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The Global Corporate Advisor

The Corporate Finance newsletter of Crowe Horwath International

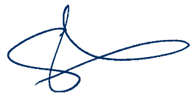
In this month's issue, our primary focus is on the new reality for natural resources companies seeking to finance exploration activities and development projects in volatile and difficult markets.

While most observers expect commodity prices to continue to increase as the world seeks raw materials to fuel global growth, the demand for funding among natural resources companies will be relentless. This dynamic will present compelling opportunities for natural resources companies, but the challenge will be to secure the right kind of funding from the right sources, in a flawed global marketplace where competition is intense.

For smaller natural resources companies seeking to raise finance, finding equity investors remains particularly challenging. For that reason, clients are becoming more nimble, challenging the ways they have operated in the past, and funding sources are becoming more innovative.

This month, Peter Bishop and Fintan Connolly from Brisbane look at the practical experiences of Crowe Horwath in Australia, a key natural resources marketplace. We also take a closer look at an increasingly important source of funding – commodity stream finance. Courtesy of Andrew Raca at VSA Capital, we get a marketplace overview from a London-based but globally 'market agnostic' investment banking and institutional broking firm focused on natural resources.

We also include in this issue a consideration of risk premiums used in the valuation of small and medium-sized companies prepared by Professor Roger Tiest, a partner at Callens, Pirenne, Theunissen & Co in Belgium, and an overview of the complexities of the Brazilian tax system produced by Franklin Bendoraytes, a GCA partner at Crowe Horwath Brazil.



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Contact Us

As ever, the GCA team is here to respond to your needs relating to M&A transaction support, valuations and M&A advisory services. If there is a topic you would like us to cover in future issues of the GCA newsletter, don't hesitate to contact Peter Varley, Chairman of GCA at *peter.varley@crowecw.co.uk*. Alternatively, please contact your local member of the GCA team to discuss your ideas.

Inside This Issue:

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Fundraising in the Resources Sector: a New Reality

By Andrew Raca, VSA Capital, London

"If you can keep your head when all about you are losing theirs, you probably haven't appreciated the gravity of the situation."

With apologies to Rudyard Kipling, this statement neatly sums up the current predicament of many mining exploration companies rather well.

Natural resources companies have a relentless need for funding, but firms are facing a very different environment to the 'good old days'. Times are very different to, say, 1988, when Cairn Energy – now capitalized at £1.7 billion – could list on the London Stock Exchange for £25 million. Instead, mining entrepreneurs complain about the regulatory burdens and the extortionate costs of being listed, whereas bruised investors add to the malaise by spurning IPOs.

The outlook is improving, however. We are detecting real market changes, which – combined with recent market moves, more competitive monetary stimulus from central banks and less economic uncertainty – have supported a stronger risk appetite from investors, although for the smaller natural resources companies seeking to raise finance, finding equity investors remains particularly challenging. In addition, ongoing increases to commodities prices will continue as the world seeks raw materials to fuel global growth.

This will present compelling opportunities for natural resources companies and investors alike. The challenge will be to secure the right kind of funding from the right sources in a flawed global marketplace characterized by intense competition. To do this, companies and their advisors may need to look for funding from different places and consider alternatives to straight equity.

The market outlook

Most institutional investors have over-allocated their portfolios to the safe havens of cash and fixed-income assets for years, with the result that under exposure to equities has reached record levels. UK pension funds, which had an allocation to equity above 70% in the 1990s and above 60% in the 2000s, now have typically less than 40% invested in equity. In addition, many insurance companies in Europe currently hold less than 10% of their portfolios in equity.

However, these safe havens are beginning to look less attractive as 'risk-on' investment strategies come back into favor. Many institutional investors are beginning to realign their portfolios in asset classes to historic levels. This shift could continue to underpin equity markets for some time, even if global economic conditions remain uncertain.

In addition, China's insatiable demand for resources and remarkably deep pockets for the right strategic investments will also help energize the market. One recent example is the A$58 million rights issue by Northern Minerals to fund its Browns Range rare earths project – which was substantially underwritten by China's Conglin Group.

