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Oil and gas taxation in Brazil

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Tax professionals of the member firms of Deloitte Touche Tohmatsu Limited have created the Deloitte International Oil and Gas Tax Guides, an online series that provides information on tax regimes specific to the oil and gas industry. The Guides are intended to be a supplement to the Deloitte Taxation and Investment Guides, which can be found at www.deloitte.com/taxguides. For additional information regarding global oil and gas resources, please visit our website:www.deloitte.com/oilandgas

1.0 Summary

The main taxes to which companies doing business in Brazil in the oil and gas industry are subject are:

- Corporate Income Tax (IRPJ) and Social Contribution on Profits (CSLL);
- Social Contributions on Gross Revenues (PIS and COFINS);
- Federal Tax on Industrialized Goods (IPI);
- State Value-Added Tax (ICMS); and
- Municipal Tax on Services (ISS).

2.0 Corporate income tax

Brazilian tax law does not provide for ring fencing, field-based taxes, and specific tax rates. Thus, profits and losses from oil and gas activities can generally offset profits and losses from any other business activity of the oil and gas company.

2.1 In general

Brazilian income tax rules apply uniformly to all Brazilian legal entities, irrespective of the form of association.

The taxable income is determined pursuant to the law in effect on the date the tax triggering event occurs. There are three taxation regimes: Taxable Income (Lucro Real), Deemed Profit (Lucro Presumido) or Arbitrated Profit (Lucro Arbitrado).

Brazilian oil and gas companies are subject to the general income tax regimes. Brazilian tax law does not provide for ring fencing, field-based taxes, and specific tax rates. Thus, profits and losses from oil and gas activities can generally offset profits and losses from any other business activity of the oil and gas company.

There are two taxes levied on corporate income: income tax and social contribution on profits. The two taxes are essentially similar. For the purposes of this commentary the term Corporate Income Tax will refer collectively to both taxes.

2.2 Rates

The Corporate Income Tax rate is 25% (15% for taxable profits of less than R$240 thousand). The Social Contribution on Profits rate is 9%. The two taxes combined rates correspond to 34%.

2.3 Taxable income

Entities subject to the taxable income method can opt for the calculation of Corporate Income Tax on a calendar year or quarterly basis. Taxable income will be calculated on the basis of the legal entity statutory accounting records, with tax accounting adjustments, add-backs, exclusions and off-sets.

The taxable income method is the most prevalent in the oil and gas sector, inasmuch as it allows for the offsetting of net operating losses derived from exploration costs against income earned in future taxable periods, as well as deduction of costs incurred in one field against income from another.

The taxable income method also allows taxpayers to capitalize development costs and amortize them during the hydrocarbons production phase.

2.4 Revenue

Revenues are typically recognized for tax purposes by oil and gas companies on an accruals basis in accordance with the Brazilian statutory accounting rules. Brazilian transfer pricing rules can have an effect on the determination of revenues for tax purposes.

Foreign exchange gains and losses are subject to Corporate Income Tax, with the taxpayer choosing each year whether to tax these on a cash or accruals basis. Capital gains and losses are taxed together with income from business activities.

PIS and COFINS Contributions

PIS and COFINS are federal social contributions levied on revenues, with some exceptions expressly stated in the legislation. The applicable tax rates are 1.65% and 7.6%, respectively.

There is a “non-cumulative” regime that allows the deduction of certain credits (basically, calculated upon inputs).

There is a cumulative regime applicable, for example, to taxpayers opting for the Deemed Profit method for Corporate Income Tax purposes. The cumulative method does not provide for the deduction of input credits. The applicable tax rates are 0.65% and 3%, respectively.

2.5 Deductions and allowances

Income tax legislation in Brazil establishes certain criteria in considering the expenses incurred by the company as operational and, therefore, deductible for tax purposes.

Operating expenses are those required for the company's activities and maintenance of its source of production, and are defined as follows:

- necessary expenses paid or incurred to carry out transactions or operations required by the company's activities; and

- operating expenses, which are usual or normal in transactions, operations or activities carried out by the company.

