



Investment in Brazil

TAX

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Preface

Investment in Brazil is one of a series of worldwide booklet prepared by KPMG to provide information on a number of subjects relevant for investment planning or doing business in Brazil.

This booklet gives a summary of the rules, regulations and tax laws applicable in Brazil.

Although covering many relevant areas, it cannot of course be exhaustive, and it is not designed to provide the complex and detailed information required for decision-making on investments.

We have prepared this booklet to render general information and to guide your preliminary planning efforts. All information contained in this booklet is valid as of July 2006. Every effort has been made to ensure that the information in this booklet is current

However, since laws change frequently, comprehensive advice should always be sought before implementing any plan to invest in Brazil. We are looking forward to assist you with the handling of your investment planning.

July, 2006.

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Chapter 1

Brazil - country outline

Geography

Brazil is the fifth largest country in the world with a total area of 8.5 million square kilometers, covering approximately half of South America. Distances are continental: 4,420 kilometers from north to south, 4,328 kilometers from east to west, an Atlantic coastline of 7.367 kilometers and a total border of 23,102 kilometers. It neighbors every country in South America except Chile and Ecuador

The country is divided into five regions:

North - made up mostly of the Amazon Basin; comprising the states of Acre, Amazonas, Roraima, Rondônia, Pará, Amapá and Tocantins;

Northeast - consisting of the states of Maranhão, Piauí, Ceará, Rio Grande do Norte, Paraíba, Pernambuco, Alagoas, Sergipe and Bahia;

Central West - consisting of the states of Mato Grosso, Mato Grosso do Sul, Goiás and the Federal District.

Southeast - consisting of the states of Minas Gerais, Espírito Santo, Rio de Janeiro and São Paulo:

South - consisting of the states of Paraná, Santa Catarina and Rio Grande do Sul;



More than half of Brazil is 200 meters or more above sea level but only a small part rises above 1,000 meters, with the highest peaks at an altitude of around 3,000 meters.

Brazil's river system is extensive. The Amazon and its tributaries, which are great rivers in themselves, drain over half of Brazil. Other large rivers include the São Francisco in the northeast and the Paraná and the Paraguay Rivers, which flow south to empty into the Rio de La Plata. The considerable hydroelectric potential of Brazil's rivers has been increasingly exploited over the last 35 years. Forests still cover vast expanses and farmland is found mainly in the South, Southeast and Central West with large areas suitable or adaptable for pasture. Brazil has some of the largest iron ore deposits in the world and mines significant quantities of many other metals, minerals and precious stones.

Climate

The equator runs just north of the Amazon while the Tropic of Capricorn passes slightly to the north of the city of São Paulo. This means that most of Brazil lies within the tropical zone. Only the southern region is in the temperate zone. The Amazon area is hot and humid with heavy rainfall.

Population

According to data published by the official statistics institute IBGE, in 2000 Brazil had a population of approximately 170 million people (157 million in 1996). According to IBGE projections based on the year 2000 census, the population on July 24, 2006 was expected to be 187 million. The next census is cheduled for 2007.

The relative areas and populations of the five regions described earlier according to the 2000 census were as follows.

Region	Area	Population	GDP ¹
North	42%	7%	4%
Northeast	18%	28%	13%
Southeast	11%	43%	60%
South	7%	15%	16%
Central West	22%	7%	7%

The Northeast and the North are the underdeveloped regions of the country. Most industrial and commercial activities are concentrated in the Southeast and the South. To reduce social tensions resulting from these regional inequalities in economic development, the government has allocated substantial resources, either directly or through tax incentives, to northern and northeastern economic development during the past forty years. Nevertheless, the practical result of this policy has been far less fruitful than expected.

Despite Brazil's vast territory, 80% of its population lives in urban areas (the metropolitan regions of São Paulo and Rio de Janeiro have populations of around 18 and 10 million respectively).

Gross Domestic Product.

The major capital cities of Brazil and related states by population, in accordance with the 2000 IBGE population report, are:

Capital	Population (millions)	State	Population (millions)
São Paulo	10.4	São Paulo	37.0
Rio de Janeiro	5.8	Rio de Janeiro	14.3
Salvador	2.4	Bahia	13.0
Belo Horizonte	2.2	Minas Gerais	17.8
Fortaleza	2.1	Ceará	7.4
Brasília	2.0	Federal District	2.0
Curitiba	1.5	Paraná	9.5
Recife	1.4	Pernambuco	7.9
Porto Alegre	1.3	Rio Grande do Sul	10.1

Over 50% of Brazilians are of first, second or third-generation foreign descent. The characteristics of various nations are apparent in the cosmopolitan makeup of the population. Portuguese and African influences become most evident towards the North, whereas German, Italian and Japanese influences are more apparent in the South.

Language

Since the discovery and colonization of Brazil by Portugal, Portuguese has been Brazil's language and Roman Catholicism the predominant religion. Brazil is the only Portuguese-speaking country in South America. The literacy rate has increased over the past 40 years from 50 to 88 percent (about 90 percent in the urban and 70 percent in the rural areas, according to IBGE data for 2003).

Currency

The Brazilian currency is the Real. The Real replaced the Cruzeiro Real in July 1994 as part of government measures to end chronic inflation. Various other currencies existed before the Cruzeiro Real.

History

Brazil was discovered in 1500 by the Portuguese explorer Pedro Álvares Cabral. From then until independence, Brazil's status was that of a group of separate colonies of the Portuguese crown. As a colony, Brazil contributed to both the personal and state revenue of the Portuguese crown via numerous taxes, of which the most onerous were a tithe of the produce of lands granted to colonists and a fifth of mining production. The wealth of the colony was based on commodities, principally sugar in the seventeenth century, gold in the eighteenth century and coffee in the early nineteenth century.

As in the neighboring Spanish American colonies, by the late eighteenth century the influx of ideas from the European Enlightenment was generating a nascent independence movement. Developments accelerated in 1808 when the Portuguese court fled to Brazil to escape Napoleon's troops. King João VI returned to Portugal in 1821 but his son, Pedro, remained as Regent. The following year, supported by Brazilian magnates, he refused the request of the Portuguese Parliament to return to Lisbon and, on September 7, 1822, declared Brazil's independence.

The subsequent imperial period was heavily influenced by Pedro II (Pedro I's son), a strong liberal who promoted education, improved communications, developed agriculture and encouraged immigration from Europe. The coffee boom also began during this period, while Brazil emerged victorious from the armed conflict with the dictator Lopez of Paraguay.

On May 13, 1888 the crown decreed the abolition of slavery. This most certainly was instrumental in the downfall of the empire. Plantation owners, who received no compensation, turned against the Emperor together with disgruntled factions of the armed forces.

On November 15, 1889 the republic was declared by the hero of the Paraguayan War, Deodoro da Fonseca, and Pedro II fled to exile in Europe. This old republican period, marked by expansion and increasing prosperity (a further commodity boom in rubber occurred in the period up to 1912), succumbed in 1930 to the revolutionary movement led by Getúlio Vargas, characterized by its social welfare program.

In 1945 the dictator Vargas was forced to resign and a liberal republic was restored. The subsequent 19 years saw considerable economic development. In particular, President Juscelino Kubitschek initiated the development of the Central West region and the construction of the new federal capital of Brasília.

The period also saw, however, growing government instability and corruption. These tendencies culminated in the military revolution of March 1964. The early and middle years of the military dictatorship coincided with a period of unprecedented growth in the economy, stimulated by the inflow of large amounts of foreign credit. The oil crisis of the late 1970s severely affected the Brazilian economy, however, and this factor, together with shrinking international credit in the face of world recession, resulted in the end of the "economic miracle" by 1980. Increasing economic difficulties and political change in neighboring states generated growing demands for an end to military rule during the early 1980s, and in March 1985 power passed to a civilian president.

A constitutional congressional convention drafted and approved a new Federal Constitution in 1988, and in November 1989 the first direct presidential elections of the post-military era were held. In 1990, Fernando Collor de Mello took power as the newly-elected President and instituted a gradual liberalization of the economy. Despite his initial success with inflation control, chronic economic distortions continued to hinder growth and eventually led to a return of high inflation rates. Collor de Mello was impeached in 1992 and removed from office amid charges of corruption. His vice-president, Itamar Franco, served out the remainder of the term of office.

Elections in October 1994 brought Fernando Henrique Cardoso to power. Cardoso had been at the helm of the *Plano Real* (a successful monetary reform initiative) as the Minister of Finance in the Franco administration. The plan reduced inflation and won wide respect for his government.

Luiz Inácio Lula da Silva, a former lathe operator and union leader, was elected President in 2003

Inflation

An important feature of post-war Brazilian economic policy has been the willingness to accept high levels of inflation as one of the costs of pursuing a policy of rapid economic growth.

The development of sophisticated mechanisms to cope with inflation enabled both individuals and business enterprises to live with a hyperinflationary economy for many years. The failure of the government to reduce inflation

was widely recognized to be the consequence of both an inability to reduce the government deficit and the refueling effect of mechanisms designed to cope with past inflation.

With the introduction of Plano Real and the new currency, inflation has plummeted and the government has successfully removed indexation mechanisms from daily life in Brazil.

Government

Brazil is a federal republic composed of twenty-six states and the Federal District. Each state has its own constitution with a governor and state legislature. The states are divided into municipalities, which have some degree of autonomy, and these, in turn, are divided into districts.

The Federal Constitution/88 provides that the executive branch of the federal government be headed by a president, elected by popular vote every four years. Legislative power is exercised by the National Congress, consisting of a Chamber of Deputies and the Federal Senate. Congress meets in the Federal District and capital, Brasília.

Representation in the Chamber of Deputies is by state and should be roughly consistent with population density, but in practice a candidate in a state with a large population requires many more votes than a candidate in a state with a smaller population to be elected. The term of office of the Deputies is four years. In the Senate, each state is represented by three senators who serve an eight-year term. All literate Brazilians eighteen years of age to sixty years of age are required to vote in elections, and there are penalties for failure to do so. The vote has also been extended, on a voluntary basis, to Brazilians from sixteen to eighteen years of age, those over sixty years of age and those who are illiterate.

Judicial power is exercised by the Federal Supreme Court, the Superior Court of Justice, the Federal Court system as well as separate courts for military, electoral and labor matters. There is a state court system with local jurisdiction.

Private ownership of property is guaranteed, except when public interest or necessity justifies expropriation. In this event, fair compensation must be paid in advance.

Economy and fiscal policy

Government policy is focused on stimulating the business activities of the private and government sectors toward rapid industrialization and economic growth. However, this policy includes some protectionist measures for domestic industries considered to be of strategic economic importance, as well as monetary policies designed to keep inflation in check and maintain the availability of foreign exchange.

Brazil's status as a world economic power is a relatively recent phenomenon. Until World War II cut off the flow of manufactured products from Europe and the United States, setting the scenario for the country to take the road to industrialization, Brazil was a classic example of a primary-product exporter which relied on other countries to supply the vast majority of its manufactured goods. Even in the early 1950s, 65% of the economically active population was still engaged in agriculture, fishing or forestry, and only 12% worked in manufacturing (the rest were employed in service industries). Coffee sales provided more than half of the nation's export revenues.

Until the early 1950s, the banking system was primarily concerned with the needs of the agricultural sector. In the 1920s and 1930s, various states founded state banks whose principal objective was to assist this sector. These institutions grew to rank among the most important financial institutions operating in Brazil. However, in the 1990s, they became a major preoccupation for the government, because they were generally used to finance state deficits.

Brazil's evolution from a backward, agricultural-mercantilist economy, to its present status as a major industrial producer occurred, in quantitative terms, largely between 1950 and 1980. During this period the gross national product grew to approximately that of Canada (albeit with several times as many inhabitants), exports reached US\$ 23 billion (of which approximately 55% were manufactured goods), and São Paulo developed into one of the world's largest manufacturing centers.

Today, Brazil is a world leader in the production of foods and minerals. Many other sectors - such as the steel, aluminum, automobile, wood pulp, chemical and textile industries - are highly developed.

Brazil's GDP in 2003, the last year for which there is official data, was R\$ 1.5 trillion (approximately US\$ 707 billion at the exchange rate in force on July 24, 2006).

More recently, unemployment figures for the major metropolitan areas have been falling back towards the traditional 5% rate. According to IBGE statistics, unemployment was 5.7% in May of 2000. However, DIEESE, which is a data institute supported by the labor unions, estimates unemployment for the same month in São Paulo at 17%. This is principally due to a difference in evaluation criteria. DIEESE considers unregistered employees as unemployed.

Brazil has overcome its history of trade deficits over the last few years. The trade surplus for 2005 was US\$ 47 billion (1.39 times higher than 2004). This surplus has been basically attributed to the 24.6% increase in exports, which totaled US\$ 121 billion in 2005. Imports for 2005 totaled US\$ 73 billion.

Privatization

One of the key elements of Cardoso administrations' economic policy was the extensive transfer of state-owned companies to the private sector. Through Law 8,031/90, Congress entrusted the sale process to the Federal Development Bank (BNDES); the initial sale of more than twenty state-owned industries, mainly in the steel, petrochemical and fertilizer industries, was authorized. Since May 1997, financial institution privatization processes have been conducted by the Central Bank and authorized by the National Monetary Council.

The BNDES and the Federal government faced intense pressure from trade unions and special interest groups in Congress, which sought to halt or hinder the privatization process. A series of challenges were also mounted in the courts. These factors delayed the privatization process, but the government showed determination and, in 1991, the privatization of a major steel manufacturer (Usiminas) was successfully completed. This initial success was regarded as a significant step forward in the privatization process and it enabled the government to privatize several other state-owned companies. Electrical and telecommunications companies have been privatized and foreign investors have won bids to assume railway concessions. The federal government's controlling interest in Companhia Vale do Rio Doce (CVRD), Brazil's largest mining company, was sold to both domestic and foreign private investors in 1997.

Infrastructure and industry sectors

Transportation, utilities and telecommunications are of fundamental importance because of the size of the country and the growing demands of industry.

The postal service is generally adequate. In major centers messenger services are widely used. There is an extensive air travel and domestic ground transportation network. Regular international services are provided by national and foreign airlines to all parts of the world.

Railroad facilities are underdeveloped, the principal lines being in the states of São Paulo and Rio de Janeiro. The privatization of railroads and ports is also considered the solution for developing these sectors. Due to the deficiencies in rail and sea transport, a very considerable amount of freight is transported by highway throughout the country. Although the main highways run near the coast, road construction in the interior is expanding and existing routes are being improved. Many highways have been privatized and are in good repair. Those that have not are in desperate need of attention. President Lula has recognized this and announced a plan to restore a federal highway system during 2006.

Subway systems are operating in the cities of São Paulo and Rio de Janeiro, and alternative transit systems are being developed in other major cities. Commuter bus services remain the principal means of public transportation.

Brazil now produces all of its crude oil requirements. Due to its large known reserves and advanced technology in many areas such as in deep sea water extraction, Petrobrás, a state controlled company is one of the largest international leaders in the oil and gas market.

The automotive industry is large and growing. Most major manufactures have operations in Brazil. In order to reduce petroleum consumption, a major project was developed in the 1980s to manufacture alcohol (produced from sugar cane) for use as fuel in cars. This project was technically very successful. Although the agricultural subsidies granted initially were significant, over time they were reduced, thus diminishing the financial benefit of owning an alcohol fueled car. Also, the price of alcohol varies considerably throughout the year in accordance with the price of sugar (an alternate consumer market for sugar cane producers). In order to address this last effect, automobiles that can run on both alcohol and gasoline have been introduced.