Emerging strategies

For institutions that can trade the physical side of metals as well as equity, the question in the minds of portfolio managers is 'where does my risk lie?'

Smart investors in natural resources have therefore seen opportunities for pairing trades: they go long on a particular commodity (such as gold or copper, whose prices have been increasing in recent times) and then go short on equities of companies exposed to that particular commodity, where prices have been declining. This strategy can complicate equity fundraising, and natural resources companies should be aware of this when seeking funding.

Offtake and marketing agreements for mine developers and producers are becoming increasingly popular. These deals involve selling future output to secure project finance and development to production. However, selling future streams must be carefully structured to avoid the sort of hedging mistakes of the 2000's or to prevent investors being put off by limited upsides.

Making your case

Another challenge for companies is that investors are overwhelmed with opportunities and they are very particular about assessing and managing risk. Investors want to know answers to questions like:

- Can you mine the mineral resources economically?
- What sort of infrastructure – road, rail, power, and water – is required?
- What will come out of the ground and how will you optimally process it?
- Is the local government taking a benign or intrusive approach, and can you get assurance of terms and sovereignty over mining title?
- What levels of financing are required to realize value, and how far does each financing take you?
- What local and environmental issues must you accommodate?
- How good is the team that will deliver all this?

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These may sound like obvious points but investors take them seriously. Many companies neglect to address these issues fully when presenting their investment case. Further, care should be taken to present each of these components in a way that allows them to be evaluated individually and collectively against other investment opportunities worldwide.

The breaking of the covenant

Listing used to liberate business founders and entrepreneurs, give them tangible value for their shares, and reward their entrepreneurialism. Companies gained access to simple, straightforward long-term equity funding, and shares generally went up in value.

We believe that this traditional model – the 'sacred covenant' – is broken. Obtaining funding is no longer as straightforward as simply raising equity finance from pools of capital overseen by long-only fund managers devoted to equity salesmen from their favorite broking houses.

Most brokers want private companies to list because that is what their traditional investing clients want. In this new reality, what companies really need are advisors that understand their company and what they are trying to achieve, and who can effectively advise how best to secure funding in an increasingly complex, and global, arena.

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Breaking with Tradition: Helping Mining Companies Find New Financing Strategies in Challenging Markets

By Peter Bishop and Fintan Connolly, Brisbane

In recent years, mining companies have been at the center of a perfect storm. They've been hit by volatile capital markets, negative sentiment (which has driven down commodity prices), and higher costs. These factors have dampened investors' appetite for mining stocks and threatened funding sources for small and early-stage miners.

This lack of liquidity has affected the valuations of smaller mining companies, and in some cases their market values have fallen below the fair value of their underlying assets. This experience has been replicated across global markets.

In our experience, mining companies are increasingly looking to make up funding shortfalls through non-traditional corporate finance strategies. In this article, we will discuss a number of these strategies, including cost reduction measures and innovative corporate transactions.

Exploring new sources of capital

Traditionally, mining companies seek funding through equity markets and return to the market to meet additional project requirements. However, over the past 12 to 18 months, many equity raising efforts have struggled to close even at discounted prices, or failed altogether.

As a result, only the most confident mining companies are considering IPOs and most miners are considering alternative sources of funding.

Royalty financing

A number of investors are open to funding proven assets that are close to or already extracting resources. Under royalty financing, investors provide up-front finance, and receive a fixed percentage payment from future project revenue. However, this approach is only available for later-stage projects and opportunities.

Commodity-stream finance

Similar to royalty financing, an investor agrees to purchase all or part of an asset's future production in exchange for an up-front cash payment (with conditions attached). This form of finance is also best suited to later stage projects.

Private placements

Off-market capital raisings (known as private placements) can help mining companies mitigate the difficulties and potential costs of capital raisings on public markets. By directly negotiating with private providers of capital (such as investment funds and family offices), investors can secure the incentives they need to invest in mining companies.

Further, recent changes to Australian Securities Exchange (ASX) rules help facilitate private placements. From August 1, 2012, listed entities with a market capitalization of less than A$300 million can issue up to 25% of their share capital through off-market placements within a 12 month period. However, companies must meet two conditions:

- shareholders approve the placement at the annual general meeting
- shares are not offered at a discount greater than 25% of their 15-day volume weighted average price.

