
THE MINING LAW REVIEW

FOURTH EDITION

EDITOR

ERIK RICHER LA FLÈCHE

LAW BUSINESS RESEARCH

THE MINING LAW REVIEW

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THE MINING LAW REVIEW

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EDITOR'S PREFACE

I am pleased to have participated in the preparation of the fourth edition of *The Mining Law Review*. The *Review* is designed to be a practical, business-focused 'year in review' analysis of recent changes and developments, and their effects, and a look forward at expected trends.

This book gathers the views of leading mining practitioners from around the world and I warmly thank all the authors for their work and insights.

The first part of the book is divided into 22 country chapters, each dealing with mining in a particular jurisdiction. Countries were selected because of the importance of mining to their economies and to ensure broad geographical representation. Mining is global but the business of financing mining exploration, development and – to a lesser extent – production is concentrated in a few countries, Canada and the United Kingdom being dominant. As a result, the second part of this book includes eight country chapters focused on financing.

The advantage of a comparative work is that knowledge of the law and developments and trends in one jurisdiction may assist those in other jurisdictions. Although the chapters are laid out uniformly for ease of comparison, each author had complete discretion as to content and emphasis.

The mining sector is facing uncertain times. Commodity prices are lower and continue to be soft. Demand growth from China, the world's largest consumer of commodities, has slowed considerably. New markets such as India are not picking up the slack. Operating costs in certain markets exploded during the good years and must now be reined in. Traditional lenders to the industry are more highly regulated and have less flexibility to assist companies during this difficult time. Equity markets know that big declines in the price of commodities have preceded recessions and bear markets and as a result are doubly cautious.

While times are tough, we know that mining is cyclical and that continued world population and economic growth as well as the depletion of current resources mean that growth in the mining sector will resume. The only question is when.

In the meantime, we are seeing a return to basics coupled with innovation. Companies are reducing their operating costs and curtailing exploration efforts. Executives are looking at new ways of doing things, from cost sharing to automation to alternative financing. When financing projects, companies now attempt to secure most if not all of the financing upfront. To do this they have to cobble together financings from various sources, including stream and royalty arrangements that in the past were only available once a project had been considerably de-risked. Adapting the financings to the particulars of each project and making sure that the various bits work together and form a coherent whole is a source of interesting and sophisticated work for mining lawyers these days.

But companies are not the only ones implementing change. In some jurisdictions, Quebec for example, governments and other stakeholders (e.g., indigenous peoples) are taking advantage of the lull to put into place comprehensive strategies for welcoming new mining projects. Such strategies include clear timelines for the approval of projects, objective project approval standards, investments in infrastructure (e.g., ports, roads, railroads, airports and power lines), and transparent rules regarding the sharing of project benefits among local communities, indigenous peoples and government, all so as to be able to ramp up quickly when opportunity strikes.

As you consult this book you will find more on topics apposite to jurisdictions of specific interest to you, and I hope that you will find this book useful and responsive.

Erik Richer La Flèche

Stikeman Elliott LLP

Montreal

October 2015

Chapter 24

BRAZIL

Carlos Vilhena and Adriano Drummond C Trindade¹

I INTRODUCTION

The mining sector is a significant part of the Brazilian economy and accounts for a large proportion of Brazilian exports. According to the Brazilian Mining Association (IBRAM), national mineral production in 2014 was US\$40 billion, and the estimate for 2015 was US\$38 billion. The Brazilian Department of Mines (DNPM) reports that mineral commodities represented more than 15.2 per cent of Brazilian exports in 2014, with iron ore the most exported mineral substance representing over 75 per cent of overall mineral exports.

Despite those significant figures, the Brazilian capital market for mining activities does not present the same level of sophistication as in other jurisdictions. Apart from a few companies that are listed on the São Paulo stock exchange (e.g., Vale, MMX, CSN, Gerdau, Litel, Manabi, CCX, Magnesita and Ferbasa), most capital market transactions involving mining assets are structured in other markets through parent companies, which are usually listed on the Toronto Stock Exchange (TSX) or on the Australian Securities Exchange. Juniors and mid-tier exploration and mining companies tend to float in those jurisdictions where exploration and mining markets are more developed. The TMX Group reports that over 40 with assets in Brazil are listed in the TSX or TSX-V. In some cases, the original shareholders are from Brazil and resort to a non-Brazilian, more traditional, market to raise capital.

