Overview of the Brazilian Tax System

Upstream taxation and foreign investment
I. Overview of the Brazilian Tax System

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I. Overview of the Brazilian Tax System

Brazilian legislation and regulations regarding accounting, taxes and corporate matters still do not provide a specific framework for the Oil and Gas industry, especially upstream activities. Nowadays, the industry is characterized by the presence of several companies acting both independently and through consortium agreements in order to carry out exploration, development and production activities.

Most of the companies currently investing in upstream in Brazil initiated its activities on the last years of the 90’s, especially since the market opening to local and foreign investors (the Brazilian state-owned company – Petrobras – was previously the exclusive monopoly concessionaire).

As a result, the accounting procedures adopted by each of the upstream companies are still diverse and many times influenced by the international accounting procedures adopted by the corresponding controlling companies. This situation might change with the adoption by Brazilian companies of the International Financial Reporting Standards (IFRS) and corresponding regulations that are being issued. Current legislation is not capable to provide adequate responses to several aspects associated with the upstream industry. Consequently, our comments in this guide are based on present legislation and regulations and what is our current interpretation of what would be applicable to the companies engaged in upstream activities.

Accordingly, this guide is not intended to represent a complete study regarding the tax implications related to the upstream petroleum and natural gas industry in Brazil, but instead, to provide an overview of the local environment for this segment of the Oil & Gas industry.

I.1 Introduction

The current Brazilian taxation system was introduced by the 1988 Constitution, which granted power to Federal, State and Municipal Governments to collect taxes. Due to the several regulations enacted by each of these governmental instances, Brazilian taxation system is very complex, leading to an environment in which taxpayers are required to comply with many obligations, both comprising tax collection and reporting (accessory obligations).

Within this same context, in January 2008 came into force the Law #11,638, enacted in December 2007, amending, repealing and adding new provisions on accounting matters. This law’s main purpose was to enable the convergence of accounting practices adopted in Brazil with the International Financial Report Standards (IFRS).

The transition of accounting procedures could have a direct effect on the Brazilian taxation system. This is the reason why, in May 2009 Federal Law #11,941 was enacted, providing for the transitional tax regime (RTT) which aim was to neutralize the effect derived from the adoption of the new accounting rules in the computation of the federal taxes, until the introduction of specific tax regulations on this matter.

Below you will find a brief summary of the Brazilian Taxation System, outlining the main taxes and contributions and the corresponding calculation basis and rates, including some of the changes observed in the past years. A more thorough description of these taxes is embedded in the guide’s applicable chapters.
I.1.A Federal Taxes

Federal taxes vary according to their nature, being the most important to the upstream industry those levied on:

- **Revenues / Sales**: Social Contributions on Gross Revenues (PIS and COFINS) and Federal Tax on Industrialized Goods (IPI);
- **Importation of Goods**: Federal Tax on Industrialized Goods (IPI), PIS-importation and COFINS-importation;
- **Importation of Services**: PIS-importation and COFINS-importation; and
- **Profits / Net Income**: Corporate Income Tax (IRPJ), and Social Contribution on Profits (CSLL).

Federal taxes also comprise Social Security Taxes (INSS and FGTS) and taxes levied upon financial transactions (IOF), which are briefly commented in this introductory section and for which we provide further comments in the specific sections.

In addition to those taxes, international transactions, especially those related to loans, royalties and service rendering, can be affected by the Brazilian Withholding Income Tax on Outbound Remittances (IRRF) and by the Contribution for Intervention in the Economic Domain (CIDE), for which we provide specific comments in sections IV and VI.2.

Below we present an overview of the Brazilian federal taxes, briefly pointing out its rates and calculation bases.