Structured finance

A number of structured lenders and equity investors offer finance to listed mining companies, including through standby equity distribution arrangements and convertible loans.

These arrangements can offer companies access to funds by capitalizing on the upside potential of listed equity, while incorporating drawdown measures to protect investors from downside risks in volatile markets.

In our experience, these arrangements are most appropriate to mining companies with strong prospects for share price growth and demonstrable cash flows and can be unpopular with brokers as they create a market overhang that may discourage further equity investment.

Dual listing

Another option is for ASX-listed mining companies to undertake a secondary listing on another international market with a focus on mining, such as TSX or TSX-V in Toronto, or AIM in London. For instance, the London Stock Exchange offers a fast-track route to a dual listing on AIM from the ASX (and other designated markets around the world).

Dual listing can help raise awareness of ASX-listed companies and create access to wider and deeper pools of international capital. However, a dual listing can add further cost burdens if it is not coupled with a successful fundraising round.

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Improving internal processes

Mining companies can also help resolve funding shortages through cost-reduction strategies.

For example, our team works closely with mining company managers to give them an independent financial assessment of their operations and projects. We examine the merits of current spending, project, and funding strategies, and identify opportunities for improvement.

In our experience, mining companies can become more efficient and reduce costs through the following steps.

Cost-rationalization programs

Companies can save funds by streamlining their operations. This may involve outsourcing administrative functions and non–value adding services, renegotiating supply contracts, and encouraging business partners to provide services in exchange for a stake in the project or opportunity.

Identifying new sources of revenue

Some businesses can develop new revenue streams by leasing out surplus premises or equipment, or harnessing internal management skills to consult to third parties (such as other mining and exploration companies).

Accessing government incentives

The Australian Government offers incentive schemes that can help mining companies access funds to improve their operations, including:

- *The research and development (R&D) tax incentive:* This scheme offers an additional 15% income tax saving on expenditure incurred during eligible R&D activities. In some cases, this saving takes the form of a tax credit. While this incentive does not typically apply to exploration or drilling activities, it may apply to R&D of new technology or processes – such as those developed to extract or refine resources.
- *Clean energy grants:* Other schemes can assist in the development and commercialization of products, and clean energy technology.

The need for constant vigilance

Cost reduction is an ongoing process. We recommend miners subject their planned projects to continuous examination and funding review to help ensure effective project management and cost control. This may include:

- Reprioritizing capital projects: Companies should focus on projects with the most likely or accessible returns, rather than those with the greatest absolute return.
- Re-assessing business cases: In the case of underperforming projects, likely returns may need to be reconsidered.
- Reviewing project controls: Current expense and progress metrics should be examined to ensure they will help deliver a project on time and to budget.

Exploring innovative corporate transactions

A final way to resolve funding issues is for mining companies to undertake innovative corporate transactions that bolster their short to medium-term outlook and improve shareholder value.

Acquisitions

Where mining companies have surplus funds, they can take advantage of the currently low valuations to acquire businesses and projects. This may include acquiring targets with greater cash reserves, or that are likely to have more success in future capital raisings. Further, this strategy can help mining companies boost their deal pipeline.

Joint ventures and M&A

By joining with other businesses, mining companies can combine management expertise and assets, allowing for productivity improvements, cost reductions, and better asset utilization. This consolidation may take place through joint ventures or M&A activity.

Selling non-core assets

Mining companies can increase their cash reserves by selling off non-core assets that have attractive and realizable market values.

However, in enacting this strategy, managers need to take care in selecting which assets to dispose of, and how they structure disposals; consider how easy it is to find interested parties; determine whether the assets are of strategic value to other parties; and account for potential financial, taxation, and legal risks.

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Management buy outs

In the current climate, mining company managers may see greater value in their business than the market does. If managers believe that we have reached the bottom of the cycle and that market valuations are irrationally low, they may wish to buy their operations.

Going private

In a volatile and illiquid market, the costs and burdens of being publicly listed may outweigh the benefits – particularly as deep sources of funding are hard to find. If this is the case, it may be an option to delist the company and return to private ownership.