Depreciation

In Brazil, depreciation is typically recorded using the straight-line method.

The Federal Tax Authorities have issued ordinances stipulating the maximum depreciation rates of tangible assets, which are acceptable for tax purposes without the need of further documentation by the taxpayer. In the event the taxpayer employs assets in conditions that result in more expedite depreciation of such assets, the taxpayer is required to rely on a specialist appraisal report supporting the shorter life term.

The Federal Tax Authorities have issued ordinances stipulating the maximum depreciation rates of tangible assets, which are acceptable for tax purposes without the need of further documentation by the taxpayer.

While as a general rule, depreciation for book and tax purposes is consistent, the tax law allows for different depreciation rates for tax purposes in accordance with the table issued by the Federal Tax Authorities:

Product	Useful life (in years)	Yearly depreciation rate (%)
Vehicles	5	20
Machinery and equipment	10	10
Computers	5	20
Buildings	25	4
Vessels destined to support research, exploration, drilling, production and storage of oil and natural gas	20	5
Vessels used in research activities and acquisition of geological and geophysical and geodesical data related to exploration of oil and natural gas	20	5
Equipment for acquisition of geological and geophysical and geodesical data related to the research of oil and natural gas	10	10
Floating crane used in offshore rig facilities	20	5
Tugs for vessels and support equipment used in research, exploration, drilling, production and storage of oil and natural gas	20	5
Fixed exploration, drilling or production units (machinery)	10	10
Floating, production, storage, offloading units	20	5
Floating or semi-submersible exploration, drilling or production units (platforms)	20	5

2.6 Losses

Tax losses can be carried forward to be offset in future years with no time limit (no statute of limitation applies to tax losses). Nonetheless, such tax losses cannot reduce taxable income by more than 30% in any given fiscal year. Such limitation also applies to negative results for CSLL purposes calculated for a given period.

2.7 Foreign entity taxation

Foreign entities are not allowed to engage in oil and gas exploration and production in Brazil, therefore, it is unusual for foreign oil and gas entities to be taxed in Brazil as a consequence of doing business in Brazil.

According to legislation in force, profits earned by foreign subsidiaries are subject to tax in Brazil on the same year in which earned overseas, irrespective of effective distribution, thus lacking deferral provisions. There are cases in court disputing the immediate taxation in Brazil of undistributed profits, nevertheless this issue is still unresolved.

3.0 Other corporate income tax

3.1 Additional profits taxes

Brazilian legislation does not provide for additional profits taxes, There is a specific charge applicable to the oil and gas sector, that is not a tax, called Special Participation, that levies on large and profitable producing ring fenced fields.

3.2 State taxation

Under the Brazilian Constitution, States are not competent to levy income taxes.

3.3 Municipal taxation

Under the Brazilian Constitution, Municipalities are not competent to levy income taxes.

4.0 Tax incentives

4.1 Research and development

The eligibility for Brazilian R&D benefits is broad and is not limited to particular industries. Activities undertaken to achieve technological innovation qualify for the R&D tax incentives. These activities include designing new products or processes, as well as the aggregation of new functionalities or characteristics to a product or process, resulting in incremental improvements in quality or productivity. Additionally, software development qualifies as an R&D activity as long as it is undertaken to advance scientific or technical goals.

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R&D expenditures include wages, salaries, and certain payments to third parties (e.g. laboratory tests, etc.), directly attributable to the conduct of qualified R&D activities.

The program allows taxpayer to take advantage of the following incentives for corporate income tax purposes:

- super Deduction: Super deduction equal to 160% of the total R&D expenditures;

- enhanced Super Deduction: If the entity increases the amount of researchers exclusively dedicated to research projects by up to 5% in a given year, super deduction increases to 170%; and if headcount increases more than 5% in a given year, the super deduction increases to 180% of the qualified expenses. Employees who relocated internally to work exclusively in research projects may also be considered in the increase of the number of researchers; and

- enhanced Super Deduction for Patents: An extra 20% deduction is allowed for the qualifying costs incurred in developing a patent, but the super deduction is only allowed when a patent is registered. Since the super deduction is delayed until the patent is registered, few taxpayers take advantage of this provision.