In addition to the lack of an investment culture in the mining business, other factors may explain the slow development of Brazilian capital markets for mining, compared with other jurisdictions. The first is the economic downturn of the mining sector, which has been experienced worldwide over the past few years. The second reason

¹ Carlos Vilhena is a partner and Adriano Drummond C Trindade is a counsel at Pinheiro Neto Advogados.

is the fall of the empire of Eike Batista, a Brazilian investor who built his fortune in the mining, and oil and gas sectors, and contributed to an increased awareness of the resources industries by investors and the public in general; however, following the failure of his oil and gas flagship company, Brazilian investment in the resources industries in general was adversely affected. More recently, Mr Batista's mining company – MMX – started a reorganisation procedure.

In the past few years, the number of public offerings in the Brazilian market reduced significantly. A handful of mining companies with operations in Brazil postponed or cancelled their listing plans. One mining company listed in the São Paulo stock exchange (All Ore) left the mining sector and redirected its business to other industries. Likewise, the number of companies that hold mining assets in Brazil listing in other jurisdictions has also fallen significantly as a result of the market conditions of the mining sector.

II CAPITAL RAISING

i General overview of the legal framework

Capital raising in Brazil in general is subject to federal corporate laws, capital markets laws and regulations issued by the securities commission (CVM).

Listing in Brazil

There are no specific requirements for raising capital for mining activities in Brazil. Mining companies listed on the São Paulo stock exchange will be subject to the usual requirements in terms of governance and disclosure that are applicable to other industries.

On the other hand, there are no incentives tailored for the mining sector either. Mechanisms such as flow-through shares that may be common in other jurisdictions have no equivalent in Brazil. In terms of incentives for exploration companies, there were studies to create benefits so that the shareholders of listed exploration companies could deduct exploration-qualified expenditure for tax purposes. As the incentive implies a reduction of taxes assessed by the Brazilian government, such studies are still under consideration by the Ministry of Development Industry and Foreign Trade (MDIC) and the Brazilian Agency for Industrial Development, and the mechanism has not been put in place.

As a consequence, the absence of specific rules considering the particularities of the sector, coupled with high costs in terms of governance and disclosure requirements, discourage exploration companies, juniors and companies with smaller projects or operations from listing in the Brazilian market.

Foreign investment

Foreign direct investment plays an important role in the Brazilian economy and the legislation imposes few requirements (such as the online registration of the investment within 30 days of the date the funds are converted into Brazilian currency). According to the United Nations Conference on Trade and Development, Brazil was the sixth most popular destination for foreign direct investment in 2014, in the amount of US\$62.5 billion. In terms of the overall investment in Latin America, Brazil was the main destination for 39 per cent of investment in general.

Foreign investors find no legal restrictions on acquiring stakes in Brazilian mining companies, but in the past few years, the government has put forward the interpretation that restrictions on non-Brazilian ownership apply to border areas (i.e., areas within the 150-kilometre wide strip of land parallel to Brazilian borders), as in other countries of the region. Hence, for those companies based in or that have mining assets in the border area, non-Brazilian equity interest is limited to 49 per cent, directly or indirectly.

Likewise, the Brazilian government also establishes that Brazilian companies that are directly or indirectly controlled by non-Brazilians are subject to certain requirements to acquire rural land, such as the prior approval of the National Institute for Colonisation and Agrarian Reform (INCRA). Since access to land is of paramount importance to the mining sector, non-Brazilian investors should bear in mind this element in channelling their investment.

Debt

One of the main sources of funding for mining projects is through debt transactions. The National Bank for Economic and Social Development (BNDES) has played a key role in financing major mining projects at more favourable rates. It operates in strengthening the capital structure of private companies and provides more favourable conditions for financing intended for projects that contribute to social, cultural and technological development. In 2014, the BNDES approved financing of US\$2.2 billion to Vale for its Carajás iron ore operations and associated logistics.

Brazilian commercial banks also provide finance for projects, but in many cases the internal requirements make it harder for projects at the exploration stage to be funded. Non-Brazilian-based banks may also provide funding for mining projects and usually do so through pre-export finance mechanisms that ensure more favourable taxation.