Conclusion

Mining companies have a number of non-traditional ways to seek finance in a very challenging funding environment. We believe that the most successful companies will be those that embrace innovation and combine a variety of methods to secure sustainable and long-term funds.

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Explaining Commodity Stream Finance

By Stephen Bullock, London

Commodity stream finance is an attractive option for mining companies with advanced-stage development projects or operating mines.

It involves a commodity purchase agreement between a mine operator and an investor (usually a specialist fund or non-operating mining company). The party providing the finance (or purchasing the commodity) makes an upfront cash payment to the operator in exchange for the right to purchase a percentage of the mine's commodity at a fixed price.

Here are two recent examples showing how this form of financing works in practice.

Case study one

The mine is a massive underground sulfide copper-gold mine located in northern Canada – an area which has a strong history of gold, base metal and industrial minerals mining. The company is operated by a company listed on Canada's TSX Venture Exchange and London's AIM Market.

The mine's stream finance agreement entitles its investor to 25% of the first 175,000 ounces of gold and 12% of the life of mine gold produced after that. To acquire this stream, the investor made an upfront payment of US$20 million. Under the agreement, the cost per ounce for the gold delivered from the mine is zero.

The mining company used the upfront payment to help finance the mine's development. The company provided the investor with the following completion guarantees:

- production of payable gold within 24 months of commencement or the investor will have the option to require a partial refund of its upfront payment
- minimum cash flows from the gold stream in the first three years of production.

The outstanding balance on the upfront payment is secured by a fixed and floating debenture over the assets of the mining company (subject to ranking with other creditors).

The mine was not producing gold when the financing arrangement was entered into. As a result, the agreement included provisions under which the upfront payment could be wholly or partially repayable on demand. As such, this advance payment was recorded as a loan liability, and any estimated payments over and above the repayment of the amount of the principal were accounted for as financing charges.

Further, future cash flows that arise from sales of payable gold have been estimated. These values depend on future production, gold prices at the time of delivery and the total amount of gold expected to be produced over the life of the mine. Estimates are also used to calculate an effective rate of interest on the loan.

Case study two

This mine is located in the Timmins gold district in Canada. It is 100% owned and operated by a mining company listed on TSX Venture Exchange. The mine includes concurrent open pit and underground operations. The ore is trucked to a nearby mill, which processes 2,200 tons per day.

The stream finance agreement entitles the investor to purchase 12% of the gold produced over the life of the main mine, and 10% of the gold produced over the life an extension to the mine. The agreement applies over a maximum period of 80 years at a fixed price per ounce which is the lesser of US$500 an ounce (with an annual inflation adjustment capped at 2%) and the London fix gold price.

The investor made an upfront payment of US$56 million to acquire the stream. The mining company used the upfront payment to repay existing derivative-based borrowing facilities and to provide general working capital.

The outstanding balance on the upfront payment will be amortized over the life of the agreement. The amount is equal to the difference between the market price of gold at the date of delivery and the fixed price, multiplied by the number of ounces of gold delivered.

The outstanding balance on the upfront payment is secured by a fixed and floating debenture over the assets of the mining company (subject to ranking with other creditors).

This mine was a producing mine at the time the financing arrangement was entered into. The investor did not include any provisions under which the upfront payment could be wholly or partially repayable on demand.

This advance was therefore accounted for as a sale of gold at the point it received the money to acquire the stream. The sale created a cash receipt in advance for the gold not yet delivered, which gave rise to deferred revenues.

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Disclosure is included in the financial statements of the mining company under 'deferred revenues' rather than debt, although the deferred revenue balance was recorded within liabilities and split between current and non-current amounts. Revenues recognized on future deliveries of gold under the agreement are recorded by releasing part of the deferred revenue balance.

The investor's role in commodity stream finance

In both examples, the investor seeks to secure the risks and rewards associated with mining by providing for specific projects.

In both cases, the investor expects to make its return from the sale of purchased gold over time at a margin between the applicable market price when it sells, and the fixed or formula price at which it is contracted to purchase the gold.

