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Brazil Tax Seminar

Brazilian Tax Development Impacting Charters Agreements

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Summary

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3. Petrobras´ tax dispute and how it might be resolved
4. The pass through: a tax issue or a legal/contract issue?
5. Conclusion

Background of the dispute (components)

A. **Zero tax rate of IRRF** on outbound payments related to charter of vessels:

- Tax exemption introduced by Law n. 4,862/**1965** (50 years ago);
- Law n. 9,481/1997 restablished the zero tax rate;
- Rule created to stimulate maritime and air transportation, not specific to benefit oil & gas industry.

B. **Split** of Drilling Contracts into Charter and Service Contracts:

- Contractual model in place since the 90´s and imposed in every tender process;
- Split of 90/10 or 85/15 of the global price to charter and service, respectively.
- This percentage was attributed to service contract due to:
  - the need for local crew – labor and regulatory local content requirements;
  - the need to perform payment of local costs in Brazilian Reais, in order to avoid exchange variation on foreign currency.

Background of the dispute (components) – cont.

C. **Brazilian Revenue Service mindset** – tax authorities understand that the industry is over benefited, due to the existence of a lot of tax exemptions that benefit not only exploration, but also development and production:

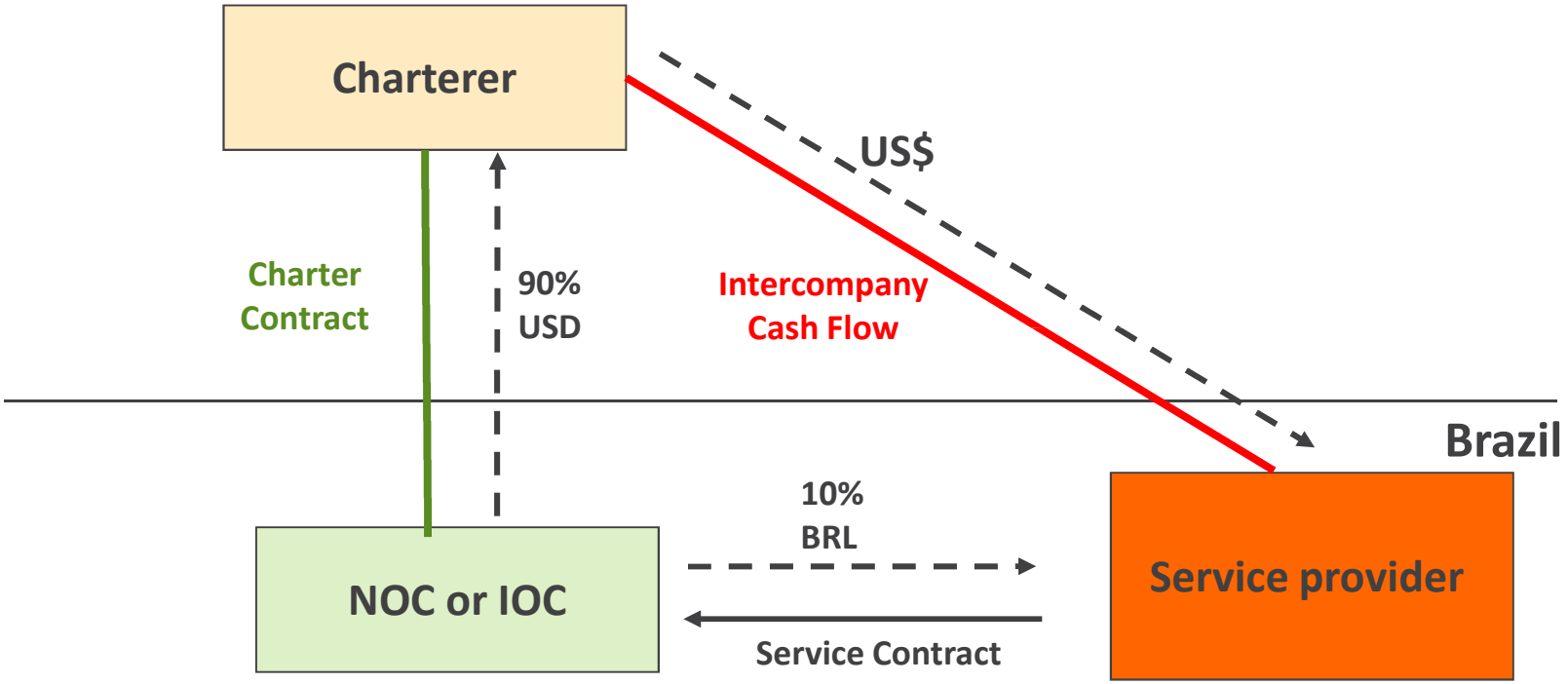
- REPETRO - tax relief mechanism applied to CAPEX;
- Convention CONFAZ ICMS No. 130/2007 - state tax benefit (ICMS) applicable to tangibles;
- Zero tax rate of IRRF on outbound payments related to charter of vessels.