The telecommunications and electrical energy sectors have experienced a considerable amount of privatization. Regulations for cellular phone band B system have been approved and licenses have been awarded to private telephone groups. It is expected that the sale of government control of the traditional telephone companies which occurred in 1998 will make it possible to satisfy demand in the next years. Investment requirements for infrastructure in coming years are estimated at more than 70 billion dollars and it is envisaged that such investment will be achieved through private sector foreign financed projects.

Private-public partnerships (Parcerias público-privadas)

The public-private partnership (PPP) has become an important administrative instrument for providing high quality public services for the population in a number of countries. Most countries have decided to adopt PPP due to the lack of budgetary resources to meet the growing demand from the population for more public services. Accordingly, it has been observed that, in addition to the advantage of enabling the services to be made available earlier, there have also been additional advantages such as the gains in constructive, operational and managerial efficiency that these types of contracts provide for the public administration.

The main, and longest, experience with PPP is in Great Britain, where the first PPPs were contracted in 1992. Today, there are more than 600 projects, with a total investment of £57 billion. A number of countries have followed this example and are adopting PPPs. Following this trend, in Brazil, Law 11,079/04 (Federal PPP Law) was enacted. In addition, various Brazilian states (such as Minas Gerais, Santa Catarina, São Paulo, Goiás, Rio Grande do Sul, Bahia, Ceará and Sergipe) have also issued their own state PPP laws, which are very similar to the Federal PPP Law.

In general terms, the PPPs are a sponsored or administrative type of concession agreement. A sponsored concession consists of the concession of public services that involve, in addition to the tariff charged from the users, a consideration from the public partner to the private partner. An administrative concession consists of a contract for providing services where the public partner is the direct or indirect user of the public service.

The main characteristics and innovations of the Federal PPP Law are:

- Contracts are effective for more than five years and less than thirty five vears;
- Prohibition of contracts for values lower than R\$ 20 million and whose sole objective is the supply of labor, the supply and installation of equipment or the execution of the public works - i.e. the contract must necessarily include operating the service;
- Sharing of risks between the public and private partners;
- Establishment of objective criteria for assessing the performance of the private partner and payment according to results:
- Mechanisms and guarantees for the financers to reduce the financing risks;
- Possibility of using arbitration to resolve conflicts;
- Provision of guarantees for the payment of a consideration by the public administrator:
- Provision of contracting the PPP through a competitive bidding process.

The Federal PPP Law has introduced several innovations to Brazilian administrative contracts, which may substantially improve the quality of the projects of the public administration in the eyes of the investors and the private financiers, allowing the application of internationally accepted PPP principles, which assure better quality in the public services for the users in a continuous, long-term manner.

Chapter 2

Setting up business in Brazil

Benefits of locating in Brazil

Brazil presents one of the prime opportunities for the potential investor:

- The current population of approximately 170 million (according to the data published by IBGE in 2000), of which almost one half is under 20 years of age, is projected to reach more than 180 million by the year 2010.
- Rural-urban migration and the spread of modern agricultural methods are bringing an increasing proportion of the population into the market for manufactured goods.
- The Brazilian public is highly receptive to foreign brand names, which can demand a premium price over competing domestic products.
- Has a democratic government.
- Has had a stable economy and has been successful in controlling inflation.
- Has a modern telecommunications and bank systems.
- Is one of the ten world's largest economies.
- Has the most diversified industrial park in Latin America and the Caribbean.
- Is one of the world's top generators of electric energy.

As far as the actual establishment of an operation in Brazil is concerned, the potential foreign investor will have no difficulty in obtaining skilled professional assistance in preliminary stages, and will find that due to the large industrial base few problems are encountered in locating a

joint-venture partner or a suitable manufacturing facility. Investors may seek assistance in the following areas:

- To determine whether a market exists for a particular product, there are several competent consulting firms with wide experience in market research. Several of these consulting firms are associated with the major multinational consulting companies.
- Similarly, plant location studies and industrial design services may be undertaken, and there is an adequate supply of competent engineering expertise.
- Assistance is available for locating possible joint-venture and equity participation partners.
- Labor in Brazil is plentiful and there is a good supply of skilled and disciplined production workers in the principal industrial centers.
- Skilled local management is readily available and at a cost well below that of the expatriate executive.
- Raw materials and energy supply are easily obtainable, without interruption.
- The marketing and promotion industry is well-developed and media advertising is used extensively.

The potential foreign investor is, of course, interested in the long-term prospects. In this respect, the most important feature of Brazil is that it is a truly developing country. A few of the factors that should ensure an expanding market for manufactured goods and for services are the following:

- Population growth and demographic factors, as previously described.
- A flourishing, export-oriented agricultural base, with a huge potential for expansion of land under cultivation and the improvement of crop yields by the increased use of irrigation and fertilizers.
- The existence of vast, untapped mineral wealth and massive investment projects currently in progress to exploit those resources.
- The development of energy source alternatives to imported oil, including harnessing hydroelectric power and expanding the use of ethanol and gas.
- The growth of an urban working class with expanded disposable income.

Overall, the best advice for potential investors in Brazil is to look to the past experience and future plans of foreign companies that already operate here. From the smaller foreign company that has found a niche for its particular product line or technological expertise to the major multinational corporation whose Brazilian operation is among the largest of its international subsidiaries, the general message will be clear: Brazil is an option that is hard to overlook for the long-term investor.

Restriction on foreign investments

Only a few economic activities such as public health, mail and telegraph, nuclear energy, mining, airlines with domestic flight concessions, transportation and aerospace industry continue to be restricted to foreign investors.

Foreign investors can currently hold only a minority participation in media, financial institutions and insurance companies, but with prior authorization from the government or under a reciprocal agreement, they may acquire control of a bank.

Additionally, there are restrictions on foreign participation in activities subject to national security concerns, and on foreign ownership of rural areas and business on border zones. However, such limitations will not normally affect the average foreign investor.

A potential investor should consult the government agencies that would most likely hold an interest in a proposed project. This process can sometimes yield significant benefits to the foreign investor, since the government generally prefers to grant incentives, rather than restrictions, to encourage investors to modify their plans. In general terms, incentives granted are associated to tax, rental or funding costs.

Acquisition of real estate

Issues regarding real estate property situated in Brazil are governed primarily by the New Brazilian Civil Code (NBCC).

Basically, foreign individuals and entities have the right to acquire real estate property in Brazil according to the same conditions applied to national individuals or entities. However, it is important to mention that the federal tax authorities require that nonresident individuals or entities that hold real estate located in the national territory apply for the individual or corporate taxpayer registration number (CPF or CNPJ).

Furthermore, regulation provides for special restrictions in case foreigners are interested in purchasing properties located near the coast, at the frontiers or at certain specific areas considered as of national security.

To the extent that title to large areas of Brazilian land has been in dispute since colonial land grants were made, it is very important to ascertain that the seller has good title of the object area. This verification can be made at the real estate registry. If the seller has been in possession for many years, and in the absence of ongoing lawsuits, purchase of the land is reasonably safe. In all cases, buyers should seek legal advice. Upon the purchase of freehold property, buyers should follow steps to register the change of title at the real estate registry.

It is also recommended that long and short leaseholds be registered at the real estate registry in order to minimize potential disputes with the landlord.

Law 5,709/71 establishes that foreign individuals who have permanent residence in Brazil, foreign companies authorized to operate here and Brazilian companies controlled by foreigners are authorized to acquire rural properties, under certain conditions and limits.

On the other hand, foreign entities not authorized to operate in Brazil and foreign individuals who do not have permanent residence in Brazilian territory cannot acquire rural properties here. However, an exception applies to the latter: acquisition of rural property due to inheritance rights.

Structuring the business

Foreign investors may enter the Brazilian market directly - through a branch or a subsidiary - or through third parties by means of distribution and sales representation activities.

Distribution and sales representation are, in most cases, cost saving when compared to the incorporation of a local branch or subsidiary. However, these alternatives may bring lack of control to the foreign investors over the way the third parties distribute or sell their products in Brazil and deal with their trademarks.

Both distribution and sales representation activities must be ruled by written agreements to be entered into between the foreign investors and the local third parties. Before entering into such agreements, it is recommended that the foreign investors register their trademarks with the Federal Intellectual Agency (INPI).

Distribution activities

The new Brazilian Civil Code (NBCC - Law 10.406/02) brought relevant rules to distribution and agency activities. These activities are very similar. The difference, according to the NBCC, is that under distribution activities the distributor possesses the products object of such activity.

Before the NBCC was enacted, agreements on distribution activities were freely regulated by the parties and governed by the general provisions of the former Brazilian Civil Code related to contractual issues. In fact, only automotive vehicles and parts' distributions were regulated by a specific law (Law 6,729/79 further amended by Law 8,132/90).

Under a distribution agreement, an individual or an entity becomes committed to do business on behalf of another party (the manufacturer of the products to be distributed) in a designated area for a specific remuneration, not on a sporadic basis and without employment bond.

It is recommended that a distribution agreement defines in detail its object (description of the involved products), the exclusive sales territory, its duration, purchase obligations, advertising issues and licensed use of the involved trademarks.

Pursuant to the NBCC, if the term (duration) of the agreement is not formally established, it shall be considered as undetermined and its termination would require a ninety day prior notice.

Sales representation

Differing from the distribution arrangement, the sales representation is governed by a specific law (Law 4,886/65 further amended by Law 8,420/92), and in a supplementary way - by the general provisions of the NBCC applicable to contractual issues.

Sales representation may be understood as an intermediation activity, in which the sales representative (entity or individual), not on a sporadic basis and without employment ties, is a client prospector for the represented entity or individual, negotiating proposals or requirements in order to submit them to the latter. In exchange, when the proposed deals are closed between the purchaser and the represented party, the sales

representative becomes entitled to a fee usually based on the value of the sold products.

These activities must also be formalized in written agreements.

Special care must be taken when drafting a sales representation agreement in order to avoid the characterization of labor relationship between the contracting parties, or a permanent establishment of the foreign represented party.

It is recommended that a sales representation agreement comprise, among other provisions: (a) a description of the products object of the representation; (b) the period or term of the representation; (c) the indication of the territory such as a state or region; (d) the total or partial guarantee of exclusivity on the representation territory, if applicable: (e) the conditions for the payment of the commissions: (f) exclusivity, or not, in the given territory; and (g) indemnification payable to the sales representative for the termination of the agreement without just cause, which amount cannot be lower than one-twelfth of the total remuneration earned, during the period when the representation was performed.

Branches

As mentioned above, foreign investors may enter the Brazilian market directly, through a branch or a subsidiary.

Although some multinational corporations originally set up their Brazilian operations through a branch (especially commercial aviation businesses), the most commonly used entity is the *Limitada* as a controlled subsidiary.

The formation of a branch requires prior approval from the federal government by means of a presidential decree, which is a very lengthy process. The federal government must also authorize any amendments to the branch's articles of incorporation. The power to grant the authorizations may be delegated. Currently, the authorizations must be issued by the ministry of development, industry and commerce.

Differently from the subsidiary, the branch is theoretically considered an extension of the foreign entity in Brazil. In this sense, the branch's foreign parent company may have unlimited liability for its debts.

It is important to bear in mind that a branch is subject to Brazilian law and courts with regards to its business and transactions carried out in Brazil.

Subsidiaries

The incorporation of a subsidiary is made by most foreign investors in Brazil

There are two important factors which lead to this choice (i) the shareholders are not responsible for the Brazilian subsidiary's debts, except for specific provisions set forth by corporate, tax, labor and bankruptcy rules; and (ii) the process of setting up a subsidiary in Brazil is fairly simple and much less time consuming when compared with the establishment of a branch.

Laws regulating the formation of legal entities in Brazil are applicable to foreign and Brazilian entities or individuals in substantially the same manner. Nonresident individuals or legal entities may adopt any type of legal entity recognized by Brazilian legislation, such as - but not limited to Limitadas (Limited Liability Companies) or SAs (Corporations).

The selection of the most appropriate type of legal entity for any particular business may come to depend on various considerations, such as the nature of the business and the desired capital structure. However, foreign investments are normally conducted through a subsidiary under the form of either a limited liability company or a corporation.

According to the New Brazilian Civil Code (NBCC), legal entities may be classified as sociedades simples and sociedades empresárias. In general, those entities that perform business activities are considered sociedades empresárias, while those involved with intellectual, artistic, scientific, and literary professions would be considered sociedades simples.

In practice, sociedades empresárias, regardless of the type of legal entity adopted and their type of activities (services, sales, or manufacturing) must be registered with the Registry of Commerce (Junta Comercial). In addition, such entities must be registered with the federal tax authorities, the state tax authorities (depending on the activities to be performed by the entity), the municipal tax authorities and the social security system.

Separate registrations are required for each branch of the subsidiary located in the Brazilian territory.

Both sociedades simples and sociedades empresárias can adopt different types of legal vehicles. Both can choose, for instance, the legal form of a Limitada,, which is normally preferred because of more flexible provisions with respect to limitations on liability and, to some extent, the simplified level of administrative formalities when compared with SAs. However, the appropriate type of entity for a structure or activity depends on various factors, including the nature of the business, the desired capital structure, and shareholding relationships. For instance, only a SA is able to issue public shares/debt.

Please note that *Limitadas* and *SAs* are required to have at least two shareholders. Sole ownership is generally not allowed (but the second shareholder can hold a minimal interest).

Under normal circumstances, it takes around 45 working days to have a subsidiary duly incorporated in Brazil, as a Limitada or as a SA.

There is no difference, from a tax perspective, between the branch of a nonresident company and a local subsidiary (whether in the form of Limitada or of SA).

Limitadas (Limited Liability Companies)

Structure

The sociedade por quotas de responsabilidade limitada, commonly referred to as a *Limitada*, used to be the most convenient form of incorporation of subsidiaries of foreign investors, due to the flexibility offered by previous Brazilian legislation.

However, in 2003, new civil law provisions related to the structure of the Limitada were introduced by the NBCC. These new rules approximated even further the corporate requirements applicable to a Limitada to those applicable to a SA.

The articles of incorporation of a *Limitada* follow the form of a partnership contract. Nevertheless, it is considered an entity that is separate from its quotaholders.

A Limitada must have at least two quotaholders, regardless of citizenship or residency.

Companies as well as individuals may be quotaholders of a *Limitada*. Nonresident quotaholders must grant a power of attorney to a representative in Brazil (who must be a lawyer or another quotaholder) to receive service of notice and act on their behalf at meetings of the quotaholders.

Local representation is also required by the federal tax authorities.

Corporate capital

No minimum capital requirements are imposed, except in specific situations, such as obtaining a permanent visa for a nonresident to manage the company (US\$ 200,000 or US\$ 50,000, in July 2006, depending on some specific circumstances), applying for import/export licenses or registrations or the incorporation of a financial institution for which the SA form is also mandatory.

The corporate capital of a Limitada, which must be denominated in Brazilian currency, is divided into quotas with fixed or different unit values as specified in the articles of incorporation.

The *Limitada* may have its corporate capital increased any time after the subscribed capital is fully paid-up by the quotaholders. The reduction of the corporate capital of a Limitada, on the other hand, is only accepted when certain specific conditions are met (such as the offset of accumulated losses).

Administration

The administration or management of the *Limitada* must be performed by a resident individual (quotaholder or not), who can be a foreigner with a permanent visa and a work permit (commonly referred to as delegate-manager).