The investor makes an informed decision when entering into commodity-stream finance and its related purchase contracts. Investors expect that the net present value of the future cash flows from contracted gold purchases will considerably exceed the amounts advanced.

In essence, the nature of the finance provided is the same – a gold purchase agreement. The investor does not charge an interest coupon in either case and investment return is based on an equity interest in the assets. The accounting by the mining companies is different because the substance and conditionality of the funding is different – in the first case a mine development loan accounted for as a financial liability attracting a financing charge and in the second case an advance of consideration for future gold purchases.

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Calculating Risk Premiums for Small and Medium-Sized Companies During Valuations

By Roger Tiest, Antwerp

When buyers are looking to acquire other businesses, it is important they undertake a valuation to understand how much the target is worth.

Most valuation techniques involve reducing future income or profit to its present value by using a discount rate. This rate typically reflects the general conditions of an industry, but not the specific circumstances of a target company.

However, individual companies face different levels of risk. During valuation, there are many ways to identify such risks, incorporate risks into schemes, and assess the links between risks and general industry indicators.

However, there is little consensus on how to incorporate company-specific risks into valuations. In this article, we will establish a valuation method that accounts for the characteristics of a target company when calculating the risk-premium component of the discount rate.

Figure 1: Risk factor analysis for a company

Risk factor	Risk rating (0 to 5)	Weighting	Weighted risk
Market and competition		(a)	(b)
Quality of products and services	2	1	2
Differentiation of goods and services	2	1	2
Market trends	3	1	3
Market position or share	2	1	2
Price competition	3	2	6
Low entry barriers	2	2	4
Protection of legal rights	**1**	**1**	**1**
Subtotal		**9**	**20**
Total weighted risk average (b)/(a)/100			**2.22%**
Financials			
Continual or seasonal impact	1	1	1
Long term debt to equity ratio	0	1	0
Liquidity and cash flows	2	1	2
Financing and credit flexibility	0	2	0
Financial stability	1	1	1
Actual credit facilities	0	1	0
Subtotal		**7**	**4**
Total weighted risk average			**0.57%**
Operations			
Customer credits and turnover	1	1	1
Inventory turnover	2	1	2
Turnover and short-term assets	2	1	2
Customer loyalty	2	1	2
Workforce turnover	4	1	4

Risk factor	Risk rating (0 to 5)	Weighting	Weighted risk
Management quality	1	1	1
Infrastructure quality	2	1	2
Administrative quality	3	1	3
Importance of contracts	1	1	1
Subtotal		**9**	**18**
Total weighted risk average			**2.00%**
Stability			
Years of operation	3	1	3
Company size	2	2	4
Product and technology life-cycle	3	3	9
Societal influences	2	1	2
Government influences	0	1	0
Social environment	1	1	1
Subtotal		**9**	**19**
Total weighted risk average			**2.11%**
Profitability			
Gross sales margin	2	2	4
Return on fixed assets	2	1	2
Return on shareholders' equity	1	1	1
Contribution margin	2	1	2
Dividend requirements	1	1	1
Subtotal		**6**	**10**
Total weighted risk average			**1.67%**
Total risk premium			**8.57%**

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Taking a build-up approach

The build-up method calculates a discount rate by applying a premium to a company's risk components, such as entry barriers, legal protections, liquidity and cash flows, and customer loyalty. Build-up formulas help to specify the risks in a target company, and their relative importance.

Some analysts use the Black/Green Build-up Summation Method for this purpose, but this method tends to focus on company weaknesses. We recommend a more balanced approach; one that considers company strengths and characteristics that may positively affect risk profiles.

A more sophisticated analysis of a target company's strengths and weaknesses (supported by detailed due diligence) can identify all relevant company and market factors. Reliable risk profiles and reference periods for risk compensation can then be constructed. This approach is very flexible and can be adapted to the specifics of the company and market under consideration.

Examining risk

Consider the risk analysis example in Figure 1. The table contains an assessment of all future risks for a hypothetical company, conducted as part of the process of calculating an appropriate discount rate. Business valuation practitioners will typically use a five-point scale where a score of '5' represents a considerable risk that could reduce a target company's value.