Background of the dispute (components) – cont.

- Tax benefits (the government total take) on the oil & gas industry was designed during the 90´s when the sector was opened to the private investments:
    - potential fields: 300 and 500 million barrels of heavy crude oil;
    - exploration offered high risks to investors (only 30% of possibility of successful);
    - oil prices ranging from US$ 15/bbl to US$17/bbl.

- BRS understand that the reduced tax burden shall not be applied to the new scenario:
    - pre-salt offers lower risk to investors (close to zero, according to ex-president Lula);
    - oil prices around US$ 100,00/bbl;
    - super giant field of 12 billion barrels;
    - 500 mbbl per day, during the first 8 years of exploration

Overview of the contractual model



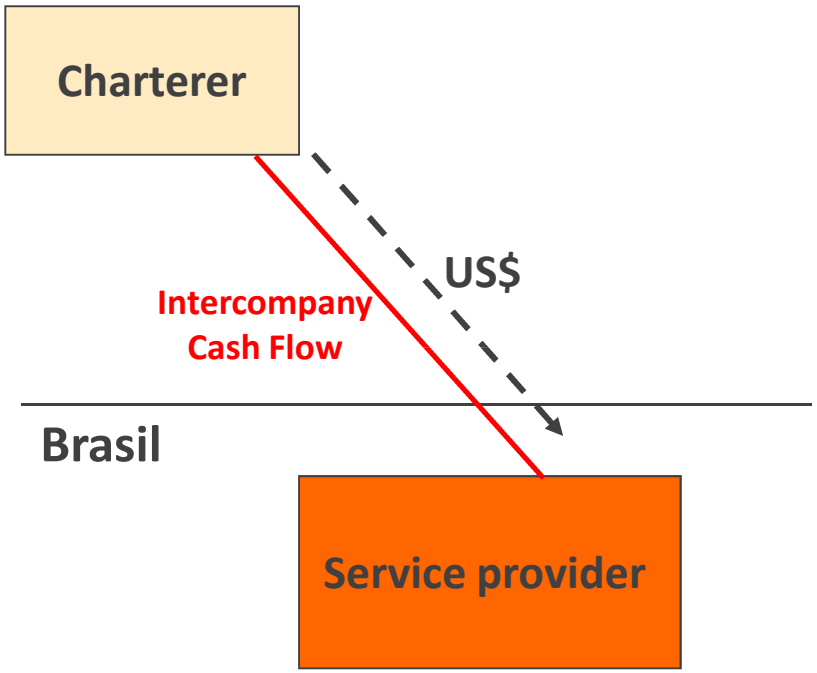
“3 round fight” (for the moment)

- **Tax assessment 1 - year 2003:** the concept of vessel shall not encompass productions platforms for purposes of applying of zero tax rate of IRRF on outbound payments. A lease rather than a charter;
- **Tax assessment 2 - year 2005:** any amount sent by the charterer to the service provider should be considered as revenue and as part of the service fees paid by the NOC or IOC to service provider;
- **Tax assessment 3 - year 2013:** the charter contract is actually a services contract.