Unused deductions may not be carried forward or carried back.

Brazil also provides the following additional research incentives:

- equipment, machinery, and tools exclusively dedicated to R&D can be deducted when the expense is paid or incurred. However, if assets initially acquired for the use in R&D activities are later sold or destined to other activities, the expense paid or incurred should become taxable when they are sold or transferred to another area (non-R&D related);

- equipment, machinery and tools acquired exclusively for R&D by IT companies, as well as companies with automation activities, that benefit from specific IPI Reduction (see below), can take a super deduction on the cost of such equipment; and

- IPI Reduction (federal excise tax): Equipment, machinery, and tools dedicated to R&D receive a 50% reduction of the IPI due. This incentive must be claimed at the time the research related equipment, machinery, or tools are acquired.

4.2 Manufacturing

Industrial undertakings set up in the regions in the North (SUDAM) and North East (SUDENE) were granted with regional tax incentives, including a reduction of Income Tax.

Under these programs, the benefits are extended to corporate entities that have projects approved for installation, expansion, modernization or diversification in sectors of the nation's economy considered a priority for regional development by act of the Executive Branch of the Federal Government, which includes oil and gas production projects.

According to both Supplementary Law #124/07 (SUDAM) and #125/07 (SUDENE), the areas covered are the northern region of Brazil, basically the Amazon Basin (SUDAM) and the Northeast (SUDENE), the latter including part of the northern region of the State of Minas Gerais and certain municipalities of the State of Espírito Santo (both the latter technically classified in the Southeast geographically speaking), and which meet the legal requirements of these entities.

In accordance with the abovementioned legislation, for projects approved up to 2013, a 75% reduction of Income Tax, calculated under the exploitation profit method, may be granted if all conditions stipulated by the applicable legislation are met.

4.3 State

As previously stated, under the Brazilian Constitution, States are not competent to levy income taxes.

5.0 Payments to related parties

Brazil does not follow the international transfer pricing standards, for example, under the OECD guidelines. Most of the Brazilian transfer pricing methods are based on statutory margins provided to test inbound (import) and outbound (export) transactions ...

5.1 Transfer pricing

The Brazilian transfer pricing legislation stipulates certain methods applicable to transactions involving goods, services and rights between related parties.

Brazil does not follow the international transfer pricing standards, for example, under the OECD guidelines. Most of the Brazilian transfer pricing methods are based on statutory margins provided to test inbound (import) and outbound (export) transactions, except for certain methods based on similar transactions performed by unrelated parties.

For Corporate Income Tax ("IRPJ") and Social Contribution on the Net Profit ("CSLL") computation purposes, costs, expenses and charges resulting from import transactions may be treated as deductible items only up to the amount that does not exceed a "parameter price" calculated under the rules set forth by the Brazilian Transfer Pricing legislation.

With respect to export transactions, the revenue earned by the taxpayer in a certain operation with a related party domiciled abroad must be equal or higher than the parameter price resulting from one of the methods provided in law.

The Brazilian Government published on 3 April 2012 the Provisional Measure (MP) 563/2012. This Measure introduced significant changes to the Brazilian transfer pricing legislation; however it still has to be converted into law. Although the changes introduced by MP 563/2012 are valid for fiscal years starting 1 January 2013, taxpayers can chose to apply those for fiscal year 2012 onwards. Highlights of MP 563/2012, specifically for the oil and gas sector, include changes to the resale price minus profit method (PRL).

The PRL has historically been the most frequently used method to assess the reasonableness of prices paid by Brazilian taxpayers in inbound intercompany transactions. The PRL method takes into consideration certain statutory gross profit margins, which have historically varied depending on the purpose of the imported product, service, or right. The statutory gross profit margins were 60% (i.e. for imported items utilized in the production process by the imported) and 20% (i.e., in all other cases in which the imported items were not utilized in the production process) regardless of the taxpayer's industry.