Our analysis allows for risk values of zero, which indicates strength rather than weakness. However, we do not believe it is valuable to include 'negative' risk values or risk reduction factors. After all, these values do not offset risks in other areas, but they may provide resources to counter risks.

We will also apply a constraint to the risk premium. When calculating discount rates, it is not useful to frequently use risk-free interest rates and risk premiums of zero, as these values could reduce takeover bids to symbolic amounts with little returns for investors.

Instead, we will apply a 15% constraint on any risk premium. This means that a company's value will diminish by 50% after five years. In our opinion, this seems to be the lower value limit for a company that conducts its operations in a considered way.

If we add another 4% to the risk-free interest rate, our discount rate will increase to 19%, which will yield a company value of 42% after five years. In this scenario, potential new owners (who receive a reduced sale price) will need 22 years of 4% risk-free investment to receive the company's value, as they have received the company's net present value in cash.

Validating risk analysis estimates

Risk analysis estimates should always be justified, including through:

- Due diligence: This will highlight positive and negative aspects of the business, and clarify the need for future investment.
- Strength, weaknesses, opportunities and threat (SWOT) analysis: This will help highlight areas of concern and opportunity.
- *Detailed financial analysis:* This analysis will evaluate risks and continuity arrangements.
- Third-party research: Research from industry and business publications.

By taking this individual and comprehensive approach, we can incorporate a number of items into the valuation – such as size risk premiums and general industry-related risk rates.

The shifting risk landscape

Naturally, risks and risk compensation will change over the course of a business's operations. There are a number of ways to incorporate such changes in valuation calculations.

First, valuation practitioners can align specific risks to time periods. For example, practitioners may establish risk levels for the first three years of a reference period, and then undertake fresh calculations for the following five years.

Second, professionals can use compound calculations that allow for a gradual increase of pre-established risk levels. The important issue is how to determine the rate at which risk increases.

A final approach involves constructing annual tables to calculate risk premiums for specific reference periods. Business valuation practitioners can adjust this table as the company's circumstances change.

Each of these approaches can support robust analysis and decision making, which forms a valuable foundation for reliable business valuation.

This article is an edited excerpt from the book 'Manual on business valuation for small and medium-sized companies: due diligence and valuation techniques', by Professor Roger Tiest and published by Intersentia, Antwerp and Cambridge, 2013. The book discusses due diligence, the basics of mathematical techniques, defining and calculating variables, and several evaluation methods.

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Taxing Times: Negotiating Brazil's Complex Tax Landscape

By Franklin Bendoraytes, Rio de Janeiro

Brazil's taxation environment is among the most complex in the world and the penalties for non-compliance can be harsh. This means businesses must undertake detailed tax planning to ensure their strategic decisions result in profits rather than large tax bills.

In this article we will discuss the array of taxes in Brazil, with a focus on corporate taxes.

Brazil's tax system

The Brazilian tax system consists of a range of different taxes levied by the Federal Government, 27 states and more than 5,500 municipalities.

This complicated environment means companies have to pay close attention to a variety of compliance demands. Therefore, businesses need the services of highly-experienced tax professionals to complete forms, provide error-free information and regularly update critical tax and company details.

While these tasks can consume valuable resources, it is usually more appealing to ensure compliance than the alternative. Tax and income errors can lead to under or overpayment of tax, which can in turn result in substantial fines and penalties (including jail time).

When it comes to tax assessments, officials generally issue infraction notices as soon as they spot a potential mistake. They don't wait for the opportunity to discuss the error with a company or business. This is true even if the tax department has not lost any revenue, and even if the department's interpretation is unlikely to hold up on appeal.

Types of taxes

There are nearly 50 different taxes in Brazil, each with multiple rates. A summary of the country's major taxes and contributions is listed in Figure 1.

Corporate income and social contribution taxes

Companies face the Corporate Income tax (IRPJ) and the Social Contribution tax (CSLL).

The IRPJ is calculated as 15% of net profit. Any profits that exceed R$240,000 (US$120,000) in a given year are subject to an additional tax rate of 10%. The CSLL is calculated as 9% of net profit.

Both tax measures can be based on companies' actual or estimated profits.