### I.1.A.1. Federal Taxes on Revenues / Sales

<table>
<thead>
<tr>
<th>Tax</th>
<th>Rate</th>
<th>Calculation Basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>PIS and COFINS</td>
<td>1.65% and 7.6% (respectively)</td>
<td>Calculated on gross revenues, subject to a “non-cumulative” mechanism in which some credits are allowed (basically, calculated upon inputs)</td>
</tr>
</tbody>
</table>

- PIS and COFINS are calculated and paid on a monthly basis;
- Some entities and/or revenues are not subject to the so-called “non-cumulative” system, being subject to lower rates of these taxes: PIS – 0.65% and COFINS – 3% (e.g. entities adopting the Estimated Profit for purposes of calculating its federal income taxes);
- PIS and COFINS rates applicable to financial revenues were reduced to 0% (except those derived from Interest on Net Equity);
- Revenues derived from the exportation of goods are exempt from PIS and COFINS and the corresponding credits accrued according to the “non-cumulative” system can be kept and used to offset other federal taxes;
- Rendering of services for entities resident or domiciled abroad, the revenues will also be exempt from PIS and COFINS and the corresponding credits accrued according to the “non-cumulative” system can be kept and used to offset other federal taxes, as long as the applicable payments are made in a convertible currency.

<table>
<thead>
<tr>
<th>Tax</th>
<th>Rate</th>
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</tr>
</thead>
<tbody>
<tr>
<td>IPI – Federal Tax on Industrialized Goods</td>
<td>Variable by product (HTS code)</td>
<td>Price of the industrialized good (Note that there is a credit mechanism that may be compared to a VAT system)</td>
</tr>
</tbody>
</table>
- IPI are usually calculated and paid on a monthly basis and the rates are based on the Harmonized Tariff Schedule (HTS) code;
- IPI is to be collected by the manufacturing company (note that importer of goods are deemed to be manufacturing company);
- IPI is not levied on the sales of natural gas, crude oil and its derivatives;
- Goods exported from Brazil are exempt from IPI and the corresponding credits accrued can be kept and used to offset other federal taxes.

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<tr>
<th>Tax</th>
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<tbody>
<tr>
<td>II – Import Duty</td>
<td>Variable by product (HTS code)</td>
<td>Custom value of the imported good (CIF value)</td>
</tr>
</tbody>
</table>

• II is due on the custom’s clearance and the rates are based on the Harmonized Tariff Schedule (HTS) code;
• II is not a creditable tax.

<table>
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</thead>
<tbody>
<tr>
<td>IPI – Federal Tax on Industrialized Goods</td>
<td>Variable by product (HTS code)</td>
<td>Custom value of the imported good (CIF value) plus the Import Duty (Note that there is a credit mechanism that may be compared to a VAT system)</td>
</tr>
</tbody>
</table>

• IPI is due on the custom’s clearance and the rates are based on the Harmonized Tariff Schedule (HTS) code.

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<tr>
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<tbody>
<tr>
<td>PIS-importation and COFINS-importation</td>
<td>1.65% and 7.6% (respectively)</td>
<td>CIF value added by State Value-added Tax – ICMS (specially calculated) – due upon importation and the PIS-importation / COFINS-importation themselves (gross-up method).</td>
</tr>
</tbody>
</table>

• The above-mentioned rates are the general rates applicable on the importation of goods. However, some items are subject to exemptions or different PIS-importation and COFINS-importation rates;
• PIS-importation and COFINS-importation are due upon the registration of the Import Declaration (DI).

I.1.A.3. Federal Taxes on Importation of Services

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>PIS-importation and COFINS-importation</td>
<td>1.65% and 7.6% (respectively)</td>
<td>Comprises the amounts paid, credited, delivered or remitted abroad (before the withholding income tax), plus the Municipal Tax on Services (ISS) and the PIS-importation and COFINS-importation themselves (gross-up method).</td>
</tr>
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• PIS-importation and COFINS-importation are due upon the payment, credit, delivery or remittance of the amounts related to the service import.