Quotaholders' rights

The voting rights of the quotaholders are proportional to their capital holdings. In general, one quota equals one voting right.

Other rights legally guaranteed to the guotaholders of a *Limitada* are (i) participation in the corporate profits; (ii) participation in the net assets in the event of liquidation; (iii) supervising the conduct of the business; (iv) preference in subscribing new quotas; (v) withdrawal from the company under certain circumstances, with reimbursement of the value of their quotas as ascertained by a balance sheet drawn up for this purpose.

Profit participation

The distribution of profits is usually stated in the articles of incorporation or subsequent amendments.

Although the non-proportional distribution of profits is accepted under the NBCC, foreign investors may find problems with the Central Bank of Brazil implement it.

Other issues related to the Limitadas

The articles of incorporation of the Limitada must be filed with the Registry of Commerce for due registration.

The transformation of a *Limitada* into a SA or vice versa may be effected through a simple legal procedure. The applicable laws state that all shareholders/quotaholders must agree with the transformation, unless the articles of incorporation provide otherwise. In general terms, the Corporations' Law (Law 6,404/76) is also applicable to a *Limitada*.

SAs (Sociedades Anônimas or Corporations)

The organization and operation of a SA in Brazil is governed by Law 6,404/76 - the Corporations' Law, amended by Laws 9,457/97 and 10,303/01. The Corporations' Law was designed to stimulate the development of the Brazilian capital market and to provide additional protection for minority shareholders.

The SAs may be publicly-held (in this case supervised by the Brazilian Securities Exchange Commission – CVM) or privately-held, depending on whether their securities are accepted for trading in the securities market.

An inaugural meeting of prospective shareholders must be held to approve the articles of incorporation and to elect the board of directors and administrative councils, if applicable.

The incorporation process depends on compliance with the following preliminary requirements:

- Subscription by at least 2 persons of all the shares;
- Initial payment of at least 10% of the issue price of shares subscribed in cash unless specific legislation requires a higher percentage. This payment must be kept on deposit with an authorized bank until approved by the Registry of Commerce.

Formation by public subscription is subject to previous registration of the share issuance within the CVM and requires the mediation of a financial institution.

Corporate capital

The SAs corporate capital is divided into negotiable shares which are indivisible in relation to the company.

No minimum capital requirements are imposed for the SA, except in specific cases such as obtaining a permanent visa for a nonresident to manage the company (US\$ 200,000 or US\$ 50,000, in July 2006, depending on some specific circumstances), applying for import/export licenses or registrations or the incorporation of a financial institution for which the SA form is also mandatory.

The SAs may issue shares with or without par value. If the corporation establishes a par value for any of its shares, this must be the same for all other shares. The issuance of shares at a price lower than their par value is prohibited.

Shares can be ordinary or preferred. Preferred shares grant their holders preferential rights with respect to dividends and/or reimbursement of capital, with or without a premium. Normally, depending on the privileges that they enjoy, preferred shares are subject to certain restrictions.

Preferred shares without voting rights (or with restrictions to voting rights) cannot exceed 50% of total capital.

Bearer shares are not allowed.

The SAs corporate capital may be increased after the payment of $\frac{3}{4}$ of the subscribed shares.

Administration

The articles of incorporation attribute responsibility for management duties solely to the board of directors or to the administrative council in conjunction with the board of directors.

The election of an administrative council is mandatory only for publicly-held companies and SAs of which articles of incorporation provide for future capital increases up to authorized limits. The council must have a minimum of 3 members who must be individuals.

The decisions must always be under majority voting. Members of the administration council may be nonresidents as long as a resident in Brazil is elected as legal representative with powers to receive service of notice.

The administrative council defines policy guidelines for the SAs business activities, including the election, dismissal, indication of responsibilities and supervision of the board of directors. It is also responsible for appointing independent auditors.

The council does not have any executive function, and representation of the company is restricted to the directors.

The board of directors is responsible for executing the policies defined by the administrative council or by the shareholders' meetings and may represent the company in relations with third parties. It must be formed by 2 or more resident individuals, shareholders or not, elected by the administrative council or, in the absence of a council, by the shareholders' meeting. Up to $\frac{1}{3}$ of the council members may also be board members.

In the absence of any specific provision in the articles of incorporation and of any restriction imposed by the administrative council, each director is responsible to achieve the SAs business objective.

The fiscal council is responsible for overseeing the performance of the administrative council and the board of directors. Its authority and powers are wide and not restricted to the periodic review of financial statements and certain administrative acts.

The Corporations' Law allows the articles of incorporation to determine whether the fiscal council shall have permanent status or whether it will be appointed only when requested by shareholders.

The remuneration of directors as well as administrative and fiscal council members must be determined by the shareholders, in accordance with consistent criteria.

Shareholders' rights

The following are the fundamental rights of the shareholders: (i) participation in corporate profits; (ii) participation in net assets in the event of liquidation; (iii) supervising the conduct of the business; (iv) preference in subscribing new share issues, subscription rights and debentures as well as profit participation certificates; and (v) withdrawal from the company under certain circumstances, with reimbursement of the value of the shares if the shareholder disagrees with a shareholders' resolution that fundamentally affects the company.

The foregoing rights cannot be denied by either the articles of incorporation or shareholders' resolutions. The articles of incorporation may confer additional rights that can be different for each type, form and class of share, but all shares of the same class must confer equal rights to their owners.

Shareholders' agreements with regard to the purchase and sale of shares, preemption rights or voting rights must be filed with the company and are then valid in relation to third parties.

Profit participation

Dividends may be paid out of accumulated earnings, profits and unrestricted reserves. Preferred dividends may also be paid out of certain capital reserves subject to authorization in the articles of incorporation.

Shareholders have the right to receive a compulsory minimum dividend as established in the articles of incorporation. If the articles of incorporation are silent, a compulsory dividend must be paid, calculated as follows: (1) 50% of net profits increased or decreased by the legal reserve and contingency reserve or reversal of this reserve created in prior years; (2) the payment of the dividend in accordance with item 1 above may be limited to realized net profits, provided the difference is posted as profits to be realized; and (3) the profits to be realized, when realized and not absorbed by losses in subsequent periods, must be included in the first dividend declared after their realization.

When the articles of incorporation are silent and the general meeting resolves to change them to regulate the matter, the compulsory dividend may not correspond to less than 25% of the net profits.

Despite of the legal requirements, the compulsory dividend may not be paid if the payment of dividends would be incompatible with the company's financial situation. Profits not distributed because of financial difficulties must be transferred to a special reserve and, if not absorbed by subsequent losses, are to be paid out as dividends as soon as the company's financial situation allows such a payment.

Normally, dividends are paid out once a year. However, companies authorized or required by law or their articles of incorporation may prepare financial statements each semester as basis for distribution of an interim dividend out of current year profits.

Other issues related to the SAs

The shareholders may be represented at the shareholders' general meeting by another shareholder, by a lawyer or by a company's officer, provided that this individual was appointed as the shareholders representative with an anticipation of at least 01 year.

It is important to stress that the corporation must publish not only the notice of shareholders' general meetings, but also its financial statements and any shareholders', administrative council's, board of directors' and fiscal council resolutions'

Please refer to Chapter 13 for Corporate Governance information.

Other forms of legal entities and partnerships

Although it is unlikely that any of these would be used by a foreign investor, some other types of legal entities and partnerships accepted in Brazil are:

Simple companies

It is the type of legal entity usually adopted by intellectual professionals or for scientific, literary or artistic purposes. Its corporate acts shall be recorded in the Civil Registry of Legal Entities (Registro Civil das Pessoas Jurídicas).

Joint venture partnership

Joint venture partnerships (described in the NBCC as Sociedades em Conta de Participação) are entities without legal personality, although they are subject to the same taxation rules.

They are created through contracts that are not considered registered and require the participation of at least one legal entity or individual, which figures as the representative partner (visible partner) of the group before third parties, with unlimited responsibility on the partnerships' debts.

Operations may be recurring or non-recurring, but they must always be of a commercial nature.

Limited partnerships

These are considered legal entities incorporated through a corporate contract entered into between the limited partner (sócio comanditário), whose liability is limited to the value of its quotas and the general partner (sócio comanditado), with unlimited responsibility on the entity's' debts.

Chapter 3

Foreign exchange controls

Foreign exchange policy

The balance of payments status is one of the most critical elements of the government's economic policy. Accordingly, maintenance of the exchange rate at an appropriate level has been and still is an important objective of economic policy. Exports are encouraged, in order to offset a large bill for raw materials and capital equipment, as well as all kinds of consumer goods more recently. The government also needs a positive current account to provide hard currency funds for servicing and amortizing the foreign debt.

Keeping domestic interest rates higher than interest rates overseas produced obvious long-term disadvantages for a country that is historically a net foreign debtor. However, over shorter periods it has been successful in attracting foreign capital. More recently, the interest rates have decreased, although they continue to be very high for international standards.

Until 2005, there were two official foreign exchange markets in Brazil, both of which were subject to Central Bank regulation and operated at floating exchange rates. However, following the trend of liberalization of exchange market, the Central Bank issued new foreign exchange provisions, effective March 2005 (Resolução 3,265/05 and Circular 3,280/05).

Basically, the new legislation (RMCCI - Regulamento do Mercado de Câmbio e Capitais Internacionais) unified the foreign exchange market in the country, integrating the regulations in connection with the free exchange rate market (Mercado de Câmbio de Taxas Livres), floating exchange rate market (Mercado de Câmbio de Taxas Flutuantes) and the transactions known as International Transfer of Reais.

The RMCCI introduced flexibility in terms of foreign exchange transactions, reducing the burdensome requirements to implement certain operations. In this context, legal entities and individuals may purchase foreign currency without direct or prior Central Bank approval.

According to the new RMCCI, cross-border obligations contracted in local currency (Reais) between a resident and a nonresident party, may be liquidated in foreign currency, in case appropriate documentation is presented. Such a transaction was not allowed or authorized by the previous regulations.

According to the *RMCCI*, Brazilian entities or individuals are allowed to make foreign direct investments abroad without prior approval from the Central Bank or quantitative limitations. Under the previous regime investments abroad higher than US\$ 5 million were subject to the Central Bank's prior approval.

All foreign exchange transactions must be contracted with an authorized agent (normally a private financial institution authorized by the Central Bank to operate in the exchange market). Most foreign exchange transactions do not depend on the pre-approval from the Central Bank. In this sense, the private financial institutions may implement the remittances provided appropriate supporting documentation and proof of applicable tax payment is presented.

Proper registration of foreign direct investments with the Central Bank in the RDE-IED electronic system is very important to enable future repatriation of capital and remittance of dividends, interest on equity and capital gains. Lack of proper registration may generate the so-called tainted capital (not registered foreign capital).

New foreign exchange regulations are expected to be published in August 2006. They will probably provide solutions to eliminate existing tainted capital, the possibility for Brazilian exporters to keep foreign currency abroad for a longer period and the possibility of using Brazilian currency in Brazilian duty-free shops.

An illegal but organized parallel (black) market exists, and the daily rate is openly quoted in the media. The spread between the official exchange rate and the parallel exchange rate is relatively small.

International transfer of Reais (CC-5)

Brazilian bank accounts owned by nonresidents used to be utilized to remit local currency abroad. This was especially useful when the remittances in foreign currency were not allowed due to foreign exchange restrictions. This was known as international transfer of Reais or CC-5 transactions (due to the fact that they used to be regulated by a Central Bank rule named Carta-circular n. 5, already revoked).

In the past, the nonresident company could then open its own "CC-5" account (a nonresident Brazilian bank account in local currency). Payments in Reais received in this account were then exchanged abroad for another currency.

However, over the time, this type of accounts were heavily used also for remittance abroad of illegal funds and, therefore, because of the associated bureaucracy and close Central Bank scrutiny, it became very difficult in practice to open new accounts. On the other hand, it also because very common the utilization of third parties' accounts, such as banks, to implement the international transfer of Reais.

It should be noted that the international transfer of Reais is permitted and legal, provided the funds also have a legal origin.

Nevertheless, the RMCCI prohibited the use of "CC-5" accounts of third parties, i.e., the companies cannot use the "CC-5" account of private banks anymore, if they do not have their own accounts.

Financial transactions (RDE-ROF)

Most cross-border financial transactions, such as loans, rental, lease as well as agreements involving transfer of technology (royalties, know-how, technical assistance, etc.) must be registered in the Central Bank on-line electronic registration system called RDE-ROF (Registro Declaratório Eletrônico de Operações Financeiras) to enable the remittances abroad.

The private financial institution responsible for the corresponding foreign exchange contract, normally assists the companies with the RDE-ROF registrations.

As far as cross-border loans are concerned, it should be noted that the system indicates the acceptable level of interest to be charged. As loans registered with the Central Bank are not subject to transfer pricing rules, the interest rates accepted by the Central Bank are also accepted for tax deductibility purposes, even when the loan is executed between related parties.

Foreign direct investments

Foreign capital in Brazil is governed by Law 4,131/62 and Law 4,390/64. According to the law, "foreign capital is considered to be any goods, machinery and equipment that enter Brazil with no initial disbursement of foreign exchange, and are intended for the production of goods and services, as well as any funds brought into the country to be used in economic activities, provided that they belong to individuals or legal entities resident or headquartered abroad."

In 1988, political leaders representing labor in Congress sided with conservative politicians to approve an openly nationalistic constitution. Since then, however, the treatment of foreign investment has improved. The constitutional distinction between foreign-owned and Brazilian-owned companies was repealed by a constitutional amendment approved in 1995. Other constitutional barriers against foreign investment in protected sectors have also been removed. These reform efforts have led to an increase in foreign investments, especially in capital intensive industries.

Capital contributions

The Brazilian concept of capital covers economic benefits in any form, and accordingly, foreign capital contributions include cash, goods, services, and intangibles.

In practice, investments in cash are the simplest and most common form of initial investment, but investments in the form of assets and the capitalization of balances payable for goods supplied by the foreign parent are often used when making subsequent investments. Capital contributions in productive assets, such as plant and equipment, are subject to rigorous controls, which are similar to those placed on the import of capital equipment when domestic suppliers are able to provide similar equipment. The import of used equipment as a capital contribution is also subject to restrictions. In order to receive an import license, the equipment must contribute to the Brazilian economy in technological and economic terms. Those who intend to import capital equipment should be prepared to present an analysis covering why the equipment cannot be purchased in Brazil and what technological and economic benefits it will bring to the economy in general, as well as a justification of the foreign currency value attributed to the equipment.

Capital contributions in intangibles are in principle allowed, but the Central Bank is very reluctant in accepting them. Proper valuations are required and discussions with the Central Bank may be recommended.

Registration in the RDE-IED

All foreign direct investments must be registered with the Central Bank. The registration is essential for offshore remittances, capital repatriation and registration of profit reinvestment. In this sense, in order to allow the remittance of dividends, and to assure the eventual repatriation of the original capital and subsequent reinvestment, foreign investors must comply with the foreign capital registration rules associated with the entrance of the funds.

The registration of foreign capital must be made within a maximum 30-day period in the on-line Central Bank electronic system named RDE-IED (Registro Declaratório Eletrônico de Investimentos Estrangeiros Diretos). Some information must be kept updated in the system, such as accounting information of the Brazilian entity, shareholding, etc.