Under the actual profit regime, companies calculate their quarterly or annual income tax liability based on their net profit for the relevant taxable period – subject to additions and deductions allowed under tax law. The following companies must use this method:

- those with total gross income in the previous year of more than R$48 million (US$24 million)
- financial institutions, insurance companies, and similar entities
- legal entities that derive profits, income, or capital gains from overseas.

Figure 1: Brazil's main taxes

Tax jurisdiction	Taxes
Union	■ On imports of goods and services (II) ■ On exports of goods and services (IE) ■ On income and earnings (IR) ■ On industrialized products (IPI), a value added tax levied on manufactured goods ■ On financial operations (IOF) ■ On rural land property (ITR)
States	■ On inheritance and gifts (ITCD) ■ On the circulation of goods and transportation and communication services (ICMS), a value added tax levied on goods in general and some services ■ On motor vehicles (IPVA)
Municipalities	■ On urban land property (IPTU) ■ On real estate conveyance (ITBI) ■ On services (ISS), except those subject to ICMS
Tax jurisdiction	**Contribution**
Union	■ Contribution for the Financing of Social Security (COFINS) ■ Social Integration Program/Civil Servants Savings Program Contribution (PIS/PASEP) ■ Contribution on Net Profit (CSLL) ■ Provisional Contribution on Financial Movement (CPMF), a bank debit tax ■ Social Security Contribution, a contribution on payroll and self-employment earnings (INSS)

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Companies can also calculate their tax liability based on their estimated profits. Under this simplified method, a company calculates its taxable income by applying a set rate to its total gross income earned during the quarter.

The applicable rates range from 1.6% for income from the sale of fuel and natural gas, to 32% for income from providing services (including real estate rentals). Sales of goods are taxed at 8%, while income tax is imposed at 15%. Additional taxes – including CSLL – may also apply.

Federal taxes charged on gross receipts (similar to VAT)

Companies may also be required to pay extra social contribution taxes.

First, the Contribution to Social Security Financing (COFINS) is levied on companies to help finance Brazil's social security and health care, and provides the second-largest amount of federal revenue after general income tax.

Second, the Contribution to the Social Integration Program (PIS) is imposed on businesses to give private-sector workers salary bonuses after at least five years of employment.

The rate of COFINS and PIS depends on the taxation regime companies are subject to. In actual profit regimes, companies are levied 1.65% of gross revenue by PIS and 7.6% through COFINS (exceptions can apply). In estimated profit regimes, companies are levied 0.65% of gross revenue through PIS and 3% through COFINS.

Sales taxes and other revenue taxes

Companies also face a federal tax on industrialization (known as the IPI) when goods are sold in final or intermediary form. The IPI rate varies for a wide range of products, and in some cases (depending on government policy) exemptions may be granted.

In addition, companies must pay the state tax on goods and selected services (those services that are not subject to ISS) at the time of sale, similar to VAT, known as ICMS. The ICMS rates vary between states, and some companies can gain exemptions.

Finally, companies must pay a municipal tax on service revenues, known as the ISS. This is levied when invoices are issued, and tax rates vary across municipalities.

Import taxes

Additional federal taxes are levied on imports. These are added to COFINS, PIS, IPI, and ICMS, in addition to other customs and harbor taxes.

Property taxes

Companies may face three sets of property taxes – the municipal tax on real estate property (IPTU), the municipal tax on real estate transfer or sale (ITBI) and the state tax of vehicle property (IPVA).

Tax on financial transactions

The Tax on Financial Transactions (IOF) is a federal tax that is levied on:

- credit transactions made by financial institutions
- exchange transactions made by authorized institutions
- insurance transactions made by insurance companies
- transactions involving securities and carried out by institutions authorized to operate on the securities market
- transactions relating to intercompany loans, and loans between companies and individuals.

The IOF rates vary according to the type of transaction involved. They are also frequently subject to changes, depending on government policy.

Conclusion

As this article has shown, Brazil's tax environment is complex, with penalties for non-compliance. Companies need to pay close attention to all their tax liabilities, and ensure they are meeting their obligations. It can be helpful for companies to create specialized internal tax teams, or consult external advisors, to effectively manage their tax affairs.

For more information:

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