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<tbody>
<tr>
<td>Corporate Income Tax (IRPJ)</td>
<td>effective 25% rate (15% plus a 10% surtax on annual taxable income exceeding R$240,000.00)</td>
<td>Taxable Income, understood as the accounted for net income (profit or loss) as per financial statements as of the end of the tax period (quarter or year), adjusted by add-backs and exclusions provided by the tax legislation.</td>
</tr>
</tbody>
</table>

• Taxpayers may choose one of the three taxation methods provided by the tax legislation for purposes of calculating IRPJ and CSLL. These methods are: Taxable Income (Lucro Real), Estimated Profit (Lucro Presumido) and Arbitrated Profit (Lucro Arbitrado);
• Taxpayers that choose the Taxable Income method are eligible to calculate IRPJ on an annual (Lucro Real Anual) or quarterly basis (Lucro Real Trimestral). In case of adoption of the annual calculation period, tax anticipations must be calculated and collected (if applicable) on a monthly basis, based on monthly revenues (Receita Bruta e Acréscimos) or year-to-date accounted for net income (Balancete de Suspensão e Redução);
• Tax losses, understood as the IRPJ Net Operating Losses (NOLs) and the CSLL negative bases (CSLL NOLs) have no statute of limitations, remaining available for an indefinite period. However, please note that NOLs offsetting is limited to 30% of the periods’ Taxable Income / CSLL positive calculation basis;
• The IRPJ and CSLL calculations in the Estimated Profit and Arbitrated Profit methods are not based on the company’s net income, but rather on the determination of deemed profit percentages, which varies according to the company’s activities. Under these methods, IRPJ and CSLL payments are due on a quarterly basis.
I.1.A.5. Social Security Taxes

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>INSS (Social Security Contribution)</td>
<td>Usually ranges from 26.8% to 28.8%</td>
<td>Total gross compensation amounts paid to employees.</td>
</tr>
<tr>
<td>FGTS (Severance Indemnity Fund)</td>
<td>8%</td>
<td>Total gross compensation amounts paid to employees.</td>
</tr>
</tbody>
</table>

- The INSS rate is based on: a) the Social Security contribution itself (20%), b) the RAT contribution (Work accident risk – 0.5% to 6%), that is determined considering the risk-level associated with the activities developed by the Company, and c) the payments of additional Social Security charges (usually 5.8%), that must be made to the Federal Government, who will then transfer the funds to third parties (Senai, Sesc, Sebrae, among others).
- Regarding the Severance Indemnity Fund (FGTS), companies must pay a 50% fine in case of unfair dismissal (that is, termination without cause). The applicable FGTS rate is 8%.


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</tr>
</thead>
<tbody>
<tr>
<td>IOF</td>
<td>Varies according to the financial transaction</td>
<td>Financial operations (e.g. outstanding loan balances, insurance contracted).</td>
</tr>
</tbody>
</table>

It is not a cumulative tax, that is, such tax is only assessed on the increase in the price of the product in each part of the circulation process. The calculation process involves a system that, in each payment period, the taxpayer must check the amount of ICMS debits (generated on the circulation of merchandise/rendering of services) and ICMS credits (generated on the acquisition of goods) and if the taxpayer has more debits than credits, it will have to pay the tax on the difference.

Since the collection of this tax is under state responsibility, each of the Brazilian states has specific regulations concerning ICMS calculation, rates, payments and accessory obligations. Therefore, companies that operate in different states are subject to several different compliance requirements.

The ICMS is collected by most states at the rate of 17%, except for the states of São Paulo and Minas Gerais, whose tax rate is 18%, and Rio de Janeiro, whose tax rate is 19% - special rates apply to interstate sales.

I.1.C Municipal Taxes

Supplies of services, other than those subject to ICMS, are subject to a cumulative tax called Imposto Sobre Serviços (ISS). This is a municipal tax on certain services listed by the federal government as per Complementary Law # 116/2003. The taxable basis of ISS is the price of the service rendered.

In general, the service tax is levied by the municipality in which the company is established and its rates vary from 2% to 5%. ISS is also due on the purchase of services from entities domiciled overseas (the so-called importation of services) in case the service is performed in Brazil or in case the results of this service are verified in our country.

I.1.B State Taxes

The 1998 Constitution granted authority to the Brazilian States to collect the tax on the circulation of merchandise and on rendering of interstate and intermunicipal transportation services and on communications, even when the transaction and the rendering of services start in another country, including import operations.
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