

Brazil's Petrobras Wins \$2.4 Billion Appeal Over Deductions of Oil Development Costs

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By William Hoke

Brazil's Petr leo Brasileiro SA (Petrobras) was justified in taking deductions for development of an oil and gas field during fiscal 2010, an administrative tax appeals board ruled October 20. The company said the decision negates an assessment for BRL 7.8 billion (around \$2.4 billion) issued by the Federal Revenue Service (RFB).

The RFB had argued that the company's costs were not deductible in the year of expenditure, and should have been amortized. In March another appeals panel agreed with Petrobras, a public company in which the government owns a majority stake, in the company's challenge of assessments disallowing deductions on its 2009 tax returns for corporate income tax and the social contribution on net profit.

In its June 30 financial statements, Petrobras included a contingent liability of \$4.7 billion related to the tax dispute over the amount of allowable deductions for crude oil production development costs. The company didn't state at that time what periods the contingent liability applied to.

Leonardo Homsy of Mattos Filho, Veiga Filho, Marrey Jr. e Quiroga said section 416 of Decree 3,000/99 allowed Petrobras (and only Petrobras) to deduct expenses in the same year they were incurred for exploration and production activities. When the decree was issued in 1999, Petrobras held a monopoly over the exploration and production segment of the oil and gas industry in Brazil. Homsy said that because the decree didn't include the development phase, the RFB claimed that the expenses for that phase should have been capitalized and then amortized over succeeding years.

"The tax authorities also [said] that the section of the legislation in question was unconstitutional because it granted only Petrobras with such a 'benefit,'" Homsy said. "However, the administrative court ruled that the tax administration has no power to question the constitutionality of a law. Moreover, the judges mentioned in the decision that . . . the legislation should have been interpreted in a way that extends to all oil and gas companies acting in Brazil."

Homsy said the decision by the appeals panel appears to be consistent with both the tax code and the Brazilian Constitution. The rulings by the appeals panels for both the 2009 and 2010 tax years were unanimous in the company's favor.

Homsy said that, historically, the tax treatment of exploration and development costs has been unclear and subject to controversy. "The tax authorities have even expressed [a position] that exploration costs should be treated as pre-operational and therefore not possible to be directly expensed, but rather, amortized upon starting of production," he said.

Mario Graziani Prada of Machado, Meyer, Sendacz e Opice said the RFB could ask for a review of the decision by the highest chamber of the administrative appeals body, but only if it conflicts with rulings reached by other, lower-level panels. “Apparently, there are no other precedents in favor of the tax authorities,” he said.

Prada said the government recently issued a decree (795/17) revoking section 416 of Decree 3,000/99 that is currently before the National Congress awaiting approval.

Homsy said the new decree should bring clarity to the issue as it finally regulates the tax treatment for expenses and costs related to oil and gas exploration and production activities. “Basically, [the] provisional measure allows companies to expense, as incurred, exploration and production costs. For development costs, it provides an accelerated amortization regime,” he said.