According to the provisions of Circular 2,997/00 the foreign investment to be performed and registered is not subject to preliminary review and verification by the Central Bank, being thus declaratory, performed through a statement, which means that the Brazilian investee and/or the representative of the foreign investor are responsible, themselves, for registration of foreign investments.

To be registered as foreign capital investment, the amount contributed must originate from persons resident, domiciled, or with a head office outside Brazil, the capital contribution must be effectively brought into the country, and must be invested in the acquisition of shares or quotas.

Payments of dividends and interest on equity

Provided the foreign capital is properly registered in the RDE-IED, the foreign investor should have no foreign exchange difficulties in receiving dividends or interest on equity from its Brazilian subsidiary.

Conversion of foreign debt into share capital

The conversion into investment of foreign credits duly registered in the RDE-ROF (Central Bank electronic registration system for cross-border financial transactions) does not require prior approval from the Central Bank. According to Circular 2,997/00, the conversion of debt into foreign direct investment is defined as "the transaction whereby credits eligible for offshore transfer based on prevailing rules are used by nonresident creditors to acquire or pay in an ownership interest in the capital of a company in Brazil."

Registration of foreign direct investment resulting from conversion, however, depends on receipt by the Brazilian entity of (i) a statement from the creditor and committed investor, defining exactly the due dates of the installments and respective amounts to be converted, and in the event of interest and other charges, also the period to which they refer and the respective rates and calculations, and (ii) a binding statement from the creditor, agreeing to the conversion.

Portfolio investments (RDE-Portfolio)

Nonresident individuals or legal entities (including foreign funds or financial institutions) that make certain financial investments in the Brazilian market are also required to register such investments in an electronic Central Bank registration system called RDE-Portfolio. Please note that the investor must observe Central Bank and CVM (Brazilian Securities Exchange Commission) rules. It is necessary, for instance, to appoint a legal representative in the country and to open an individual or collective bank account.

Chapter 4

Corporate taxation

Introduction

The Brazilian legal system is based on civil law. In this sense, only formal legislation determines the rules. Court decisions as well as analogy functions as tools for the interpretation and correct application of current legislation. Accordingly, court precedents do not serve as source of legislation, binding only the litigating parties.

The Brazilian tax system is based on the principle of strict legality and its main principles are defined by the Federal Tax Code of 1966 and by the Federal Constitution/88. Three jurisdictions and tax collection levels are defined by the tax legislation. Thus, taxes may be levied by the federal, state and municipal governments.

On the other hand, there is a separation of jurisdictions and powers between the judiciary and the administrative boards for the judgment of controversies. In this sense, a tax matter is usually analyzed at the administrative level before the judiciary.

The federal tax system is managed by the Secretaria da Receita Federal -SRF, which is part of the Ministry of the Economy (Ministério da Fazenda). States and municipalities have similar agencies.

Federal corporate income taxes

- There are two income taxes in Brazil (a) the corporate income tax (IRPJ) and the social contribution tax on profits (CSLL) charged on similar bases.
- Profits, income and capital gains earned worldwide are subject to Brazilian corporate income taxes.
- There is no distinction made as to the origin of the capital (whether the investors are foreign or domestic).
- Branches of foreign companies, although rare, are in general taxed in the same manner as standalone subsidiaries.
- A company is, in principle, considered resident in Brazil if it has been incorporated under Brazilian corporate law and is domiciled in Brazilian territory. In addition, Brazilian law requires the company's effective management to be in Brazil. Please refer to permanent establishment issues on the Chapter - International Tax.
- The Brazilian tax year is the calendar year, irrespective of the corporate year. The annual income tax return must be filed by the last business day of June. The income tax return must also be filed in certain special events occur during the year (e.g., mergers, liquidations, spin-offs).
- There are three methods provided by legislation to calculate corporate income tax and social contribution tax due on profits, the actual profit, the presumed profit and the arbitrated profit, as further explained below.

Corporate income tax (*IRPJ*)

The income tax regulations in force are consolidated under Decreto 3,000 of March 26, 1999. These regulations apply to all taxpayers. Only the federal government may charge income tax, however, part of the income tax collected is transferred to states and municipalities.

Brazilian corporate income tax is a federal tax charged on the net taxable income. It applies at a basic rate of 15%, plus a surtax of 10% on the annual income that exceeds R\$ 240,000.00 per year or R\$ 20,000.00 per month.

Social contribution tax on profits (CSLL)

This tax was introduced to fund social and welfare programs and is paid in addition to the corporate income tax.

Social contribution tax on profits is also a federal tax levied on the net taxable income and applies at 9% and is not deductible for corporate income tax

purposes. Social contribution tax on profits' tax base is similar to the tax base for the corporate income tax, although some specific adjustments may be applicable to one tax and not to the other.

Actual profit system

Under the actual profit system, the net taxable income corresponds to the company's net book profit, arrived at by applying Brazilian GAAP, adjusted by some inclusions and deductions as per Brazilian corporate taxes legislation.

In this sense, under the actual profit system, companies are required to keep appropriate accounting records, an income tax book (LALUR) and supporting documentation and calculations in order to demonstrate the amount of the taxes due.

Taxpayers on the actual profit system may choose to calculate taxes on (i) a quarterly basis or (ii) on an annual basis. The choice is made at the beginning of each calendar year and is valid for the entire fiscal year. Under the annual actual system, the taxable income is computed on an annual basis, but monthly advances during the year are required to be made on an (a) estimated basis or (b) actual basis. The estimated base corresponds to the presumed profit tax base, commented further below.

Main exclusions from taxable income include dividends received from other Brazilian entities and related to profits generated as of 1996 and equity pick-up revenue from relevant investments in other companies (please refer to the comments in the Chapter on the Accounting Practices in Brazil). Main inclusions relate to non-deductible accounting provisions and non-deductible expenses.

Deductible expenses are generally all items relating to the ordinary business of the company, properly documented and which are necessary to maintain its source of income. The following are some examples of rules related to deductibility of expenses for income tax purposes:

• Depreciation - Depreciation may be charged based on the useful life of the related asset. There is a detailed list of assets published by tax authorities which contain the accepted depreciation rates. Higher rates may be accepted if certain requirements are met. In case the company functions in two or three shifts, these rates may be increased by 50% and 100%, respectively. Additionally, assets acquired under approved projects or eligible under certain income tax incentive programs may be depreciated at higher rates.

- Deferred expenses Expenses that will benefit future years such as interest paid during the construction and pre-operational phase of a new plant, and expenditures on company reorganization, should be deferred for future amortization.
- Start-up expenses should be deferred until the project is operational, at which time these expenses should be amortized over at least five years.
- Technical assistance and royalty payments are tax deductible subject to specific conditions and limits established by law, which among other things require the approval of the Federal Intellectual Property Agency (INPI).
- Fines are in principle not tax deductible.

Tax losses

- Tax losses may be carried forward indefinitely. There is no statute of limitations
- The offset is limited to a maximum 30% of the annual taxable income.
- No carry back of losses is allowed.
- Non-operational losses may be carried forward, but they may only be utilized to offset non-operational profits (e.g., capital gains).
- Tax losses are lost if between their generation and their utilization, cumulatively, there is a change in control and change in the type of activity performed by the taxpayer.

Presumed profit system

Brazilian companies may elect to compute corporate taxes based on presumed net profit, provided they do not (a) have total revenues in the preceding year higher than R\$ 48 million, (b) be financial institutions, similar entities or factoring companies, (c) earn foreign profits, income or gains (i.e. directly or through foreign subsidiaries) and (d) qualify for an exemption or reduction of the corporate income tax.

The election is made annually, at the beginning of the year and the choice may be renewed every year. The election is valid for both corporate income tax and social contribution tax on profits. Under the presumed tax regime, the taxes must be calculated and paid on a quarterly basis.

The presumed profit is arrived at by applying a certain pre-determined percentage, which varies according to the activity, over the gross sales. The total amount of capital gains, financial revenue and other revenue must be added to this presumed profit base to compute the corporate taxes. The corresponding tax rates and then applied over the presumed profit.

For instance, for the income tax, the percentage for the revenues derived from the sale of products is 8%, while the percentage for service revenue is 32%. For the social contribution tax on profits, the percentages are, respectively, 12% and 32%.

For example:

Gross Sales Revenue – R\$ 1.000

Presumed Profit – for income tax (8%) – R\$ 80 (+) Financial revenue – R\$ 500 Total Presumed Profit – for income tax – R\$ 580 Income tax due (app. 25%) - R\$ 145

Presumed Profit – for social contribution (12%) – R\$ 120 (+) Financial revenue – R\$ 500 Total Presumed Profit – for social contribution – R\$ 620 Social contribution tax due (9%) - R\$ 55.80

It should be noted that under the presumed tax system, no tax losses may be carried forward and losses carryforwards may not be utilized the reduced the presumed profit.

The choice to pay the income taxes under the presumed system does not prevent the Brazilian entity from paying dividends corresponding to the amount of the actual book profit, in case it exceeds the presumed profit. However, the company is required to keep proper accounting records and balance sheets to demonstrate the book profits.

Arbitrated system

Under certain circumstances, such as inadequate or unreliable record keeping, the tax authorities may arbitrate profits. In this sense, this method is a type of punishment applicable in situations provided for by law. The income tax paid over the arbitrated profit is definitive and cannot be offset against future payments. The arbitrated profit amount is similar to the presumed profit.

Tax audits

Tax audits are performed by federal tax inspectors on a random basis. The scope and frequency of auditing does not follow a set pattern. In general, the right of the tax authorities to make corporate income tax assessments (statute of limitation for tax purposes) expires five years after the end of the tax year in which the tax return should have been filed.

Administrative appeals against assessments must be filed within 30 days of assessment. If the assessment is upheld, the taxpayer may appeal to an administrative court. If still unsuccessful, the taxpayer can appeal to the iudicial court.

Penalties and fines

From 1995 onwards, tax credits and obligations are calculated in Reais. The fine for overdue federal taxes is currently set at 0.33% per day up to 20% depending upon the period in arrears. Interest on overdue federal taxes is charged at a floating rate (SELIC) plus 1%.

Assessed tax deficiencies are subject to a 75% fine. If fraudulent intent is proven, the fine is increased up to 150%.

When business entities are in arrears with any federal taxes or social security contributions, they are prohibited from distributing bonus shares to their stockholders or from paying any profit participation to "quotaholders", partners, directors, or members of the administrative council. In case of failure to comply with the restrictions, penalties apply.

Gross revenues taxes

PIS and COFINS

PIS and COFINS are federal taxes charged on revenues, on a monthly basis, including income from financial transactions, under two regimes: cumulative and non-cumulative

Historically, for most companies PIS and COFINS were charged at 0.65 and 3%, respectively, and generated a harmful cascading effect because of the lack of a credit mechanism, thereby increasing the tax burden and the cost of products and services in Brazil.

New PIS tax provisions were implemented in December 2002 (MP 66/02 and Law 10,637/02). As a result of such rules, the PIS rate was increased from 0.65% to 1.65% and a credit mechanism was introduced. According to this new non-cumulative mechanism, in general, the taxpayers may recognize PIS credits corresponding to 1.65% over certain costs and expenses. Such credits may be used to offset the PIS due on their taxable revenue.

Later on, Law 10,833/03, enacted on December 29, 2003, introduced similar non-cumulative rules to COFINS. The tax rate also increased (from 3 to 7.6%) and COFINS tax credits corresponding to 7.6% over certain costs and expenses became available to offset the tax due on the monthly taxable revenue.

Thus, taxpayers under the non-cumulative system are subject to PIS at 1.65% and COFINS at 7.6% and are allowed to recognize tax credits for PIS and COFINS paid on certain inputs, including, for instance, (a) products purchased for resale; (b) the goods and services used as inputs in the rendering of services or manufacturing (excluding labor); (c) consumed electrical power; (d) the rental of real state and fixed assets applied in the activities; (e) the acquisition of fixed assets and (f) returned goods, if the corresponding revenue was included in the previous month's PIS and COFINS taxable bases.

Tax credits may be used to offset future PIS and COFINS due or other federal taxes, provided certain requirements are observed.

The PIS and COFINS non-cumulative regime is mandatory for companies subject to the actual profit method of computing corporate income taxes.

The former PIS and COFINS cumulative system remains applicable for certain entities, such as financial institutions and companies under the presumed profit system, among others. Entities that are subject to the cumulative system are subject, in general, to a 0.65% tax rate for PIS and 3% tax rate for COFINS and no credits are available. Financial institutions are subject to a 4% COFINS rate.

Revenues related to export transactions are in general exempt from these taxes as well as the sale of permanent assets.

There are special PIS and COFINS regimes for companies engaged in some types of industries, such as automotive, auto parts, cosmetics, pharmaceutical, oil, beverage, packaging materials, energy, real state, among others.

Additionally, as of May 1, 2004, the import of goods and services also became subject to PIS and COFINS at a combined rate of 9.25%. This new taxation and the 9.25% combined rate apply to taxpayers under both cumulative and non-cumulative regimes. In some cases, taxpayers may recognize PIS and COFINS credits on the import. We discuss this subject further in the Trade & Customs Chapter.

Indirect taxes

IPI

IPI (imposto sobre produtos industrializados) is a federal tax levied on the import and manufacture of goods. In many aspects, it operates like a valued-added tax, which is charged on the value aggregated to the final merchandise. As a general rule, the IPI paid on a prior transaction can be used to offset the IPI liability arising out of subsequent taxed operations.

The applicable rate depends on the product and its classification under the IPI tax rates table (TIPI). The classification within TIPI generally follows the Brussels Harmonized Tax Codes.

IPI has also a regulatory nature, i.e., the Executive Power may increase its rates at any time by decree as a way to implement financial and economic policies. Additionally, IPI rates can be higher for non-essential products such as cigarettes, perfumes, etc.

Each facility (branch) is considered a separate taxpayer for IPI tax purposes.

For imported products, the taxable event is the customs clearance as well as the first exit of the product from the importer's facilities (generally the sale). For most products, the IPI on imports is charged on the CIF value added by certain customs expenses and the import tax.

For domestic transactions, in most cases, the taxable event is the exit of the manufactured product from the facility where it has been manufactured. IPI usually applies on the value of the transaction plus the ICMS tax.

Brazilian tax legislation defines "manufacture" as any process that modifies the nature, operation, finishing, presentation or the purpose of a product, or that improves a product for consumption.

IPI taxpayers are entitled to an IPI tax credit equivalent to the tax paid upon the acquisition of the inputs to be used in the manufacturing process. This credit may be offset against the IPI triggered by subsequent transactions. Under certain circumstances, the excess IPI tax credits that cannot be offset against the IPI due on subsequent transactions may be offset against other federal taxes.

IPI does not apply on the sale of fixed assets, but some requirements must be observed.

ICMS

ICMS stands for imposto sobre operações relativas à circulação de mercadorias e sobre prestações de serviços de transporte interestadual e intermunicipal e de comunicação.

The ICMS is a state type of value-added tax levied on the import of products and certain transactions involving goods (including electricity), inter-municipal and inter-state transportation services and communication services.

In general, in the transactions involving two different states, the rates are 7% (when the purchaser is located in the states of the North, Northeast and Center-West regions or in the state of Espírito Santo) or 12% (for purchases located in the Southeast and South regions). For transactions within the same state and in the case of imports, the rates may be 17 % or 18%. The 19% rate is applicable for the state of Rio de Janeiro; the 18% is applicable for the states of São Paulo, Paraná and Minas Gerais; and the 17% is applicable for the remaining states.

Sales of automobiles, communications services and electricity are subject to 25% ICMS.

