

Impacts of CBS on the Oil and Gas Industry

By Carolina Bottino and Diana Castro

Summary Several proposals of tax reforms have been subject to discussion in the last months of 2020 in Brazil. The proposals currently under debate are the Bill of Constitutional Amendment No. 45/2019 ("PEC 45"); the Bill of Constitutional Amendment No. 110/2019 ("PEC 110"), proposed by the Chamber of Deputies and the Federal Senate, respectively; and the Bill of Law No. 3,887/2020 ("BL 3,887"), proposed by the federal government, with the purpose to create the Contribution on Goods and Services ("CBS").

This article does not intend to analyze the potential unfairness and/or unconstitutionality of BL 3,887 or the other bills, if approved, but rather the goal is to discuss and identify the potential impact of these bills, especially BL 3,887, on the oil and gas industry.

Several proposals of tax reforms have been subject to discussion in the past months in Brazil. Among them, the protagonists currently under debate are (i) the Bill of Constitutional Amendment No. 45/2019 ("PEC 45"); and (ii) the Bill of Constitutional Amendment No. 110/2019 ("PEC 110"), proposed, respectively, by the Chamber of Deputies and the Federal Senate.

Although different, the goal of both proposals is to simplify tax collection by unifying the consumption taxes. The

tax burden, in theory, would be maintained but several taxes would be extinguished and combined into a sole consumption tax (Value Added Tax (VAT) like), while the form of collection would be changed to a destination-based VAT (tax collected in the State where the product will be consumed).

In summary, PEC 45 intends to extinguish the following taxes: Tax on Manufactured Goods ("IPI"), Contribution to the Social Integration Program (PIS), Contribution to the Social Security Funding (COFINS), State VAT (ICMS) and Services Tax (ISS). These taxes would be replaced by the so-called IBS (tax on goods and services). It proposes the creation of a Selective Tax focused on specific goods and services whose consumption should be discouraged due to the applicable tax burden, including cigarettes and alcoholic beverages.

On the other hand, PEC 110 intends to extinguish the following taxes: Tax on Manufactured Goods ("IPI"), Contribution to the Social Integration Program (PIS), Contribution to the Social Security Funding (COFINS), State VAT (ICMS) and Services Tax (ISS); Tax on Financial Transactions (IOF); Social Security Contribution associated to the Education Salary Fund and Contribution on Intervention

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on Economic Domain (CIDE – Fuels). These taxes would also be replaced by the so-called IBS (tax on goods and services). PEC 110 also proposes a Selective Tax focused on specific goods and services, including oil and oil products, fuels and lubricants, power and telecommunication services, cigarettes, etc.

The debate on the tax reform intensified with the crisis associated to COVID-19 and has been one of the priorities of the government for the recovery of the economy.

In view of the foregoing, this year a new Bill of Law was proposed by the federal government (Bill of Law No. 3,887/2020 - "BL 3,887"), to create the Contribution on Goods and Services ("CBS"). Since then, the theme has been subject to passionate debates, both by the expectations generated around the highly discussed Brazilian tax reform, and due to the community's fear of an increase of the tax burden, which has generated numerous criticisms of the proposed model.

The goal of this article is not to analyze the potential unfairness and/or unconstitutionality of BL 3,887 or the other Bills, but rather to discuss and identify the potential impact, especially of BL 3,887, on the oil and natural gas industry. We focused, mainly on BL 3,887's effects on customs and tax regimes that currently benefit the oil and gas industry, as they are extremely relevant for the continuity of this successful industry in Brazil.

In accordance with article 81 of BL 3,887,¹ the **suspension** of the Import Tax ("II") or the Excise Tax ("IPI") linked to an **import** due to the application of a **special customs regime** also implies the suspension of the payment of CBS. Thus, it is possible to interpret that the following customs treatments inherent to the special tax and customs regime for the economic use of goods destined to the exploration, development and production of oil and gas ("Repetro-SPED") would also be exempt² from CBS:

1. temporary admission for economic use with exemption of federal taxes for the period of time the goods remain in the customs territory, as per item "a" of item I of article 376 of Decree No. 6,759/2009 ("Customs Regulation"); and
2. temporary admission for economic use with proportional payment of federal taxes in accordance with the period of time the goods remain in the customs territory, as per article 373 of the

Customs Regulation.

The CBS suspension occurs in such cases because, since such regimes consist of temporary admission for economic use, they are subject to the provisions of articles 353, 373 and 376 of the Customs Regulation, which establish the suspension of II, IPI, PIS-Import and COFINS-Import in the regimes indicated above.