“3 round fight” (for the moment) – cont.

- **Tax assessment 1 – year 2003:**
  - Tax authorities filed assessments against NOC´s and IOC´s charging IRRF on outbound payments, considering that the concept of vessel shall not encompass oil rigs, since vessels would be [exclusively] designed for the transport of people and goods because that was the reason for the tax benefit.
  - Those assessments are being challenged on judicial level and although there are favorable and unfavorable decisions, it appears that decisions are now mainly favoring the E&P companies.
  - The final Court decision will be relevant for IOC´s and NOC’s tax planning.

“3 round fight” (for the moment) – cont.



- **Tax assessment 2 – year 2005:** Brazilian entities, in its intercompany contracts, may classify the funds received from abroad as reimbursement of expenses incurred on behalf of the charterer, loans and capital contributions. In this case, such amounts are not included in Brazilian companies’ P&L, which has been challenged by the Tax Authorities.

  ✓ Tax assessments charging: IRPJ, CSLL, PIS and COFINS

- Tax authorities consider that the services fees paid by the charterer to the service provider (included in local entity P&L) should be part of the service fees paid by the NOC or IOC to service provider and not treated as revenues from the export of services for tax purposes.

  ✓ Tax assessments charging PIS and COFINS.

- 150% qualified penalty - a sham transaction with purpose of tax evasion

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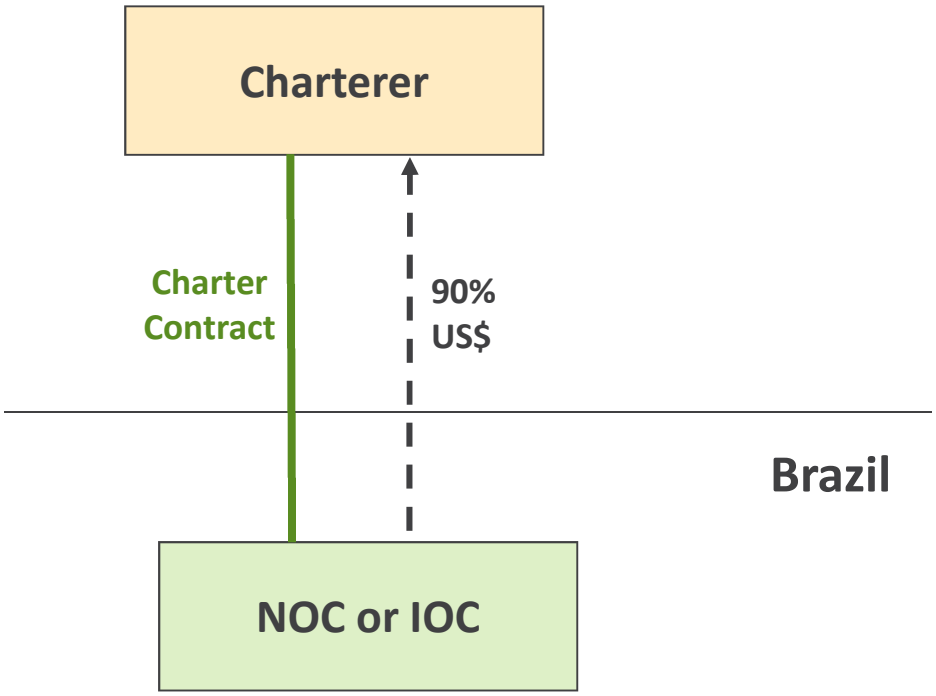
“3 round fight” (for the moment) – cont.