On imports, in general, ICMS tax base is equal to the CIF value added by the applicable import tax, IPI, certain customs expenses, the ICMS itself and PIS and COFINS due on the import.

The ICMS is also due either when a product is resold in the domestic market or when it is physically removed from a manufacturing facility. The taxable base is equal to the value of the transaction, including the ICMS itself (gross-up), insurance, freight and conditional discounts. IPI must also be added to the ICMS tax base when the transaction is carried out between non-ICMS taxpayers or when it involves a product that will not be further manufactured or resold (e.g. fixed assets).

Similarly to the IPI, each branch of a company is considered a separate taxpayer for *ICMS* tax purposes.

In general, ICMS taxpayers are entitled to a tax credit in the amount of the tax paid in the previous transaction with the same asset (inputs), provided the purchaser is an ICMS taxpayer with respect to that product, i.e., that the subsequent transactions with the purchased product are also subject to ICMS. The tax credit may be offset against future ICMS payables.

If the purchaser is not an ICMS taxpayer, and depending on whether its sales are subject to this tax, ICMS may become a cost and will not be recoverable as a credit.

ISS

ISS is a municipal tax levied on the revenues derived from the provision of services. Although being a municipal tax, the services subject to the ISS are listed in a federal law (Lei Complementar 116/03).

The tax base is the price of the service and the rates vary from 2 to 5%, according to the municipality where the service provider is located, where the service is provided and the type of the service. For most services, there is a significant debate as to whether the ISS should be paid to the municipality where the service provider is located or where the service is performed.

The taxpayer is, in principle, the service provider. However, the municipal tax legislation may impose a withholding responsibility to the company hiring the services.

As of January 2004, ISS also applies on the import of services. The Brazilian company retaining the services is obliged to withhold the tax on the services fees paid to the nonresident.

Furthermore, Lei Complementar 116/03 introduced an ISS exemption to certain export of services.

When the provision of the service also involves the provision of goods, the ISS applies on the total price of the service, except when there is a specific provision determining the applicability of the ICMS on the value of the goods.

Other federal taxes

Withholding income tax

Withholding income tax applies on certain domestic transactions, such as payment of fees to some service providers, payment of salary and financial income resulting from banking investments. In most cases the withholding tax is a prepayment of the income tax on the individual or entity's final tax return. However, in some cases it is considered a final taxation.

Also, withholding income tax is due on most nonresidents' income that has a Brazilian source of payment (e.g., royalties, service fees, capital gains, interest, etc.). According to Brazilian tax law, withholding tax is due upon the payment, credit, delivery, utilization or remittance of the funds, whichever occurs first.

The rates depend upon the nature of the payment, on the residence of the beneficiary and on the existence of tax treaties between Brazil and the country where the beneficiary is located. Most common rates range from 15 to 25%. As a general rule, income paid to beneficiaries located in low tax jurisdictions is subject to 25% withholding tax. Please refer to more detailed information in the International Tax Chapter.

CIDE

CIDE (contribuição de intervenção no domínio econômico) is a 10% special contribution levied on payments due to nonresidents in the form of royalties, technical services and technical assistance, among others, at a rate of 10%. Note that, differently from the withholding tax, CIDE is a tax imposed on the Brazilian payor of the fees and, therefore, may not be reduced by tax treaties and does not generate a tax credit abroad.

There is a limited tax credit granted to the Brazilian entity for the *CIDE* paid on royalties for the use of trademarks or trade names which reduces the tax's effective rate.

CIDE Combustíveis is another special contribution levied on the import and on sale of oil and gas-related products and also on the ethylic alcohol. The manufacturer, the formulator and the importers are the taxpayers of the CIDE Combustível, according to the Law 10,336/01.

CPMF

CPMF (banking tax) is a federal tax levied at 0.38% on the withdrawal of funds from a Brazilian bank account. This means that all payments made by Brazilian individuals and corporations are subject to a 0.38% tax unless made in cash. The banks are responsible for the withholdings. It is also charged on symbolic foreign exchange transactions.

IOF

IOF is a federal tax levied on credit, exchange, insurance and securities transactions, executed through financial institutions. The tax also applies to gold transactions and includes intercompany loans.

The tax rates can be raised by the government by decree and become effective immediately. The tax base varies according to the taxable event and the financial nature of the transaction.

On loan transactions in Brazilian currency, the *IOF* is levied on the average daily balance or on a transaction basis, at 0.0041% a day when the lender is a legal entity, limited to 1.5% on the loan proceeds for a loan maturing in 365 days.

The *IOF* is levied at varying rates, depending on the maturity terms and the type of transaction:

Type of transaction	Range of tax rate
Credit transactions	0-1.5% per day
Securities transactions	0-1.5% per day
Insurance transactions	2-25%
Exchange transactions	0-25%
Gold transactions	1% (payable on the first sale transaction)

Currently the *IOF* tax rate is reduced to zero on most foreign exchange transactions, but it may be increased at any time.

ITR

ITR (imposto sobre a propriedade territorial rural) is an annual federal property tax levied on the ownership or possession of real estate located outside urban perimeters. Tax basis vary according to the value, size and location of the real estate, and tax rates vary in accordance with land-use.

CONDECINE

Condecine (contribuição para o Desenvolvimento da Indústria Cinematográfica Nacional) – is a contribution levied on the broadcasting, production, license and distribution of advertising cinematographic and videophonograph works, with commercial purposes.

Other state taxes

ITCMD

The ITCMD (imposto sobre transmissão "causa mortis" e doacão de quaisquer bens ou direitos) is a state tax that applies on the transfer of the ownership of goods and rights upon causa mortis (succession) and donations. Tax rates vary according to the state legislation.

IPVA

IPVA (imposto sobre a propriedade de veículos automotores) is a state tax levied on the ownership of motorized vehicles in general (cars, trucks, boats, etc.). Tax base is the value of the vehicle and rates vary according to state legislation.

Other municipal taxes

IPTU

The IPTU is an urban real estate property tax annually charged by municipalities based on the assessed value of the property (which may not correspond to fair market value). Tax rates vary according to the municipality and location of the property. The IPTU taxpayer is the owner of the real estate, or the tenant if the property is leased and the agreement provides for that.

ITBI

The ITBI is a real estate transfer tax charged at variable rates (from 2% to 6%). This tax is usually not levied if real estate is transferred under a corporate reorganization (e.g., mergers, spin-offs, capital contribution in kind, etc.).

Anti-avoidance rules

Brazilian tax legislation currently provides that tax authorities may have the power to disregard, for tax purposes, the acts or transactions intended to reduce the amount of a tax due, avoid or postpone the payment of a tax, or conceal aspects of a taxable event or the true nature of elements that give rise to such an event.

However, such provisions are still pending administrative regulation in order to be fully effective from a legal perspective. Without court precedents on the subject, the only certainty at this point is that the rules are vague and unclear.

Tax incentives

A wide range of government incentives is available for start-up projects in Brazil. Generally speaking, the international investor has equal access to these incentives and treatment when compared with local investors.

The use of government incentives is a significant feature of the Brazilian business environment. Usually, incentives take the form of subsidized loan financing and of tax exemptions or reductions, rather than cash grants.

Local, state, and federal incentives

Federal government incentive programs are designed to promote domestic policy objectives, including the growth of exports and the capitalization of domestic private industry, whereas state and local incentive programs are directed toward specific objectives such as increasing local employment opportunities. State and local governments commonly use an exemption or deferral of indirect and property taxes that they are entitled to levy, and provide assistance to potential investors in obtaining access to available federal programs. Thus, a company that has decided to establish a new plant for export production and which is eligible for federal programs will seek the best available package of local incentives when deciding where to locate a plant.

Frequency of revisions

Brazilian government incentive programs are subject to frequent revisions, both in relation to their basic approach and the specific categories and rates of tax incentives granted. Accordingly, companies planning to avail themselves of incentive programs should, as a first step, obtain the latest available information.

Capital grants

Governments do not give cash grants to reduce initial outlays on industrial buildings and equipment. Exceptionally, capital grants in the form of land can be obtained from local governments and are often provided through state development agencies.

Low-cost finance

There are various government incentive programs providing low-cost finance. In former years, Brazil has experienced chronic inflation and even presently continues to have some of the highest rates of banking interest. Under these circumstances, subsidized rate financing has for long been very important for certain sectors of the Brazilian economy, and has formed the basis for the expansion and modernization of Brazilian agriculture.

Regional and industry incentive programs

Various concessions are offered to encourage economic development in Brazil, either on a regional or industry basis, by offering taxpayers the opportunity to invest part of their tax liability and also by granting the following fiscal incentives for approved investments:

ADA and ADENE

Until year 2023, companies located in the Northeast region and the Amazon region may benefit from certain tax incentives.

ADA, a federal agency formerly known as SUDAM, oversees development in the Amazon region. The region encompasses the states of Acre, Pará, Roraima, Rondônia, Amapá, Amazonas, Tocantins, Mato Grosso, Mato Grosso do Sul, Goiás and part of Maranhão.

ADENE is a federal agency formerly known as SUDENE which oversees the development in the Northeast region. The geographical definition of the

Northeastern encompasses the states of Maranhão, Piauí, Ceará, Rio Grande do Norte, Paraíba, Pernambuco, Alagoas, Sergipe, Bahia and the semi-arid region in the northeastern part of the state of Minas Gerais.

Eligibility for these concessions depends on ADA/ADENE's approval of an industrial project or a project for the expansion of an existing industry. ADA/ADENE not only evaluates the project in terms of its technical and economic feasibility, but also verifies whether the project is appropriate within the overall economic development of the region.

The benefits are available for companies that have set-up, modernization, extension and diversification projects in the region. The main benefit is in a reduction of the income tax due over the tax-benefited income (lucro da exploração) at a 25% rate until December 31, 2008 and at a 12.5% rate from January 1, 2009 through December 31, 2013.

Also, companies that have their projects approved for the set-up, modernization, extension and diversification of businesses recognized as priority for the regional development may benefit from a 75% reduction of the income tax during a 10-year period (the project must be presented and approved until 2013). Such companies may also benefit from upfront depreciation for certain new equipment, acquired between 2006 and 2013, as well as accelerated PIS and COFINS tax credits, provided that the company is located in specific low-developed regions (micro-regiões).

It is important to note that the tax liability investments above are considered local currency investments and therefore, any related-profits do not qualify for remittances abroad.

Lucro da exploração is based on the net profit for the fiscal period before the deduction of the provision for income tax, reduced by the following main adjustments:

- The part of the financial income that exceeds the financial expenses;
- Revenues and losses related to shareholders' interest:
- Non-operating income;
- Foreign-based income.

In addition to the above, the investment incentive plan may include the following tax benefits:

- Exemption from federal taxation on imported equipment used in new industries established in the region:
- Eligibility to receive tax-related investments from other companies;
- Government loans or loan guarantees from the Bank of Northeastern Brazil (BNB) or the Federal Development Bank (BNDES).

New investments may also receive a partial exemption from state taxes (normally from 15% to 100%).

PPB

The PPB (minimum manufacturing process) benefit is usually applicable to Brazilian companies engaged in the manufacturing and sales of products and services related to specific types of technology (bens e serviços de informática e automação).

The incentive was initially addressed to the computer industry, being later expanded to include a wider range of electronic products and telecommunication equipment.

The PPB benefit is granted to Brazilian companies that have a PPB project approved by the MCT (Ministry of Technology and Science) and that annually invest a percentage (limited to 5%) of their gross revenue derived from the sale of technology related goods and services with R&D in the country. The percentage varies per year.

The benefits are basically related to the IPI and ICMS.

A reduction of the IPI tax due is granted as follows:

- 75% through December 2005; and
- 70% from January 2006 through December 2009.
- After 2009 the benefit is scheduled to be extinguished.

In the case of the ICMS, the benefits vary according to the state involved. Basically, the benefit may relate to a reduction of the ICMS rate for intrastate transactions; a deferral or exemption of the ICMS due or a "special credit" (crédito outorgado).

Manaus Duty Free Zone

Manaus is the capital of the Amazon state at the junction of the Amazon River and Rio Negro. The city is home to over 600 industries, which are eligible for the tax incentives offered under its duty free zone regime, designed to foster the development of the Amazon region. A company operating in Manaus is eligible for the following tax incentives:

- Income tax reduction of corporate income tax (excluding the social contribution tax on profits). The tax reduction must be booked as a capital reserve (lucro da exploração) and cannot be distributed as dividend.
- Import duties deferral of import duties until the products leave the duty free zone. If the imported product is used in a manufacturing process within the free zone, the law grants a reduction of import duties.
- Excise taxes (IPI) IPI exemption on the import of products which remain in the duty free zone and for products manufactured within the duty free zone provided that companies employ local labor, incorporate new technologies into their production process, increase levels of productivity and reinvest profits in the region.
- Sales tax (ICMS) the law grants a presumed tax credit on the purchase of products from other states in Brazil and an exemption of ICMS paid on imports, for some industries.

Technology incentives

Law 11,196/05 and Decree 5,798/06 provide for various tax benefits for the high-tech industry with the purpose of fostering research and development and technological advances.

Tax benefits include:

- Accelerated and boosted depreciation in the acquisition of new equipment;
- IPI tax reduction and accelerated and boosted depreciation for certain equipment;
- Accelerated amortization for certain intangibles and R&D expenses;
- Tax credit on the withholding tax on royalty payments for the license of technology until 2013; and
- Withholding tax exemption on the fees for the maintenance of trademark and patent registrations.

RECAP - Export companies

According to the Law 11,196/05, under the RECAP regime (regime especial

de aquisição de bens de capital para empresas exportadoras), companies that pay PIS and COFINS under the non-cumulative regime, with export revenues greater than 80% of their annual sales for the previous calendar year may qualify for a PIS and COFINS exemption on acquired capital goods for a 3-year period that begins after the approval of the benefit.

REPES - Software developers and hardware sales

Law 11,196/05 provides for a special tax regime for the exports of information technology services called REPES (regime especial de tributação para a plataforma de exportação de serviços de tecnologia da informação) and another directed to hardware sales (programa de inclusão digital).

Companies that are involved exclusively in the development of software applications and other technology services, that pay PIS and COFINS under the non-cumulative regime and that have export revenues that are greater than 80% of their annual sales may benefit from a PIS and COFINS exemption, for a 5-year period, with respect to the acquisition of goods and IT services, if certain conditions are met.

Please note that IT service companies are subject to the cumulative PIS and COFINS with respect to software development, software license and assignment of software rights. Therefore, they may not benefit from the REPES.

Regarding the hardware benefit, a zero-rate PIS and COFINS regime is also available for revenue related to the retail until 2009 of certain hardware equipment.

Corporate income tax reductions

Certain expenditures made by the corporate taxpayer in specific cultural, audiovisual, children funds donation, meals program may also generate reductions in the amount of the corporate income tax payable according to the actual profit method. These reductions, however, are subject to individual and global limits that vary from 1% to 3% of the amount of tax due.

Chapter 5

International tax matters

Permanent establishment

In general, only companies incorporated in Brazil are subject to taxation as residents. In principle, Brazilian companies must register for tax purposes, but irregular companies that carry out taxable activities in the country are also subject to taxation.