The MP 563/2012 introduced a specific gross profit margin of 40% for oil andgas exploration and production and for the manufacturing of oil related products.

5.2 Thin capitalization

There are no specific thin capitalization rules that would apply to the oil and gas industry. Brazil`s general thin capitalization rules establishes that any interest credited or remitted by a Brazilian entity to an entity or individual domiciled or incorporated abroad are subject to two general criteria of deductibility:

1) Interest paid to related Parties that are not located in tax haven jurisdiction or that do not benefit from a "preferential tax regime" may be deducted on an accruals basis for corporate income tax purposes only if the expenses are necessary for the company's activities, and both of the following thresholds are met:

- the related party debt-to-equity ratio does not exceed 2:1 calculated based on the proportion of related party debt to direct equity investment made by related parties; and

- the overall debt-to-equity ratio does not exceed 2:1 based on the proportion of total debt to total direct equity investment made by related parties.

2) Interest paid to an entity or individual located in a tax haven or that benefits from a preferential tax regime (regardless of whether the parties are related) may be deducted only if the expenses are necessary for the company's activities, and both of the following thresholds are met:

- the amount of the Brazilian entity's indebtedness to the tax haven resident does not exceed 30% of the net equity of the Brazilian entity; and

- the Brazilian entity's total indebtedness to all entities located in a tax haven jurisdiction or benefiting from a preferential tax regime does not exceed 30% of the net equity of the Brazilian entity.

5.3 Interest deductibility

Interest is generally deductible on an accruals basis by the taxpayers subject to the Taxable Income method. Related party loans are safe harbored by the Brazilian transfer pricing rules if registered with the Brazilian Central Bank.

Moreover, regarding inbound and outbound loan transactions, taxpayers have successfully argued in the past that interest paid on intercompany loan transactions is not subject to the Brazilian transfer pricing legislation if the loans are registered with the Brazilian central bank (BACEN).

As a recent change, applicable for 2013, Provisional Measure 563/2012 specifically provides that interest expense paid to related parties will not be deductible if it exceeds the six-month London Interbank Offered Rate (LIBOR) plus a spread (to be determined by the Brazilian tax authorities). In practical terms, the new provision indicates that interest expense above such a threshold will not be tax deductible.

Regarding inbound and outbound loan transactions, taxpayers have successfully argued in the past that interest paid on intercompany loan transactions is not subject to the Brazilian transfer pricing legislation if the loans are registered with the Brazilian central bank (BACEN).

6.0 Transactions

6.1 Capital gains

Capital gains earned by a Brazilian resident taxpayer are taxed together with income in general at general corporate tax rates.

As per Brazilian tax legislation, in case a foreign entity sells its investment in a Brazilian entity, such transaction is subject to Capital Gains taxation at source (the general rate corresponds to 15%; an increased rate of 25% applies if the seller is domiciled in a tax haven jurisdiction). An entity is considered as domiciled in a tax haven if any of the following conditions is met:

- the foreign company is subject to tax in its jurisdiction at a rate lower than 20%;
- the amounts paid out of Brazil are not subject to tax in the jurisdiction where the foreign entity is domiciled at regular rates and conditions; or
- this foreign jurisdiction does not provide public access to information regarding company's structure and ownership by non-residents.

Note that Tax Authorities published a Normative Instruction with a list of tax haven jurisdictions.

6.2 Asset disposals
Assets disposals shall be computed in companies' taxable income.

6.3 Like-kind exchanges and involuntary conversions
Like-kind exchanges are expressly dealt with in tax regulations with respect to real estate, that provide for realization of gain exclusively in the event boot is paid.

6.4 Abandonment
All accruals, including those applicable to the Brazilian oil and natural gas industry, such as the provision for well abandonment and field restoration, will be considered non-deductible for purposes of calculating Income Tax and CSLL.

