municipality to which territorial waters projects - discussion that a establishment of the service provider is located there?

Material Issues of Services Tax in the Energy Industry

- Strict "Services" concept in Brazil and its effects to services in the energy industry :

a) Strict "Services" concept in Brazil – "Human performance upon demand";

b) ISS does not levy on pure charter/loan/lease contracts – temporary assignment of assets – the split of the contractual scope.

c) ISS does not levy on pure licensing transactions (i.e. non-exclusive seismic data) due to lack of human performance upon demand.

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Planning and Structuring Expatriates Workforce in Brazil

Material Tax Issues

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Expatriates scenario in Brazil

- "Boom" of Brazilian economy in the oil and gas sector, particularly in relation to the pre-salt recent discoveries;
- Many companies have decided to invest in Brazil and open subsidiaries in the country;
- The companies already established in Brazil have noticeably increased their operations;
- Companies are facing difficulties in finding specialized domestic manpower to perform the required activities;
- The number of expatriates (technicians, employees, executives – managers and administrators) working in Brazil has significantly increased.

Obstacles faced by US Companies in Brazil

- First obstacle faced by US companies is to adapt the hiring process of foreign individuals to the Brazilian Labor Law.
- Brazilian Labor Law known for:

a. its lack of flexibility;

b. its excessive protection of employees (based on the principle that they are the weak part of the employment relationship);

c. its heavy tax burdens on salaries; and

d. its substantial labor benefits (FGTS, Christmas Bonus, Paid Vacations, Social Security, etc.).

Key for a successful expatriate program

- Clearly understand the applicable legal and tax system; and
- Clearly understand the associated risks.

- Avoid tax assessments (from Tax or Social Security Authorities); and
- Labor disputes resulting from non compliance or the inappropriate handling of the foreign labor force issues in Brazil.

General Rules

- Expatriates working for a Brazilian Subsidiary (employees) are entitled to all labor rights and benefits afforded by the Brazilian Federal Constitution and the applicable Brazilian Labor Laws:

➢ INSS company's contribution;

➢ INSS employee's contribution;

➢ FGTS;

➢ 13th salary (Christmas Bonus equivalent to a one month salary);

➢ 30 days paid vacation plus 1/3 of the monthly salary; and

➢ One month prior notice in case of termination without cause or a one month salary indemnification.

- The Brazilian subsidiaries of multinational corporations, while positioned as Brazilian employers, **are subject to all obligations, principles and rules set forth in Brazilian Labor Laws.**

Expatriates Program – Main legal challenges faced by Oil and Gas Industry

- Split payroll:
  - Assessment of social security contribution (INSS) on the portion of the salary paid abroad; and
  - Assessment of FGTS on the portion of the salary paid abroad.
- Individual's taxation:
  - Individual income tax; and
  - Stock Option.

Split Payroll

- Brazilian Labor Laws do not establish clear rules about split payroll, particularly regarding labor rights and social security taxes applicable on salaries paid abroad.
- Article 3º, sole paragraph, of Normative Resolution CNIg (Brazilian National Immigration Council) No. 74/07 (which contains the rules for visa and work permit applications) provides that:

> *“**Art. 3º.** Can be granted work permit to the foreigner, when the compensation to be paid is not inferior to the highest compensation paid by the company, for the same job/activity to be developed by the foreigner called in Brazil.*
>
> ***Sole paragraph**. Can be granted work permit to the foreigner, employee of a company of the same economic group, when the compensation to be paid in Brazil and abroad is not inferior to the last compensation received by him abroad.”*

Split Payroll – Social Security Contribution (INSS)

- Article 22 of Law No. 8.212/91 and Article 214, item I, of Decree No. 3.048/99: social security due on **TOTAL remuneration** paid to the employee destined to compensate the work;
- **Federal Revenue: social security is due on the portion of the salary paid abroad;**
- Federal Revenue have already issued tax assessments for the non-collection of social security contribution (INSS) on the compensation paid to the expatriate abroad;
- Additionally, possible assessment by Labor's Fiscal (Normative Ruling No. 84/2010);
- To avoid assessment risks, it is necessary to prove that the salary paid abroad is a result from the work performed by expatriate in benefit of the foreign company = impossibility of "pay back procedures".

Split Payroll - FGTS

- Article 15 of Law No. 8.036/90 and Article 27 of Decree No. 99.684/90: FGTS deposit is due on the TOTAL compensation paid;
- Authorities understand that **FGTS is due on the portion of compensation paid abroad**;
- Normative Ruling No. 84/2010 of Labor Inspection Office = possibility of assessment in case of non-collection of FGTS;
- **Attention** to procedures against law = expatriate return FGTS at the end of assignment – Risk of Labor Union, Labor Public Prosecutor, Labor claims, Moral damages.

Split Payroll – Tendency and Alternative

- Tendency in the market to include all compensation in local payroll;
- Alternative to Split Payroll = “Direct Wire Transfer”;
- Allows the payment of salary abroad, although all compensation is 100% in Brazil payroll:
    - **Advantage**: avoid risks related to assessment of social security and FGTS.
    - **Disadvantage**: Increase costs, including bank fees to remit the money.

Individual’s Taxation – Tax Refund

- Split Payroll: The portion of the salary paid abroad is subject to income tax (carnê-leão), as established in progressive table;
- Many companies pay all taxes levied on the remuneration received by expatriate (paid in Brazil and abroad);
- Therefore, they must adjust the calculation basis of Income Tax, according to Normative Ruling No. 15/2001 (article 20) – Gross-up;
- In this sense, some companies determine that eventual tax refund received by expatriate must be “returned” to the company;
- This procedure is illegal and may be object of Labor Claims and Moral Damages.

Individual's Taxation – Stock Option

- No clear rules regarding Stock Option, except the bonus paid in cash. In this sense, **all subject is open to interpretation.**
- Two possible interpretation:
  - Vesting Event is considered as taxable event for Individual Income Tax;
  - Stock Option Plans and benefits must observe the ordinary rules of taxation for transactions with stocks = **Capital Gain.**

Individual's Taxation – Stock Option

- Federal Revenue understand that Capital Gain is due on the difference between the value of alienation and the acquisition cost (that might be zero) of stocks;
- Income Tax is not levied in case of non-exercise of the right of buying stocks;
- Labor Court decisions = deny classification as salary.