Contrary to the international mainstream, Brazilian tax law does not contain the permanent establishment concept and does not provide clear guidance regarding the potential tax impacts of having foreign entities carrying out business in Brazil

There is lack also of guidance from the tax authorities and we are aware of only a few administrative precedents (tax assessments) on the matter. Maybe because in certain cases, the tax burden on nonresidents income is even higher than the eventual residents' taxation that a permanent establishment characterization would generate. For instance, while resident's corporate profits are taxed at a combined 34% rate, gross nonresident service fees are taxed in general at 25% (withholding income tax and CIDE, if applicable)¹.

Also, the NBCC (new Brazilian civil code) prohibits foreign entities to operate in Brazil without authorization. In principle, authorization is granted by means

Please refer to our more detailed comments below of the taxation of service fees

of the set up of a branch, which is taxable in Brazil in the same manner of a Brazilian legal entity.

Nevertheless, the following situations may potentially generate a taxable presence in Brazil and, therefore, it is recommended to analyze the specific activities that would be carried out in Brazil to assess eventual risks.

- De facto branch when the foreign company has an unregistered branch or office;
- Consignment if sales are made under consignment and proper accounting records are not kept by the consignee in Brazil; or
- Binding agent if sales are made in Brazil, through a resident agent or representative of a foreign company who has the power to bind the company to a contract and habitually exercises it.

Thin capitalization rules

There are no thin capitalization rules in Brazil.

Tax treaties

Brazil has signed double taxation treaties with various countries. The main method of tax relief under the treaties is the foreign tax credit. The existing treaties offer very limited opportunities to reduce or eliminate withholding taxes on payments abroad. Additionally, tax sparing clauses are also found in most treaties in force.

Brazil has double taxation treaties with the following countries: Argentina, Austria, Belgium, Canada, Chile, China, South Korea, Denmark, Ecuador, Spain, the Philippines, Finland, France, the Netherlands, Hungary, India, Israel, Italy, Japan, Luxembourg, Norway, Portugal, Paraguay, the Czech Republic, Slovakia, Sweden and Ukraine.

Treaties with Mexico, Venezuela, South Africa and Russia have been executed but are pending on final approval from the National Congress.

Brazil used to have a treaty with Germany, but it was denounced by Germany in 2006. The official German reason given for the cancellation is the existence of numerous provisions which would work only one-sided and which are no longer in line with German treaty policy and treaty practice even with regard to developing countries. The treaty would also no longer offer the necessary legal protection for the German economy.

In fact, significant debate exists on two treaty-related issues (a) whether Brazilian transfer pricing rules, which are not OECD-based, would be against the "Associated Enterprises" provisions of the treaty and (b) whether the interpretation of the Brazilian tax authorities in the sense that Brazilian withholding tax may be imposed on service fees, because they would fall under the "Other Income "and not the "Business Profits" Article is correct.

Withholding tax rates

The following are the main withholding tax rates applicable to payments to nonresidents:

Interest - 15% Interest on equity – 15% Royalties - 15% Technical service fees - 15% Non-technical service fees - 25% Lease and rental fees - 15%

The following are currently not subject to withholding tax (some requirements may apply):

Dividends (if related to post-1995 profits) – 0% Interest and commission on export financing – 0% Interest and commission on export notes – 0% Export commissions - 0% Interest on certain government bonds – 0%

Rental fees for aircraft and ship – 0%

Sea and air charter, demurrage, container and freight payments to foreign companies - 0%

International hedging – 0%

Fees for the registration and maintenance of patents, trademarks and cultivares

Low-tax jurisdictions

In most cases, remittances to beneficiaries located in listed low-tax jurisdictions are subject to a 25% withholding tax rate. Black listed jurisdictions are: Andorra, Alderney (Channel Island), American Samoa and Western Samoa, American Virgin Islands, Anguilla, Antigua and Barbuda, Aruba, Bahamas, Bahrain, Barbados, Campione d'Italia, Belize, Bermuda, British Virgin Islands, Cayman Islands, Cook Islands, Costa Rica, Cyprus, Djibouti, Dominica,

Eastern Samoa, Guernsey, Gibraltar, Granada, Grenadines, Hong Kong, Isle of Man, Jersey, Labuan, Lebanon, Liberia, Liechtenstein, Luxembourg (with respect to the 1929 Holdings), Macau, Madeira Island, Maldives, Malta, Marshall Islands, Mauritius Islands, Montserrat, Monaco, Nauru, Nevis, Netherlands Antilles, Niue, Oman, Panama, Saint Kitts, Saint Vincent, San Marino, Saint Lucia, Sark, Seychelles, Singapore, Tonga, Turks and Caicos Islands, United Arab Emirates and Vanuatu.

New jurisdictions may be included in the list at any time.

Interest on equity

According to Brazilian law, in addition to dividends, Brazilian subsidiaries may also pay interest on equity to its shareholders.

Interest on equity is a hybrid instrument in what it is deductible for Brazilian tax purposes while considered as remuneration for the investor based on shareholder's net equity.

In general terms, the interest on equity is calculated by applying the daily prorata variation of the government's long-term interest rate (TJLP) on the Brazilian entity's adjusted equity, considering all equity variations occurred during the year.

Interest on equity deduction is limited to the higher between 50% of the payer's retained earnings and 50% of the payer's current profits, with some adjustments. Nevertheless, although not clearly stated in the law, the Central Bank does not accept remittances of interest on equity based on current profits when the company has accumulated losses in the prior year balance sheet (December 31). It normally requires the offset of the accumulated losses first.

Interest on equity is subject to 15% withholding tax on the date it is paid or credited to the recipient. On the other hand, the local payer is allowed to deduct interest on equity paid or credited to resident or nonresident shareholders as remuneration on their capital investment for corporate income tax and social contribution tax on profits purposes. Furthermore, when the shareholder is a resident entity, the withholding tax becomes a tax credit.

Therefore, consideration shall be also given to the tax treatment applicable to the equity on interest in the jurisdiction of residency of the foreign beneficiary (whether the income is taxable, whether Brazilian withholding tax is creditable, etc.) as there may be significant tax opportunities in paying interest on equity.

Royalties

Withholding tax is levied on royalty payments at a standard rate of 15% or at the applicable treaty rate.

Royalty payments are also subject to CIDE (contribution for intervention in the economy) at 10%. The CIDE is not a withholding tax. It is charged to the entity that pays the royalties. CIDE generates a partial tax credit in the case of royalties for trademarks and patents.

There is also a discussion as to whether royalties are also subject to PIS and COFINS (federal taxes on imported goods and services) and ISS (municipal tax on imported services).

Royalties for trademarks, patents and know-how as well as other agreements involving transfer of technology (specialized technical services and technical assistance) are subject to specific requirements for both remittances abroad and deductibility. The agreements must be registered with the Central Bank and the INPI (Federal Intellectual Property Agency).

Royalties are limited to certain global and individual limits based on the net revenue. For example, royalties for trademarks are limited to 1% of the net revenue and royalties for patents are limited to a percentage of the net revenue that varies according to the type of industry (from 1% to 5%). Collectively, they may not exceed 5%. However, as there are specific tax deduction limitations, they are in principle not subject to the Brazilian transfer pricing rules.

Service fees

Different taxation applies to service fees depending on whether the services are considered technical or non-technical. There is no clear definition in the Brazilian legislation for technical and non-technical services. However, in recent withholding tax regulations the tax authorities described technical

services as the work or enterprise whose performance requires specialized technical knowledge and that is rendered by independent professionals (profissionais liberais) or artists.

Non-technical services are subject to 25% withholding tax while technical services are subject to a 15% withholding tax and also to the CIDE at a 10% rate.

Both technical and non-technical services are subject to PIS and COFINS (federal taxes on imported goods and services) and ISS (municipal tax on imported services). The PIS and COFINS rates are 1.65% and 7.6%, respectively.

Transfer pricing rules must be observed if the fees are to be paid to related parties as well as general tax deductibility requirements, such as evidence of the work performed, formal agreements, etc.

In case the services involve transfer of technology, specific requirements may apply for the remittances abroad and the tax deductibility as mentioned in the royalties section above.

CPMF tax

The federal CPMF tax applies at all payments made by a Brazilian entity or individual using the funds deposited in a bank account at 0.38%.

Capital gains

In case the nonresident sells an asset located in Brazil, including shares in a Brazilian company, capital gains will be subject to Brazilian withholding tax at 15% (25% if the seller is located in a listed low-tax jurisdiction).

Transactions between two nonresidents used to be tax-free in Brazil. However, since 2001 these transactions are also taxed in Brazil if involve assets located in Brazil. The representative of the nonresident buyer is responsible for withholding and paying the Brazilian tax on capital gains.

Capital gains correspond to the difference between the value of the transaction (e.g., sales price) and the cost of the investment. However, there are two possible methods to compute the costs of shares that often lead to the

determination of different costs of acquisitions and thus a different amount of capital gains.

One method considers as cost of acquisition the amount of the historical investment made in local currency (Reais), with an adjustment for inflation until December 31, 1995. Under the other method, the cost should be equal to the foreign capital registered with the Central Bank (RDE-IED).

There is a significant discussion on which method is the correct one. Therefore, proper discussions and analysis on this subject is recommended before disposing or acquiring shares in a Brazilian entity.

Taxation on foreign profits (*CFC* rules)

Brazilian controlled foreign company rules are relatively new, with some provisions that are distant from concepts and provisions present in CFC legislation of other countries.

Profits generated by a foreign subsidiary or branch must be included in the December 31 financial statements of the Brazilian company in the year when the profits are earned, regardless of an effective dividend or profit distribution. Profits would also be considered taxable for Brazilian tax purposes before December 31 in other circumstances, e.g. liquidation of the Brazilian company.

Brazilian tax law provides that the subsidiary's financial statements must be prepared according to its local commercial legislation and translated into Brazilian currency (Reais).

Consolidation of profits and losses of the foreign companies, in principle, would not be authorized for Brazilian tax purposes. Foreign profits earned by the Brazilian entity through its subsidiaries must be considered on a per subsidiary basis. However, the foreign subsidiary must consolidate, in its financial statements, the results of its foreign subsidiaries (second and further tiers).

On the other hand, the losses made by the Brazilian entity through a foreign company may not be used to offset the Brazilian profits. Nevertheless, the regulations allow the offsetting of such losses against future profits of the same subsidiary, without quantitative or qualitative limitations.

Lastly, it is important to mention that in case the foreign profits are subject to income tax in the country of the foreign company, the Brazilian parent company would be entitled to a tax credit in Brazil. However, this credit and the corresponding offsetting are subject to certain limitations.

The actual profit method (lucro real) to compute corporate taxes is mandatory for Brazilian companies that hold investments abroad.

Investments in financial and capital markets by nonresidents

With respect to Brazilian taxation, revenues earned by foreign investors and derived from investments in the financial market are subject to withholding income tax. The applicable rates are:

- 10% for investments in stock funds, swap operations, and future market operations performed outside stock or mercantile exchange markets; or
- 15% for other cases, including fixed income investments.
- 0% for Capital gains, defined as positive earnings associated with stock, commodities and other similar exchange market transactions, and for gold traded outside commodity exchange markets, earned and distributed by these foreign investment funds; for the income from Brazilian Federal Government bonds acquired as from February 16, 2006, except for on income generated by bonds with a resale clause assumed by the acquirer (locally, this operation is called a "Repo" or "repurchase operation"; for mutual funds in cases where the portfolio of this mutual fund is composed of at least 98% in Federal Government bonds; and for Investments in Partnership investment funds (fundo de investimentos em Participações) and Emerging company investment funds (fundo de investimentos em empresas emergentes) and funds that invest in quotas of these funds (the zero percent rate is applicable only if the investor and the funds comply with certain rules).

If the foreign investor does not invest through the provisions of Resolucão 2,690/00, or if the investor is domiciled in a low tax jurisdiction, income derived from the investments in the Brazilian financial market is subject to taxation in the same way as investments by residents.

For non-resident investors operating under Resolução 2,689/00 rules, the CPMF tax (banking tax) is levied at the rate of 0.38%, when the funds enter Brazil and again when they are remitted abroad. An exemption is granted, however, if the non-resident investor remits the funds in order to invest exclusively in stocks traded on stock exchanges.

IOF tax on investments in fixed rated securities is due on the value of the redemption of the fixed income securities (including mutual funds) at a maximum rate of 1 percent per day, limited to the income generated by the investment. This tax is levied in accordance with a table that decreases according to the term of the investment, from 96% to 0% (limited to the total income earned), meaning that no IOF tax is levied on investments with a term longer than 30 days.

Federal tax registration (CNPJ)

All nonresident entities who own shares, financial investments, assets or rights in Brazil must obtain a corporate taxpayer registration number (CNPJ) with the federal revenue service (SRF - secretaria da Receita Federal).

Chapter 6

M&A and corporate reorganizations

Introduction

Brazil has been an attractive market for foreign investors due to a variety of economic factors, including relative economic and political stability, control over inflation, and a large and growing consumer market.

Specifically with respect to taxation, Brazil has made significant progress introducing changes in tax legislation to attract direct foreign investments. Legislative efforts have reduced taxes on dividends and resulted in the finalization of double taxation treaties with countries that are major exporters of technology.

The Brazilian merger and acquisition (M&A) environment is dynamic in the sense that tax laws are subject to frequent changes. Thus, while at times Brazilian tax law is considered complex, it can also provide significant flexibility for Brazilian tax planning.

While due diligence is important for acquisitions worldwide, it is particularly important in Brazil. The complexity of the tax system, the large amount of tax litigation necessary to resolve tax issues, and the protective labor regulations, among other issues, makes the evaluation of Brazilian targets, and sometimes the negotiations, more complex.

In this sense, merger and acquisition transactions commence with preliminary negotiations between the parties on purchase terms and conditions, representations and warranties, non-compete and indemnification provisions,

which may be reflected in a memorandum of understanding providing for further exclusive negotiations and due diligence investigations. As a preliminary discussing point, the parties of the transaction should consider whether to pursue it through an asset or share acquisition, at which time it should be noted that the outcome of due diligence investigations may determine the most cost-effective alternative.

Acquisition

Acquisition of an existing business may be accomplished through the purchase of either the company's shares or its assets.

In principle, the sale or purchase of shares in a Brazilian entity is a relatively simple transaction from a Brazilian tax perspective. The taxation depends to some extent on the residency of the seller and purchaser.

In the case of a share acquisition, during the initial stage, the articles of incorporation of the target should be reviewed for any restrictions on the assignment and transfer of shares, including rights of first refusal. Upon the successful completion of negotiations, the manner in which the acquisition is effected will depend on the company form of the target company.

The acquisition of a Limitada is effected upon the approval and registration of an amendment to the articles of incorporation of the target company, in order to reflect the assignment and transfer of quotas to the new partners. Additionally, a detailed purchase and sale agreement is usually executed, including purchase terms and conditions, confidentiality and non-compete provisions and, based on due diligence investigation results, representations and warranties, indemnification clauses and guarantees, among other case specific provisions.

On the other hand, the acquisition of a privately-held SA is effected upon the approval and execution of a share transfer in the Share Transfer Book. A purchase and sale agreement is usually executed, including purchase terms and conditions, confidentiality and non-compete provisions and, based on due diligence investigation results, representations and warranties, indemnification clauses and guarantees, among other case specific provisions.

The acquisition of a publicly-held company may be effected privately between the interested parties, in which case the acquisition process will be similar to the acquisition of a privately-held company described above. On the other hand,

when the purchaser is the controlling shareholder, and as a result of the operation, he will increase his participation in shares by 10%, the purchase must occur through a public offering.