Projects that deal with scientific or technological innovation may benefit from governmental programmes to finance such activities (e.g., the Funding Authority for Studies and Project or FINEP). The support of FINEP covers all stages and dimensions of the scientific and technological development cycle: basic research, applied research and the development and improvement of products, services and processes. Mining companies that fit in one or more of those activities may benefit from favourable conditions for funding.

ii Market overview

Investment in the Brazilian mining sector comprises both Brazilian nationals and non-Brazilian investors. The number of Brazilian investors in the mining sector is not as high as in other sectors of the economy, but their importance should not be downplayed. Vale accounts for a relevant part of the investment in mining, and so do other mining companies, such as Votorantim. In addition, private equity funds are frequently seen in the market, as well as pension funds and companies in general (for instance, in the past few years, steel companies have also gone into the mining business). Unlike other markets, however, retail investors are not common in the Brazilian market.

Non-Brazilian investors are usually global funds, private equity funds, pension funds or mining companies that seek to reinvest and expand their portfolios, as well as companies that seek to secure the supply of raw materials for their industries.

iii Structural considerations

Given the economic downturn and the market conditions of the mining sector, as well as the deteriorating situation of the Brazilian economy, alternative methods of access to funding have been developed and have become more popular in Brazil.

Royalty transactions are increasingly common in Brazil and there are more companies specialising in acquiring royalties. The main hurdle is the fact that Brazilian mining legislation does not provide for the registration of the royalty against title, so the royalty remains a contractual obligation that cannot be imposed on a third-party acquirer of the mining property unless such party expressly acknowledges that it is bound by the royalty. Consequently, a series of legal mechanisms and securities need to be put in place to reduce the exposure and provide more assurances to the royalty creditor.

During the past couple of years, there have also been a few streaming transactions in Brazil. Streaming arrangements are contracts for ongoing supply of mineral production under which, upon advance payment of a premium, the buyer agrees to purchase at a fixed discounted and predetermined price, all or part of the mineral production to be extracted by a mining company during a certain period or even throughout the life of the mine. The mining company receives an upfront payment, which enables it to develop, construct and operate or expand the mine. This arrangement allows the mining company to capitalise on the basis of proven but still unexplored mineral reserves at a cost usually below that of loans.

These streaming arrangements have been praised by mining companies, as they have access to additional fundraising mechanisms to develop the mineral project, and have a purchaser for all or part of its future production (depending on the agreement). Moreover, contrary to capital investment financing, streaming arrangements avoid debt-financing costs, particularly at times when credit access conditions are unfavourable.

One major difficulty of Brazilian mining companies in raising capital is the gap between reporting requirements under Brazilian mining law and other typical reporting standards adopted by the market. Reporting requirements in Brazil still abide by legislation enacted in the late 1960s, which employs standards and terminology that is not the same as in the current market (e.g., the inadequate use of 'measured, indicated and inferred reserves'). This means that the reporting obligations to the Brazilian Department of Mines (DNPM) are much less detailed than those required by banks and investors. In some cases, Brazilian companies reach the transitional stage between exploration and mining pursuant to domestic legislation, but still need to undertake further exploration so as to produce the report that provides a resource or reserve that is in compliance with the NI43-101 or JORC standards. The discrepancy between domestic legislation and international standards not only makes access to capital more difficult for Brazilian companies, but may also put the project at risk at a key moment.

Considering that the National Congress is currently reviewing a bill to amend Brazilian mining legislation, it is expected that the reporting standards in Brazil will be adjusted to meet international standards as part of the new legislation and respective regulations to be put in place.

A final comment should be made with regard to the social and environmental liability of financial institutions that provide funds for mining and infrastructure projects in general. Although no legal provisions impose such liability, the trend is that

such institutions are deemed increasingly responsible for the use of funds borrowed by companies – particularly those that use environmental resources and could potentially create a social and environmental footprint. In 2014, the National Monetary Council enacted a regulation that is being implemented in 2015 that requires that each financial institution to put in place a social and environmental policy.

iv Tax considerations

Brazilian legislation does not provide for any tax advantages or incentives to persons engaged in mining activities, or their investors and lenders.