Therefore, the amounts related to the well abandonment will only be deductible for income tax purposes when incurred.

6.5 Sharing arrangements and farm outs
Farm out/farm in transactions have only taken place in Brazil over the last decade (after the market opening for upstream companies in the early 2000's) and the corresponding number is still uncertain. What is seen is a transaction by transaction approach, with a number of schemes being adopted, depending on the specific purposes of the farmee and farmor.

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In connection with the above, there is no tax authorities' specific guidance interpretation concerning how to deal with such transactions for income tax purposes and there is no history of case law specifically dealing with the interpretation of farm out/farm in transactions.

Generally, what we have is that Brazilian tax legislation generally provides that income is to be determined pursuant to the precepts of local commercial law, which means that the Taxable Income will generally be determined based on the profit recorded in the manner provided by the Fundamental Accounting Principles (PFCs), which are the Brazilian Generally Accepted Accounting Principles (BR GAAP).

In this respect, Federal Law #11,638/07 introduced in our accounting system several modifications aiming at the convergence between the BR GAAP and the International Financial Reporting Standards (IFRS), which brought fundamental changes to the Brazilian accounting framework. IFRS regulations are still being enforced and interpretation for the natural resources industry is still pending.

As mentioned before, there is also no specific Brazilian accounting guidance on how the farm out/farm ins shall be treated for accounting purposes (likely IFRS, one could eventually say) and how such accounting treatment would be considered different from the one provided by Brazilian previous accounting regulations, which could eventually give rise for RTT adjustments/neutralizations of effects.

As a result, from a Brazilian perspective the tax treatment of such transactions is largely dependent on the company's specific facts and circumstances at the time such a transaction is to take place, including the accounting interpretation of such a transaction.

7.0 Withholding taxes

7.1 Dividends
Dividends are not subject to withholding (WHT) income tax, regardless of the location of the beneficiary.

7.2 Interest
Under the internal law of Brazil, interest paid to a foreign beneficiary is generally subject to a 15% WHT, while the rate is increased to 25% WHT on payments to tax haven entities.

7.3 Rents and royalties
Under the internal law of Brazil, royalties paid to a foreign beneficiary are generally subject to a 15% WHT, while the rate is increased to 25% WHT on payments to tax haven entities.

7.4 Other
Under the internal law of Brazil, technical services fees paid to a foreign beneficiary are generally subject to a 15% WHT, while the rate is increased to 25% WHT on payments to tax haven entities.

7.5 Tax treaties

Brazil has concluded a number of tax treaties, as shown below.

Country	
Argentina	Hungary
Austria	Korea
Belgium	Luxembourg
Canada	Mexico
Chile	Netherlands
China	Norway
Czech Republic	Peru
Denmark	Philippines
Equator	Portugal
Finland	Slovakia
France	South Africa
India	Spain
Israel	Sweden
Italy	Ukraine
Japan	Hungary

8.0 Indirect taxes

8.1 Value added tax, goods and services tax, and sales and use tax

Federal Value Added Tax (IPI) – IPI is a federal tax paid by manufacturers at the time of sale, either to another manufacturer who will continue the manufacturing process or to the retailer or ultimate customer. Furthermore, the IPI is also levied in the importation of goods. The applicable IPI rates depend on the goods fiscal classification on the Harmonized Tariff Schedule (HTS).

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8.2 Import, export, and customs duties

Import Duty (II) – The Import Duty (II) is a non-recoverable tax levied on all products or goods that enter Brazilian territory. Such tax is charged to the importer of the product. The applicable rate of each product is determined by the Mercosul Common External Tariff (TEC), which is similar to the Harmonized Tariff Schedule (HTS).

PIS/COFINS-Importation – Goods and services imported into Brazil will be subject to the PIS/COFINS-Importation. The PIS and COFINS rates correspond, respectively, to 1.65% and 7.6%.