In case a public offering is implemented, it must be made through a financial institution, which will guarantee compliance with the obligations of the issuer. The shares subject to the offer must, if acquired, give the purchaser a controlling interest.

The offer document must be published in the press and should indicate in summary:

- information on the issuer:
- details on shareholders:
- the price and payment conditions;
- the minimum number of stocks that the issuer wishes to purchase and, if applicable, the maximum number:
- the subordination of the offer to the minimum number of acceptances and the form of sharing among the accepting parties, if their number surpasses the stipulated maximum;
- the procedure which should be adopted by accepting stockholders to express their acceptance and transfer the stocks;
- the time period for which the offer is valid.

Additionally, the acquisition of a publicly-held company must be communicated to the CVM (Brazilian Securities Exchange Commission) and disclosed to the market as a material event. In addition, the purchaser of the controlling stake is required to make a tender offer for the acquisition of the remaining common shares of the company for a price equal to at least 80% of the price paid for the controlling shares.

The purchaser may offer minority shareholders the option to maintain their shares in the company in exchange for receiving an amount equivalent to the difference between the market value of the shares and the price paid for the controlling shares.

Moreover, within 15 days, operations which may restrict competition must be notified to the CADE (Federal Antitrust Agency). A further discussion about CADE is in the Anti-trust section of Chapter 14.

The acquisition of companies in certain sectors, including those in the banking insurance, energy and telecommunications sectors may be subject to specific regulatory approvals.

Succession issues

The succession of tax attributes and liabilities is among the most significant issues involved in acquisitions.

The succession of liabilities will depend upon the type of transaction. When the transaction is structured as an asset purchase, tax succession becomes a major concern. In summary, where the assets purchased fall within the definition of commercial, industrial or professional establishment, succession issues in the sense of inherited liabilities may result.

Specifically, the Brazilian Tax Code provides that an individual or legal entity is liable for taxes owed or later assessed related to the commercial, industrial or professional establishment or fundo de comércio (going concern). Establishment is broadly defined as an intangible encompassing the group of attributes that form the business, and which in an acquisition the purchaser intends to continue under the same or another corporate purpose or name. The purchaser is fully liable where the seller ceases to exercise the activities object of the acquisition, or secondarily liable where the seller continues to exercise the activities object of the acquisition or initiates new commercial, industrial or professional activities within six months of the acquisition, whether or not related to the activities object of the acquisition.

Additionally, in principle, the change in the ownership does not affect succession of labor liabilities, to the extent the company maintains the activities and does not terminate employment agreements.

Due diligence

The main purpose of due diligence investigations is to allow the prospective purchaser to better assess the value of proposed transactions and identify related contingencies. In addition, due diligence results may be taken into account in the drafting of specific provisions in the transaction documents, especially when it is necessary to address any issues verified during the investigations.

The investigations are also useful in the determination of steps to be taken by the purchaser when the transaction is completed, both in terms of remedying any identified problems and planning for future administrative adjustments.

The scope and length of the due diligence process will depend on the circumstances of each transaction. Various aspects of the target company may be analyzed, and many times a separate investigation by an audit firm is conducted simultaneously with the legal investigation conducted by qualified attorneys.

In Brazil, certain public records can and should be checked during a due diligence. The ownership of real estate, for instance, is reflected in records kept by the appropriate Real Estate Registry. Corporate documents such as articles of incorporations can be obtained with the competent Registry of Commerce. Additionally, Brazilian courts, including labor and tax courts, are prepared to issue certificates indicating any pending lawsuits involving the target company. In addition to the examination of public records, various documents are requested from the target company and then analyzed by the attorneys representing the prospective purchaser.

Tax structuring

Taxation of an asset deal

- The seller of assets would be subject to income tax and social contribution tax (Total of approximately 34%) on the gain inherent in the assets, if any. For Brazilian tax purposes, there are no preferential rates that apply to capital gains—both operational and non-operational gains are taxed at the same rate. (There is a difference between the tax treatment for capital and ordinary losses.)
- PIS and Cofins would apply depending on the type of asset sold. PIS and Cofins are applied on the sale of most assets other than the sale of property. plant, and equipment (e.g., fixed assets).
- ICMS would apply to the transfer of inventory. However, the ICMS tax paid may become a credit to the purchaser to the extent that these same products are subsequently sold or are otherwise used as raw materials in the manufacturing of products that are sold by the purchaser. The ICMS credits generated on the purchase of the assets may in general be used to offset the ICMS debts arising from subsequent taxable transactions (e.g., sales). There are restrictions on a taxpayer's ability to use credits on the purchase of fixed assets. The sale of fixed assets is in general not subject to ICMS. However, ICMS credits generated on the purchase of fixed assets may have to be written-off.
- IPI also applies to the transfer of the inventory, provided the inventory was directly imported or manufactured by the seller. IPI tax paid may also be creditable by the purchaser if the product is to be used in the manufacture

- of other products. IPI may also apply on the sale of fixed assets, provided the asset was directly imported or manufactured by the seller and the subsequent sale occurred within five years of the date the asset was recorded as a permanent asset by the seller.
- Municipal real estate transfer tax (ITBI) may also apply to the transfer of real estate, as well as CPMF on the sales proceeds paid for assets.

Taxation of a share deal

- The sale or purchase of shares in a Brazilian entity is more common than an asset deal because of the lower levels of documentation requirements and indirect taxation.
- The taxation of a share sale depends to some extent on the residence of the seller and purchaser.
- A Brazilian corporate seller (pessoa jurídica) is subject to income tax and social contribution tax on the net gain from the sale of shares. In most cases, where a seller owns a significant interest (usually more than 10%), the gain is calculated as the difference between the gross proceeds and the proportional book value of the target entity's equity.
- The sale of shares is not subject to PIS and Cofins, ICMS, or IPI. A Brazilian purchaser would be subject to CPMF (banking tax) on gross sales proceeds. In addition, there are no transfer taxes or stamp duties on the sale of shares in Brazil.
- If the seller is a Brazilian individual or a nonresident, the gain is subject to a final 15% withholding tax; however, the amount of the gain is calculated differently. For a Brazilian individual, the gain is calculated based on the difference between the gross proceeds and the capital contributed or paid in a previous acquisition. For a nonresident, because of the lack of clarity of the relevant tax provisions, there is some controversy about how the capital gain is determined.

A possible interpretation is that the gain is normally calculated as the difference between the amount of foreign capital registered with the Brazilian Central Bank and the gross sales proceeds as calculated in foreign currency. A contrary position is that the gain should be calculated as the difference in Brazilian currency between the sales proceeds and the capital invested, therefore including exchange fluctuations in the tax base. The different positions arise because of differences between the wording of the law and the regulations. It is important to state in the sales contract whether the sale price is gross or net of withholding tax.

- If both the buyer and the seller are nonresidents, it is likely that the tax authorities will tax an eventual capital gain. Although, the common understanding among Brazilian tax practitioners used to be that no Brazilian taxation was imposed on the sale of shares or quotas in Brazilian entities if the transaction was performed between two nonresidents (this was because Brazilian tax law would in principle require a Brazilian source of payment), as from 2004, Law 10,833/03 introduced a change to the Brazilian tax law that is being interpreted as an introduction of the taxation on nonresidents capital gains with respect to the assets located in Brazil even when both parties to the agreement are non-Brazilian residents. However, the wording of the law is not completely clear and its application should be further investigated before implementation.
- The capital gain on the sale of shares publicly traded is subject to a rate of 20% for resident individuals and is exempt for nonresidents, provided that some formalities are met and the seller is not a resident of a tax haven.

Purchase premium

One significant advantage of a share sale over an asset sale would be that, if structured properly, the amount paid in excess of the net equity of the target may result in the generation of an amortizable premium or a step-up in the tax bases of otherwise depreciable or amortizable assets. This opportunity is not available if shares in a Brazilian company are purchased directly by a nonresident and are not available to the same extent if assets are purchased.

To take advantage of this opportunity, the acquisition of shares would need to be made through a Brazilian acquisition vehicle.

According to legislation in force as of 1997, the liquidation or merger of the acquisition vehicle and the target would allow the premium paid on the shares to become recoverable in certain situations. To the extent that the premium relates to the value of recoverable fixed assets or relates to the value associated with the future profitability of the company, the premium could be amortized or otherwise recovered through depreciation.

Corporate reorganizations

Merger

A merger (incorporação) occurs when one or more companies are absorbed by another company, which survives. A consolidation (fusão) occurs when two or more companies unite to form a new company. Brazilian law permits mergers and consolidations with no special restrictions for Brazilian entities with foreign shareholding. Mergers are more frequently used than consolidations, especially because of tax consequences.

The surviving company in the merger and the new company in the consolidation succeeds its predecessors in all rights and obligations except for their tax losses. which cease to exist if not related to the surviving company. The Securities and Exchange Commission requires that certain procedures be followed in case of a merger or consolidation that includes one or more publicly held companies. Mergers and consolidations require a detailed and justified reorganization plan, subject to approval by the shareholders of the companies concerned. In addition, the administration must submit the reorganization plan to the shareholders.

The merger and the consolidation can be implemented at either book value or market value. When they are implemented at book value they are in principle tax neutral from a Brazilian standpoint. Pursuant to Brazilian corporate regulations, the company to be spun-off must prepare specific balance sheets a maximum of thirty days before the date of the event. An appraisal is also required to support the value of all assets and liabilities to be transferred. Corporate documents must be prepared and filed with the Registry of Commerce, together with the balance sheet and the appraisal report.

Drop-down

Drop-down of assets is an alternative structure for a company's reorganization, through which a company transfers part of its assets and liabilities to a newly created entity or existing subsidiary as capital increase in exchange for shares in the new company.

Such a transaction requires the preparation of the articles of incorporation for the new company, which must be filed with the Registry of Commerce. After the corporate documents are filed with the Registry of Commerce, a corporate taxpayer registration number (CNPJ) and a state taxpayer registration must be obtained.

A list of all assets and liabilities being contributed to the new company must be attached to the drop-down corporate documents. If assets subject to public registration are transferred under the drop-down (such as real estate, telephone lines, vehicles, among others), it is recommended that a more detailed list is prepared to facilitate the transfer of the proper registrations after the drop-down.

Spin-off

Corporate spin-off entails the transfer of part or all of a company's assets and liabilities to one or more companies already in existence or formed for this purpose, dividing the company's capital in the event of partial spin-off. Should all the company's assets and liabilities be transferred, the company can be liquidated. Rights and obligations of the spun-off company are absorbed proportionately by the companies receiving the net value transferred.

The spin-off can be implemented at either book value or market value. When it is implemented at book value it is in principle tax neutral from a Brazilian standpoint.

Pursuant to Brazilian corporate regulations, the company to be spun-off must prepare specific balance sheets no older than 30 days as of the date of the event. An appraisal is also required to support the value of all assets and liabilities to be transferred.

Corporate documents must be prepared and filed with the Registry of Commerce, together with the balance sheet and the appraisal report.

A down side associated with a spin-off is that tax losses carry-forward of the spun-off company are lost in the same proportion of the splitted portion of the net equity.

Transformation

A company may be transformed from one type of legal entity to another, without dissolution and liquidation. For example, a SA can be transformed into a Limitada, or vice versa. Shareholders' approval must be unanimous, unless otherwise provided for in the articles of incorporation. Dissident shareholders have the right to withdraw.

Dissolution

Normal dissolution may occur under the following circumstances:

- by termination of corporate life under the circumstances provided for in the articles of incorporation;
- by resolution of the shareholders;
- by the existence of only one shareholder as verified at the shareholders' meeting of the following year (except for wholly-owned subsidiaries);
- by termination of its authorization to operate.

Judicial dissolution may occur in the following cases:

- when the incorporation deed of the corporation is annulled in any cause of action brought by any shareholder;
- when there is confirmation that the corporation cannot achieve its business purpose, in a cause of action brought by shareholders representing 5% or more of the corporate capital;
- by court or administrative decisions, in a liquidation process.

After satisfying the claims of preferred creditors, the liquidator must pay off the company's liabilities proportionally without distinguishing between debts that are overdue and debts that are becoming due, although, in relation to the latter, he may pay with a discount at prevailing bank rates.

After all creditors have been paid, the shareholders may approve a dividend distribution prior to the completion of the liquidation, to the extent that the company's assets have been realized. In the absence of any potential harm to the creditors or the minority shareholders, specific assets may be distributed to shareholders.

When all liabilities have been paid and the remaining assets distributed, the liquidator must call a shareholders' meeting for a final rendering of accounts. Upon approval of these accounts, the liquidation is considered complete and the company is automatically extinguished.

Extinction

A company is extinguished:

- by completion of the liquidation process;
- by merger, consolidation, or through a spin-off which transfers all net assets to other companies.

Extinction by dissolution is preceded by the liquidation process, whereas in the case of merger, consolidation, or spin-off, the extinction is immediate.

Trade & Customs

Overview

The devaluation of the local currency against the US dollar over the years and particularly in the end of the 1990s - has played an important role to improve Brazilian exports in both a qualitative and quantitative manner, a key factor in the financing of the historical federal trade deficit.

Even more recently with the appreciation of the Brazilian Real towards the American dollar, the federal economic policy has managed to maintain a steady growth rate of exports with all-time record high trade surplus. In 2005, Brazil exported a record value of US\$ 118.3 billion, exceeding the established goal for that year of US\$ 117 billion. Brazilian exports expanded 22.6% compared with 2004. Exports of all products categories – basic, semi-manufactured, and manufactured – increased at a strong rate, especially manufactured goods which increased 23%. Exports of basic goods and semi-manufactured goods increased 21.8% and 18.8%, respectively.

The main products exported in 2005 were as follows:

Products Value	(US\$ millions 2005)	% 2005/2004	% share in Brazilian exports
Transportation goods	19,119	19.2	16.2
Metallurgic products	12,623	22.6	10.7
Soybeans and products	9,477	-5.7	8.0
Oil and fuel	9,079	58.4	7.7
Ores	8,024	53.2	6.8
Meats	7,990	29.8	6.8
Chemicals	7,454	24.0	6.3
Machines and equipments	6,924	23.5	5.9
Electrical equipments	4,963	59.0	4.2
Sugar	4,684	49.3	4.0
Footwear and leather	3,536	6.0	3.0
Paper and pulp	3,404	17.0	2.9

Source: SECEX/MDIC

Brazil remains one of the world's largest exporters of agricultural products, although exports of manufactured goods have largely increased and products such as airplanes, steel, electronics and many more have disputed statistics with primary products.

The expansion of Brazilian sales to non-traditional countries or countries with a small share in the total exported has been an important feature in the success story of Brazilian exports. In 2005, exports to Eastern Europe, Africa, Latin America, Asia and Oceania showed an impressive growth.

With respect to operational import and export chains, Brazilian importers and exporters are required to obtain specific registrations but in practice most of the imports are not subject to pre-licenses, while exports are in general taxfree. Brazilian foreign exchange regulations still play a significant role in the operational side due to the requirement of registrations – currency exchange contracts associated with imports and exports are linked with federal tax and customs systems. Penalties may be imposed in case a Brazilian importer or exporter fails to liquidate such contracts in due time.

Exports

Trade policy is conducted by the chamber of foreign trade (CAMEX) which is subordinated to the Ministry of development, industry and commerce. Exporters must be registered with the SECEX, a governmental agency responsible for controlling imports and exports, which is usually carried out by a forwarder.