Specifically in regard to the fictitious exportation within the scope of Repetro-SPED, in our view the same rationale above should apply, since the exemption from federal taxes is generally granted by customs legislation³ (not being specific for PIS-Imports and COFINS-Imports, for example), by equating the effects of this transaction with the effects of an effective export. Therefore, as the same tax and exchange effects of an effective export are conferred, we believe that the exemption provided in article 2, paragraph 2⁴ of BL 3,887 would in theory be sufficient to also cover export operations without leaving the national territory.

Please note that BL 3,887 does not establish an exemption for CBS in the import of goods on a permanent basis, or in the transactions within the scope of Repetro-Industrialização. Considering that from a formal standpoint such regimes do not have the nature of customs regimes, but rather of special tax regimes, they do not fall under the provisions of article 61 of BL 3,887 and, therefore, the benefit of the CBD suspension does not apply.

This seems to be the purpose of BL 3,887. It is possible to reach this conclusion due to the information contained in the "Q&A"⁵ released by the Ministry of Economy on August 5, 2020, in which there is a specific clarification on this topic. Although this document is not binding and is not a law, it is indicative of the Tax Authority's interpretation of the situations set forth therein. It seems that the government's intention is to extinguish the benefit of Repetro-SPED to the oil and gas industry with respect to CBS.

Thus, if the BL 3,887 is approved as drafted, especially the original text of article 61, the oil and gas industry, user of Repetro-SPED, will be significantly impacted. The entire supply chain of goods in the activities of exploration, development and production of oil and natural gas, which today is entirely (in practical terms) exempt from federal taxes, could possibly be taxed with CBS. Such fact could directly impact new investments in this sector.

This measure is surprising, since it not only materially burdens a sector that contributes significantly to the development of the Brazilian economy, but it also contradicts the purposes that the government previously addressed with the publication of Provisional Measure No. 795/2017 (“MP 795”). MP 795, later converted into Law No. 13,586/2017, was published in order to improve the tax legislation applicable to the exploration, development and production of oil and gas, grant legal certainty to companies and promote investments in the oil and gas industry in Brazil.

The concern regarding new investments in the oil and gas industry in Brazil was expressly addressed by the Mixed Committee of the National Congress of MP 795,⁶ when it suggested that the term of validity of the benefits for definitive import should be granted until December 31, 2040,⁷ exactly because it considered the complexity and long lead time of investments in the industry before the commencement of operations in the exploration and production of oil and gas, as well as the need to grant equal tax treatment to domestic and imported goods.

At that time, the Mixed Committee of the National Congress highlighted the need to adopt such measures in view of the drop in oil prices, starting in 2014, and, consequently, the decrease in sectoral investments and the prospect of decreased production. Thus, the importance of the improvement of the Brazilian tax regime was recognized in order to make petroleum projects viable and increase the attractiveness for foreign investors.

The change in taxation rules with the levy of CBS in transactions carried out within the scope of Repetro-Industrialização and definitive imports within the scope of Repetro-SPED could result in a breach of legitimate expectations and frustration in the confidence and planning of taxpayers, who planned their investments considering the total exemption from federal taxes until December 31, 2040.

This could result in a violation of the principles of legitimate expectations, vested rights, good faith and legal certainty of taxpayers, who, in return for the investments made, relied on the grant of tax relief by the public administration. In this sense, taxpayer expectations and confidence should be protected when granting conditioned tax benefits and subject to certain deadlines, as in the case of

Repetro-SPED and Repetro-Industrialização.

In a study carried out in 2016 by the Brazilian Petroleum and Gas Institute (“IBP”)⁸ and by the Rio de Janeiro Federal University Institute of Economics, with the aim to analyze the potential impacts of creating new taxes and a possible non-renewal of Repetro (before the publication of Law No. 13,586/2017) on the viability of oil and gas exploration and production projects in Brazil, it was concluded that the extinction of Repetro would turn the projects economically unfeasible in Brazil.

The following scenarios were considered: (i) “**reference**”—continuity of the “old” Repetro and no new taxes would be imposed; (ii) “**without Repetro**”—Repetro would not be renewed and no new taxes would be imposed; (iii) “**with ICMS and TFPG**” (state tax fee related to the control, monitoring and environmental supervision of research activities, mining and the exploration and production of oil and gas) - continuity of Repetro and the imposition of ICMS on oil and gas production and an inspection fee,⁹ and (iv) “**all evil**” scenario—no renewal of Repetro and new taxes.

Despite the fact that the study was carried out based on the old legislation of Repetro (prior to Law No. 13,586/2017), the result showed that, without a tax and customs regime like Repetro, the price of a barrel of oil would have to be at least **USD 67.38** to make projects attractive. This would mean that Brazil would no longer be able to compete for investments in the oil and gas industry worldwide. As we know, in this sector, the competition for investments is worldwide, and the change of rules “in the middle of the game” would only disadvantage Brazil.