- **Tax assessment 3 – year 2013:** Tax authorities consider that the charter contract is actually a (drilling) service, understanding that the split of contracts is artificial because the contracts are not independent. There is one sole agreement (drilling services).
- Tax authorities assessed NOC´s or IOC´s for the taxes that levy on the import of services, and should be withheld when of the remittance of funds to the charterer, because it did not qualify as a charter.
    - ✓ Tax assessments charging: IRRF, CIDE, PIS/COFINS on service imports.
- This charge represent an additional tax burden of approximately 50% over the remittances.



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Petrobras´ tax dispute and how it might be resolved

- **Tax assessment 3 – year 2013:** reclassification of the charter as a service
- Petrobras´ defense:
  - REPETRO regulations provides for 2 interrelated contracts (service and charter);
  - both contracts coexist independently and with different objects – it is not possible to unify separated contracts;
  - vessels are equipments of technical complexity;
  - freedom of the taxpayer to negotiate contracts and deals;
  - outbound payments could not be subject to IRRF when remitted to beneficiary located in a country signatory of a treaty to avoid double taxation with Brazil.
- How this dispute must be resolved?
  - Long litigation expected (10 -15 years) if “settlement” is not agreed upon – Petrobras must defend its model;
  - More likely than not that Petrobras´ defense should prevail;

The pass through: a tax issue or a legal/contract issue?

- Petrobras recently sent letters to the charterer companies informing that it is challenging Tax Assessment 3 in the administrative level, but if the final decisions in court determine that the taxes are due, Petrobras will charge back to the charterers all expenses related to the dispute (including attorney fees) as well as the amount of IRRF plus fine and interest assessed (Petrobras will not charge back the amounts of other taxes).
  - Petrobras believes that contractual language supports the pass through.
- After the letters: meeting between Petrobras, E&P and services companies´ associations:
  - letters were sent to request support to the contract model and the defense grounds raised against Tax Assessment 3;
  - alternatives to the future were discussed during the meeting:
    a) ongoing and future bids: Petrobras will clarify that the Bidders should consider a zero rate of IRRF, and Petrobras will reimburse the extra cost equivalent if the understanding of BRS prevail.
    b) bids already negotiated but with contracts not effectively signed: Petrobras could borne the IRRF costs if applicable, because companies could refuse to execute the contracts considering the current risk.
    c) contracts already signed: Petrobras will charge back to the charterer companies the IRRF amounts.

The pass through: a tax issue or a legal/contract issue? – cont.

- Charterer entities and service companies were not assessed;
- BRS did not establish joint liability for charterers – no common interest nor mutual intention – Article 124, I of Brazilian Tax Code;
- BRS understanding: only E&P companies are the ones actually benefited by the cost reduction caused by tax exemption granted to charter (sham) transaction.
  - It is a tax avoidance structure that does not cause any economic effect to charterer and local service providers;
  - Only the author of the structure shall be liable for the assessment.

Conclusion

- E&P industry should defend the contractual model and, if possible, negotiate with BRS a reasonable proposal to be applied to future contracts and outbound payments.
  - Sete Brasil;
  - Proposal of conversion of Provisional Measure N. 651 - in case of split of charter and services contracts with related company:
    - the amount of charter contract of FPSO shall be limited to **85%;**
    - the amount of charter contract of drillships shall be limited to **80%**; and
    - the amount of other charter contract shall be limited to **65%** .
  - Negotiation / proposal only applicable to the future.
    - What about payments already remitted?
    - BRS assessed fiscal years of 2008 and 2009 – fiscal years of 2010 to 2014 may be challenged in the future.

Conclusion – cont.

- Tax assessments 2 and 3 address the same economic base and represent a double taxation.
  - It should be pointed out to the BRS.

- Company should look on its own contractual language (charter agreements and the bidding proceedings) and analyze if the Petrobras´ pass trough letters make sense.

- Company should also consider that while negotiating contracts in Brazil:
  - charter price/rate was established assuming zero tax rate of IRRF on charter payments;
  - the split of the drilling services (contractual model) was presented as a valid and safe mechanism;
  - the contract model was presented as the one sole model. There were not other acceptable alternatives.

Questions ?

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Thank you.

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