As a general comment, Brazilian corporate income tax (IRPJ) is levied at the rate of 15 per cent on the taxable profits. A 10 per cent surcharge is levied on the actual profits, presumed profits, or profits determined by the tax authorities, in excess of 240,000 reais per year. Taxable profits are ascertained by deducting the operating costs and expenses from the gross income originating from the company's core activity and incidental businesses. Some of these costs and expenses are not deductible because of their nature or the amount involved. There are also certain events of tax exemption upon ascertainment of the company's taxable profit.

Moreover, it is worth mentioning that Brazilian legal entities are allowed to carry forward losses indefinitely, which is of paramount importance for companies that undertake exploration, development and later mining activities; however, such losses can only offset 30 per cent of the taxable profits, which can result in deferral of the utilisation of the losses in the event the legal entity happens to have material losses and profits that are not substantial.

In some cases, a legal entity may opt for taxation on presumed profits instead of actual profits. Under the presumed profit regime, the IRPJ's calculation base is determined upon the application of predetermined rates (that may vary depending on the activity carried out), as set out in the applicable law, over revenues derived by the legal entity from the execution of its operational activities. Expenses are not deductible to the Brazilian company when it is taxed under the presumed profit regime and, in order to be taxed under this system, the company cannot have had a gross income over 78 million reais.

The income, capital gains and other earnings paid, credited, delivered, employed or remitted by a Brazilian source to a foreign-based individual or legal entity are subject to withholding tax at a general rate of 15 per cent. Such rate may reach 25 per cent for income paid to a person residing in a jurisdiction deemed a tax haven or privileged tax regime for Brazilian tax purposes (i.e., a country or territory where income is not taxed or subject to taxation at a maximum rate lower than 20 per cent, or does not disclose information about the ownership or beneficial owner of the company's income).

The social contribution on net profits (CSL) applies to Brazilian companies (including financial institutions), and is calculated on the net profits before the allowance for income tax, adjusted by the additions, exclusions and offsets prescribed by tax law. The CSL rate is 9 per cent and the figures paid are not deductible from the income tax base (actual profits).

The profit participation programme contribution (PIS) and the social security financing contribution (COFINS) are levied at the combined rate of 9.25 per cent, assessed over the gross billings of the company.

The tax on financial transactions (IOF) is a tax on foreign exchange, securities, credit, gold and insurance transactions. The Minister of Finance sets the rates of the IOF tax, subject to limits set out by law. IOF/Exchange is currently imposed on a variety of foreign-exchange transactions. Currently, for most exchange transactions, the rate of IOF/Exchange is 0.38 per cent.

The tax on distribution of goods and services (ICMS) is a state VAT levied on the circulation of goods (thus covering the entire chain of trades from the manufacturer to the end consumer) and on the provision of intrastate and interstate transportation and communications services. Normally, the transaction value serves as the ICMS tax base. ICMS is paid by the trader or provider of carrier or communications services.

ICMS is a non-cumulative tax and, as such, generates a tax credit to be offset by the product or service recipient against the tax payable on future transactions. Each Brazilian state is free to establish its own ICMS rates (generally between 17 and 18 per cent). ICMS tax exemptions, breaks and incentives are granted or cancelled via agreements entered into among the Brazilian states; however, these states often grant ICMS tax breaks and incentives to attract investment without the approval of other states, generating a 'tax war'.

The tax on services (ISS) is assessed on the services provided by a company or independent contractor or professional, in accordance with a list of services attached to a federal supplementary law. This tax is levied by the local municipality at a rate of 2 to 5 per cent on the service value.

Mining activities are subject to a statutory royalty (CFEM), which is currently equivalent to up to 3 per cent – depending on the substance, but in most of the cases the applicable rate is 2 per cent – of the revenue arising from the sale of the mineral product, there being some deductions applicable (taxes that levy on the sale of the products, external transportation and insurance costs). For those companies that use the mineral substance in their industrial process to create an industrialised product, the statutory royalty is calculated based on the aggregate costs incurred by the mining company up to the final stage of the production process immediately preceding the creation of the industrialised product (those products that are subject to excise tax, or IPI).

Under the new mining bill under review of Congress, CFEM rates will be increased to up to 4 per cent, and expenses involving transportation and insurance will no longer be deductible.