Total oil production in Brazil in 2019 was 1.018 billion barrels, an increase of 7.78 percent in relation to the volume produced in 2018, when 944.117 million barrels were produced. The total production of natural gas in 2019 was 44.724 billion m³, an increase of 9.46 percent over the 40.857 billion m³ registered in 2018.¹⁰ According to the National Agency of Petroleum, Natural Gas and Biofuels (“ANP”),¹¹ in 2019, oil and gas production in Brazil generated, in government take, the amount of BRL 126 billion.

In another more recent study,¹² in which the IBP analyzed the economic outlook for the energy sector, pointing out the prospects for a return to economic activity in the face of the crisis related to

COVID-19, the institute highlighted how the participation of the oil and gas sector in Brazilian trade balance can contribute to the country's economic recovery after COVID-19. According to this study, the economic recovery of the oil and gas sector is essential for the recovery of the Brazilian economy.

It could not be otherwise, since the oil sector is responsible for thousands of jobs and billions of Reals in investments, having significant relevance for the Brazilian economy. This is exactly why this sector must be subject to a special tax treatment, to make

its activities viable and, therefore, playing its main role: developing the national economy.

The approval of BL 3,887 with the original wording of Article 61 will not only prevent the development of the oil and gas sector and reduce investments, but will also negatively influence the Brazilian economy in general. We therefore reiterate the need to revise the original wording of PL 3,887, in order to expressly provide for the maintenance of the benefits of Repetro-SPED (in all its modalities) and Repetro-Industrialização with respect to CBS.

Endnotes

- ¹ "Art. 81. The suspension of the payment of the Import Tax or of the Excise Tax linked to the Import due to the application of special customs regimes also implies the suspension of the payment of CBS. Sole paragraph. The rules related to the special customs regimes apply, as appropriate, to CBS."
- ² Suspension is converted into exemption in accordance with Repetro-SPED rules.
- ³ According to Article 6 of Law No. 9826/1999, Article 61 of Law No. 10,833 / 2003 and Article 233 of the Customs Regulations.
- ⁴ Art. 2 The CBS is levied on the gross revenue referred to in article 12 of Decree-Law No. 1,598, of December 26, 1977, of each transaction. § 1 CBS is also levied on revenues arising from additions to gross revenue referred to in the main section, such as fines and charges. Paragraph 2. CBS is not levied on revenues from exports abroad, ensuring the accrual of credits linked to them.
- ⁵ Available in: <https://www.gov.br/economia/pt-br/assuntos/noticias/2020/agosto/ministerio-lanca-201cperguntas-e-respostas201d-sobre-os-principais-pontos-da-primeira-etapa-da-reforma-tributaria>
- ⁶ "1.12 What are the major special regimes that will be ended? A) Reporto; b) Repes; c) Recap; d) Reidi; e) Reintegrate; f) Padis; g) Repenec; h) Reicomp; i) Retaero; j) Renuclear; k) Retid; l) Recine; m) Repetro." Accessed on August 5, 2020.
- ⁷ According to the Opinion available in: <https://legis.senado.leg.br/sdleg-getter/documento?dm=7236417&ts=1593907648188&disposition=inline>
- ⁸ The original wording provided for a period of five years for benefits related to the definitive importation of goods used in the activities of exploration, development and production of oil and gas.
- ⁹ Available in: <https://www.ibp.org.br/observatorio-do-setor/analises/incentivos-e-barreiras-do-regime-tributario-no-setor-de-petroleo/>
The attractiveness of the projects in the three scenarios in the different tax scenarios was assessed using the Internal Rate of Return (IRR) and the break-even price. For the calculation of the IRR, the price of a barrel of US \$ 70 / barrel was considered. This price level was chosen to facilitate the comparison of the attractiveness among the scenarios and does not reflect the research team's forecast for the oil price in the project horizon. The break-even price corresponds to the price of oil sufficient to compensate for project costs, government take and generate a 10% return on invested capital. The break-even price is influenced by the time between investments and bonuses and the start of production.
- ¹⁰ Instituted by Law No. 7,182/2015 and subsequently deemed unconstitutional by the Supreme Federal Court through ADI No. 5480.
- ¹¹ Available in: <http://www.anp.gov.br/noticias/5596-producao-de-petroleo-sobe-7-78-no-brasil-em-2019-e-ultrapassa-pela-primeira-vez-a-marca-de-1-bilhao-de-barris-no-ano#:~:text=A%20produ%C3%A7%C3%A3o%20total%20de%20petr%C3%B3leo,produzidos%20944%2C117%20milh%C3%B5es%20de%20barris>
- ¹² According to the report of government takes of 2019. Available in: <http://www.anp.gov.br/royalties-e-outras-participacoes/participacoes-governamentais-consolidadas>
- ¹³ Available in: <https://www.ibp.org.br/observatorio-do-setor/analises/retomada-do-setor-de-oleo-e-gas-apos-a-pandemia-de-coronavirus/>

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