Contribution for Intervention in the Economic Domain (CIDE) – CIDE is levied on technical services rendered by foreign providers and royalties paid to foreign beneficiaries. The CIDE is not a withholding tax, but rather levied on the Brazilian taxpayer benefiting from the technical services or licensing the rights compensated by the royalties.

8.3 Excise tax

There are no excise taxes in Brazil.

8.4 Stamp tax

There are no stamp taxes in Brazil.

8.5 State and municipal

State Value-Added Tax (ICMS) – ICMS is levied by the States on the circulation of merchandise, on rendering of interstate and intermunicipal transportation services and on communications services. The importation of goods into Brazil is subject to the ICMS on the customs clearance.

States also collect Gifts Tax, and Real Estate Transfer Tax.

Municipal Tax on Services (ISS) – ISS is a municipal non-cumulative tax, levied by the Brazilian service render for an extensive list of services actually designated by Supplementary Law # 116/2003. This tax is assessed on services gross billings on a monthly basis and its rate may vary from 2% to 5%, according to the municipality and the type of service rendered (the usual rate is 5%);

Municipalities also collect Real Estate Property Tax.

9.0 Other

9.1 Choice of business entity

Under Brazilian law, there are many forms of organizing a business, whether as a separate legal entity or not. Due to the procedural requirements to register a branch of a foreign entity to do business in Brazil, foreign companies rarely operate through branches in Brazil.

Although there are several company forms under Brazilian corporate law, two are the most prevalent in practice, (i) the Limited Liability Company (Sociedade Empresária Limitada) and (ii) the SA (Sociedade por Ações).

Foreign investors (which do not intend to be listed locally) usually run their businesses in Brazil through a Limited Liability Company.

9.2 Foreign currency

Exchange Controls – In recent years the Brazilian government has enacted several regulations aiming to reduce the complexity of its foreign exchange market. This exchange market is under the control of the Brazilian Central Bank and is ruled by the International Capital and Foreign Exchange Market Regulation – RMCCI.

As a general guideline, the RMCCI allows legal entities and individuals to purchase and sell foreign currency and perform international transfers in Brazilian Reais, regardless the nature of the operation, with no restriction with respect to the amount involved therein.

Additionally, such regulation requires the operations in the foreign exchange market to be performed solely through market agents authorized by the Central Bank of Brazil for such purpose, as defined in the RMCCI. This means that, in such operations, either the buyer or the seller must be an agent authorized to operate in the foreign exchange market.

The aforementioned permission applies to almost all transactions performed in the Brazilian exchange market. Only a few transactions are subject to specific ruling, such as investments performed in a foreign stock or derivatives market or foreign investments carried by an entity whose authorization to operate had been previously granted by the BACEN itself.

In general, in order to perform a transaction in the exchange market, BACEN only requires the involved parties to formalize it through an exchange contract and to register it before the Central Bank Database System – SISBACEN. There is no specific provision with respect to the documentation that must support the exchange contract. Normally, the contract whose execution led to the currency exchange is required, together with other documentation able to prove the transaction's lawfulness as well as its economic ground and the responsibilities of the parties involved therein.

Foreign Investment – A foreign investor planning to incorporate a company in Brazil may capitalize such company by means of subscribing capital shares or by loans. The Brazilian Central Bank registers all investments, whether in the form of capital or in the form of loans. Direct investments are subject to registration through the RDE-IED return.

In the RDE-IED module, the funds remitted to Brazil must be converted into local currency ("Real"), in order to qualify for registration with the Brazilian Central Bank.

The foreign currency exchange contract for capital infusion is subject to tax on Financial Operations (IOF) at 0.38%.

Foreign Currency Loan Operations – According to the Brazilian Legislation, the foreign currency loan should be registered by BACEN. Loans are generally registered through the RDE-ROF module on which the funds sent to Brazil may be registered in a foreign currency. The compliance with which will enable the borrower to remit abroad payments of interest and repayment of the loan, under the official exchange rate.

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10.0 Oil and gas contact information

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