It is worth noting that, over the past couple of years, three states (Minas Gerais, Pará and Amapá) created 'inspection fees'. A close review of these fees shows that they are actually proportionate to the mine production and are tantamount to an additional royalty.

As a measure to foster regional development, exports and the development of infrastructure, there are a number of tax breaks and incentives that investors should consider. Legislation provides for the reduction of IRPJ for industries that are established in the Amazon region or in the north east of the country as a measure to industrialise those regions.

Exports generally enjoy tax breaks in terms of ICMS and export taxes. Likewise, there are incentives for the import of machinery with no equivalent in the domestic market that will be used in the production of goods for exportation.

Finally, the government has granted tax benefits to 'infrastructure debentures' so as to reduce taxation on the income paid from debentures issued by special purpose companies created to invest in infrastructure projects (logistics, transportation, energy, telecommunications, sanitation or irrigation). Since many mining projects require associated logistics, these tax benefits should be taken into account by investors.

III DEVELOPMENTS

In June 2013, the federal government sent a bill to the National Congress to reform the mining sector. The bill is designed to change the institutional structure and the mining legislation that regulates exploration and mining activities.

The bill was originally considered by mining companies as interventionist and adding a number of uncertainties to a business that is already risky. It came out after a lengthy drafting process by the federal executive without any significant involvement of mining companies and other stakeholders. One of the errors pointed out by sector participants was the complete replacement of the first come, first served system for public offering and bid rounds (even though the first come, first served system is not perfect, it is the regime that best fits the dynamics of mineral exploration in areas with little or no geological information). In addition, the bill provided for an increase in fees and in the mining royalty, and created other levies. The bill also described situations in which the government would have wide discretion to cancel mineral rights or impose more obligations on the titleholder. All these characteristics were deemed negative and had an impact on ongoing and new mining projects. Funding was already difficult to obtain given market conditions and became even more difficult in light of the uncertainties brought by the new mining bill.

As soon as the mining bill reached Congress, a special committee was formed in the House of Representatives for its review. The committee organised a number of public hearings and meetings in various states with mining operations in order to foster public participation and to better gauge reaction to the bill. As a result, the reporting representative is reviewing the results and suggestions made over the works of the committee, and will present an amending bill in the next few weeks (at the time of preparation of this article, the amended bill was expected by the end of September).

Earlier drafts show the amending bill is much more market-friendly and with a number of changes to accommodate the concerns of the industry (including the application of the first come, first served system for greenfield areas). It is, however, still subject to voting at the House of Representatives, which may happen later in 2015, and then by the Senate. The outcome of the political discussions on the matter is likely to have significant implications for the Brazilian mining sector and the corresponding capital market from 2016 onwards.

One aspect of the draft amending bill that is relevant for the purposes of this chapter is the creation of mechanisms for the encumbrance of mineral rights as security (such as a pledge or fiduciary property), which will provide more comfort to lenders. It

also provides for the creation of mineral right credit instruments (mineral exploration credit certificates, mineral extraction credit certificates, mining credit certificates and mining receivables credit certificates), as an attempt to raise capital for mining projects by giving creditors a certain share of the revenue generated by the activity.

Appendix 1

ABOUT THE AUTHORS

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Carlos Vilhena is a partner in Brazilian law firm Pinheiro Neto Advogados. He is in charge of the firm's mining practice and governmental relations. Mr Vilhena has an LLB from the Law School of the University of Brasilia and an LLM from the Centre for Energy, Petroleum, Mineral Law and Policy of the University of Dundee. He is a member of the section on energy, environment, natural resources and infrastructure law of the International Bar Association. In his mining practice, he has advised exploration and mining companies, as well as investors, on a wide array of mining-related issues. He has been continually listed as a top mining lawyer by various international legal guides.

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Adriano Drummond Cançado Trindade is a counsel in Brazilian law firm Pinheiro Neto Advogados, where he has devoted his time in providing advise to exploration and mining companies and investors in aspects involving mining projects. He holds an LLB from the Law School of the University of Brasilia and an LLM (distinction) from the Centre for Energy, Petroleum, Mineral Law and Policy of the University of Dundee. Mr Trindade is also a professor of resources law at the University of Brasilia Law School, where he also heads the mining section of the natural resources law research group. He has been continually listed as a top mining lawyer by various international legal guides.

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