

Changes in withholding tax exemption for charter contracts

By André Hazan Fonseca*



The triangular contract structure between contractors and Petrobras and other oil exploration rights owners for Charter and Services agreements of drilling rigs, FPSOs and supply vessels, has its origins in a legitimate tax planning based on an exemption of Withholding Tax (WHT), established by art. 1, item I, of Law No. 9.481/97.

This exemption reduces the WHT tax rate from 15 percent to 0 percent on payments to foreign companies related to charter agreements of vessels. As it is only applicable to charter agreements, and not to a combined contract of charter and services, two distinct contracts are necessary: one exclusively for the charter of the rig, signed with the foreign company, and another for the services of operating this rig, signed with a Brazilian company, usually a subsidiary of the foreign company.

With this under consideration, the operation is divided between the Charter Agreement, which represents 85-90 percent of the total contract price, and the Services Agreement, which represents the remaining 10-15 percent.

Nevertheless, even though this is - in principle - a legitimate contractual structure, the Brazilian Revenue Service (BRS) has long been against this tax planning. This is partially because tax authorities believe the oil and gas industry already has too many tax benefits with REPETRO. It is also partially due to isolated cases in which this triangular contract structure is abused

by the parties, by allocating the exempt portion (Charter Agreement) a percentage that is too high, while the Services Agreement cannot break even.

This position by BRS has led to major tax assessments, under a few different legal bases, which may represent a massive impact in the cost of the operation.

Now it seems that Congress has taken a step towards mitigating these tax risks. On October 29, 2014, Congress passed a new legislation (art. 115 of Projeto de Lei de Conversão No. 15/2014), which now awaits presidential sanction.

This article establishes the maximum percentage attributable to the Charter Agreement in order to maintain the WHT exemption. This percentage varies according to the operation (see box).

Even though this legislation limits the exemption of WHT to a maximum percentage of the total day rate, it specifically mentions charters of floating production systems and/or drillships as exempt, up to the limits above. This should end the controversy regarding whether or not the WHT exemption is applicable to them. It does not mention drilling platforms, but the same logic should apply.

This limitation may represent a challenge for supply vessels, which would have to limit their exempt Charter Agreement to 65 percent of the total day rate. Nevertheless, §8 of the article establishes that the Minister of Finance may increase or reduce the limits by 10 percent. It will be up to industry to lobby for an increase.

There are several other aspects of this new legislation that deserve comments, but the space is short, and, perhaps, by the time the next issue of the magazine is published, there will be more light upon the uncertainties we face today.

Vessel Chartered	Charter Maximum Percentage of Day Rate
Floating Production Systems	85%
Drillship	80%
Other vessels	65%

*André Hazan Fonseca is a Partner at Hazan Fonseca Advogados.