Because an export transaction also brings along the requirement of executing a corresponding currency exchange contract (for the exchange of foreign currency into *Reais* or vice-versa), exporters must also register transactions with the Central Bank of Brazil, responsible for controlling the country inflow and outflow of foreign currency.

In practice, each foreign exchange contract is linked to a specific customs transaction through interconnected electronic systems, the so-called SISCOMEX, under which import and export transactions are registered, and its foreign currency exchange counterpart, the SISBACEN, controlled by the Central Bank of Brazil.

In general, export transactions do not require pre-approvals, except for transactions involving certain listed products. This list includes animals or products of animal origin, oil, gas, and goods containing nuclear and radioactive materials, weapons, among others.

Certain exports are also forbidden or restricted, or even subject to specific regulations or pre-authorizations from Brazilian government or specific governmental agencies (this would apply, for instance, to animals or products of animal origin).

As mentioned, Brazilian exporters must register with SECEX to be able to carry out export transactions. Export transactions must be registered in the electronic system SISCOMEX under which an export registration (RE - Registro de Exportação) must be obtained prior to the shipment of the products. After the registration is obtained, the exporter must ship the products within a 60-day period, otherwise the RE is automatically cancelled.

From a Central Bank perspective, Brazilian exporters are generally required to close the corresponding foreign exchange contract and settle currency exchange within a certain period as of the date of the export transaction. Please note that new rules were expected to be issued in August of 2006 on this subject.

Imports

Considering that the surplus of foreign trade balance is one of the main objectives of the federal economic policy, imports have been of critical importance and have also played a significant role in the last decade in Brazil. Since the opening of the Brazilian economy initiated in the beginning of the 90's, when a strong spike on imports ensued that would become the trademark of the last decade, this adverse condition has been largely reversed in the recent years by the historical improvements on exports, largely due to the development, modernization and increased competitiveness of the Brazilian industries exposed to the global economy.

While import restrictions have been a major element of Brazilian trade policies, import tariffs across the board have been reduced in recent years. The negotiation of a Mercosur Common External Tariff has not only made Brazil one of the major players in the region but also demanded the simplification of the import regulations to the extent that imports, with some exceptions, do not require pre-licenses. Besides, the introduction of the electronic system for the registration of imports and exports (SISCOMEX) has contributed to speeding up registrations and customs clearance as a whole.

Brazilian importers must be registered with SECEX prior to carrying out import transactions. Import transactions must be also registered in the SISCOMEX electronic system under which an import return (DI – Declaração de Importação) must be obtained to clear customs.

In case a pre-license is necessary (this may vary according to the type of product imported and the import regime adopted), it must be obtained prior to the shipment of the products to Brazil and is generally valid for a 90-day period as from the date of issuance. This is also obtained through the SISCOMEX electronic system. Certain products, such as petrochemicals, human blood, weapons, herbicides and pesticides, leather, among others, also require preapproval from certain government agencies before the import license is issued.

Import of used products requires pre-licenses, which is normally only granted if a similar product with Brazilian origin is not readily available.

From a Central Bank perspective, Brazilian importers are required to close the corresponding foreign exchange contracts to settle the import transactions within a certain period, otherwise high penalties can be imposed.

Trading companies

Trading companies generally play a very active role in the import and export of products due to their practical experience and knowledge of operational and documentation aspects. The trading companies may work as outsourced customs brokers, preparing the import and export paperwork and customs clearance, and may import products on behalf of Brazilian companies.

Export financing

Banks provide financing for exporters against forward sales contracts and by discounting drafts accepted by foreign importers. This financing is also made available for "indirect exporters" or manufacturing companies, which export through trading companies. Exporters may use these funds to buy raw materials to be applied to the manufacture of finished products to be exported.

In principle, BNDES provides the following types of financing on exports through authorized financial institutions:

- Pre-Shipping finances the production of goods to be exported in specific shipments.
- Fast Pre-Shipping finances the production of goods to be exported within 6 to 12 months.
- Special Pre-Shipping finances the domestic production of goods exported, not tied to specific shipments but having a preset time period for such.
- Pre-Shipping anchor companies finances the commerce of goods produced by small and medium companies through an export company (empresa âncora).
- Post-Shipping: finances the commercialization of goods and services abroad, through refinancing to the exporter or through the use of a buyer's credit facility.

Trade treaties

Mercosur

In general terms, Mercosur is a customs free trade zone comprised by four founding member-countries: Argentina, Brazil, Paraguay and Uruguay. Recently, Venezuela signed the trade agreement which is in process of being approved by the congress of the aforementioned countries.

Signed in 1991, Mercosur currently represents a very attractive market through which a population of approximately 250 million people can be reached, with a total Gross National Product (GNP) of approximately US\$ 1 trillion, that turns it into one of the four largest economies, right after the United States, European Union and Japan.

As a global trader, one of the main objectives of the Mercosur is not only the total elimination of import tariffs between the members, but the increase of the current free trade agreements' framework and the diversification of the current import and export table of products, things that could strengthen Mercosur's role in the global trade market. Another important goal is to eliminate the exceptions to the list of products included in the free trade (mainly automobiles, household appliances and certain agricultural products, but varying according to each country), scheduled to be extinguished in 2008 according to Mercosur's Counsel Decision 38/05.

Although import taxes have been a significant instrument in the past to protect local industry and to regulate the trade of products even between the member countries, a program of convergence that reached the Mercosur's Common External Tariff has led to an average import tax rate of 14%, turning Mercosur into a very open trade market. Import tariffs remain applicable to non-Mercosur member countries, which are, in general, subject to the same import tax rate in all Mercosur countries.

Therefore, products traded between Mercosur member countries are exempted of import tariffs, provided the products have a Mercosur origin. Mercosur origin rules are generally based on minimum local added value and changes in the classification of the product.

However, each member country may include certain products in an "exception list", under which listed products are not necessarily subject to the common rate applicable to non-Mercosur members, but to a higher or lower rate, depending on the case. This list is generally driven by political or economic reasons, i.e., the protection of local industry, the essentiality of the product to the importer country, among others.

Mercosur also has economic agreements with Bolivia, Chile, Colombia, Ecuador and Peru (associated countries). Products originated in such countries and imported by a Mercosur member generally benefit from a reduced or even zero import tax rate, depending on the tax classification of the product.

Efforts have been also made in the sense of expanding the number of country-members and of entering into agreements with other blocks. This includes Mercosur and the Andean Community (Bolivia, Chile, Colombia, Ecuador and Venezuela), with whom a free trade agreement has been in force since January 31, 2005.

An agreement between Mercosur and the European Union has been under negotiation but is pending on final approval. Therefore, potential tax benefits upon imports from European Union member countries may apply in the near future.

Specifically for India, there is a draft of a Mercosur-India agreement under negotiation since January 2004. The general rules have already been agreed upon, however in practical terms origin rules and import tax benefits associated therewith are pending on final negotiations.

Others

With respect to the Free Trade Area of the Americas (FTTA/ALCA), efforts are in the direction of achieving a common sense between the countries in America in order to implement it. Notwithstanding this, the implementation of the agreement has been delayed and rumors are that this may not be executed in the short term.

Brazil also belongs to the Latin American Integration Association (ALADI), which provides for reduced rates and other benefits. Member countries include Argentina, Bolivia, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela. Brazil is also a member of the WTO and has trade agreements with other countries such as Portugal.

With respect to the WTO, latest reports are to the effect that Brazil (under Mercosur) figures as one of the world's major producers and exporters of agricultural products, with a relative reduction of government intervention in the sector, with support programs focusing on assisting low-income farmers, while a modest agricultural assistance for large exporters is also noticed. Brazil also plays a very active role in the global trade, being involved in several cases under WTO dispute settlement, either as a plaintiff or a defendant.

Origin rules

In general, the imports covered by trade treaties benefit from import tax rate reductions or exemptions provided certain conditions are met, which are essentially related to compliance with origin rules. It is important to mention that origin rules are intrinsically associated with the country where the products are manufactured, regardless of the country that figures as the seller of the products.

The origin rules basically require a minimum local added value in the country of the manufacturer or a change in the tax classification with respect to the product exported when compared to its components, or both, depending on the product traded and the countries involved.

Imports of products originated from Mercosur member-countries (Argentina, Paraguay and Uruguay) are generally benefited with a reduction of 100% of the import tax, provided a minimum local added value in the country of the exporter of 60% occurred. A different local added value percentage may apply depending on the traded product and also the specific trade agreement.

Customs valuation

Brazilian customs rules provide for a customs valuation policy based on the 1994 general agreement on trade and tariffs (GATT), effectively introduced in Brazil in 1996. In general terms, the main purpose of the methods provided by Brazilian customs rules is to demonstrate the fair market value of the import transaction when compared to an actual transaction.

This is made by means of using the methods foreseen under Brazilian customs valuation rules, which are generally based on (a) the value of the transaction, (b) comparables, (c) resale, or (d) cost methodologies. The import price is verified for customs valuation purposes at the moment an import declaration is registered in the SISCOMEX system, based on internal lists of prices that are not publicly available and are used by Brazilian customs authorities as initial basis for comparison. To the extent that the customs value is within these parameters there should be no customs valuation issue.

In case the import price does not comply with such rules, proving the import price base is required and the importer must then fill out a customs valuation form and present proper documentation that demonstrates that the customs value adopted reflects the actual value of the transaction at fair market conditions, by using one of the six methods provided in the customs legislation.

The value of the transaction is the most acceptable and used method, and basically consists of adding to the cost of the product certain costs and expenses associated with the product imported in order to determine a real value that could be as much as possible close to the value of an import transaction at arms' length conditions. It is important to mention that the relationship between the exporter and the Brazilian importer is a key factor for Brazilian customs authorities when applying customs valuation rules.

Tax aspects

Exports

Except for Brazilian corporate taxes, export revenues are generally tax-exempt in Brazil.

In theory, an export tax exists, but it is currently applied to a very restricted list of products, such as cigarettes, certain types of furs, cowhide, weapons and ammunitions.

Generally speaking, exports are not subject to IPI (federal type of VAT), ICMS (state type of VAT), PIS and COFINS (federal gross revenue taxes) while a credit mechanism is allowed for the same taxes paid on inputs used in the manufacturing of exported products. The credits related to the federal taxes (IPI, PIS and COFINS) are normally easily consumed by the exporters as in general they may be used to offset any federal tax payables. On the other hand, several restrictions and the associated-bureaucracy make the utilization of the ICMS tax credits very difficult to companies with high level of exports.

Certain payments abroad related to export, such as agent commissions and interest related to export financing, also benefit from a zero-rate withholding tax.

Under certain specific customs regimes (see below), certain tax exemptions may also be granted to imported raw material or parts to be used in the manufacturing of products to be exported.

Imports

Brazil imposes federal, state and sometimes municipal taxes on the imports of goods and services. In general terms, the imports of goods are subject to the // (import tax or custom duty) and other miscellaneous customs duties, IPI, ICMS, PIS and COFINS.

The classification of products under the TEC (Mercosur's common external tariff) is crucial to determine the applicable rate for most taxes. The TEC is based on the Brussels Harmonized Code.

Please refer to the Corporate Taxation Chapter for more information on the various Brazilian taxes summarized below.

- Import tax (II) and other miscellaneous fees Import tax applies to CIF (cost, insurance and freight) value of imported products at variable rates. This is a final tax, meaning that no credits are granted. Specific rates depend on the classification of the imported product in the TEC. The taxable event is the customs clearance. Other customs fees include minor customs fees such as a processing fee for the import license, when necessary, a freight duty which funds the merchant marine fleet (levied at 25% on the freight cost), as well as miscellaneous port charges.
- IPI (federal type of VAT) The IPI applicable rates also varying according to the tax classification of the product in the TIPI (IPI tax products list, based on the TEC). Average rates are between 10% and 20%. IPI is levied on direct imports and subsequent domestic transactions with imported products or manufactured goods. As a general rule, an IPI tax credit in the amount of the tax paid on the import is granted in case the subsequent transaction with the same product or another in which manufacturing the imported product was used is subject to IPI. The taxable base is the CIF value added by the import tax.
- PIS and COFINS Imports PIS and COFINS are imposed on the import of products and apply at a combined rate of 9.25% (1.65% and 7.6%, individually). The PIS and COFINS paid on the imports may in general generate a tax credit to be offset with PIS and COFINS due on the domestic transactions provided the importer is subject to the noncumulative PIS and COFINS regime. The tax base is the CIF value added by the ICMS and the PIS and COFINS themselves. Certain products may be subject to different tax rates.
- ICMS (federal type of VAT) ICMS is also charged on the imports and the importers are in general entitled to recognize a tax credit in the amount of

the tax paid to be used to offset future ICMS liabilities. Applicable rates are normally 17% to 19%. The tax base is the CIF value plus the import tax, IPI, the ICMS itself and the PIS and COFINS.

Special customs regimes

Brazilian customs regulations provide several special customs regimes under which certain tax and customs benefits apply. Therefore, careful planning of the supply chain by international groups of companies with activities in Brazil is recommended before importing and exporting, in order to verify whether the Brazilian company can benefit from more efficient structures and regimes.

Below is an overview of some available customs regimes:

- Drawback is a special customs regime that grants the beneficiary exemption of import tax, IPI, PIS and COFINS and on imports of raw materials to be used in the manufacturing process of products to be exported. A minimum level of local manufacturing is required. ICMS benefits may be also available.
- Temporary admission regime is a special customs regime that allows the import of goods that will stay in the country on a temporary basis with total or partial exemption of the taxes levied on imports. This may benefit, for instance, goods that enter the country under a lease or rental transaction and those related to sports and cultural events and commercial fairs and exhibitions.
- Special temporary admission regime for manufacturing purposes (admissão temporária para aperfeiçoamento ativo) - is similar to the regular temporary admission regime, but the exemption of taxes is granted to the import of goods to be applied to certain restricted manufacturing processes of products to be exported. In principle it does not apply in case manufactured goods are sold locally.
- Temporary export regime is a special customs regime that allows the export of goods that will be out of the country on a temporary basis with total or partial exemption of the taxes levied on the export, if any, and on the subsequent re-import. This may benefit, for instance, goods that leave the country to sports and cultural events and commercial fairs and exhibitions.
- Special temporary export regime for manufacturing purposes (admissão temporária para aperfeiçoamento passivo) - is similar to the regular temporary export regime and allows the export and re-import of goods that will be subject to certain restricted manufacturing processes abroad. Import taxes and due, however, on the foreign products aggregated to the re-imported good.

- Bonded warehouse (entreposto aduaneiro) is a special import regime whereby the Brazilian party may differ the payment of the taxes due on the import, by keeping the imported goods stored in a bonded warehouse. The taxes are due only upon the customs clearance, i.e., the removal of the goods from the bonded warehouse. It may also benefit goods sent to Brazil for commercial fairs and exhibitions. In the case of exports, the Brazilian exporter, under this regime, may benefit from export tax incentives before the actual shipment of the products out of the country (available to the so-called *comerciais-exportadoras*).
- DAC (Depósito Alfandegado Certificado) is a regime under which products are presumed exported but physically remain in a bonded warehouse in Brazil. The beneficiaries are the companies allowed by the tax authorities to operate under this regime.
- Manaus Free Trade Zone Companies located in the Manaus Free Trade Zone (Zona Franca de Manaus) may benefit from an exemption of IPI, PIS and COFINS for products to be consumed and/or manufactured within the Zona Franca de Manaus. The set up project has to be pre-approved by the administration council of SUFRAMA and must comply with a minimum local production process (PPB). An import tax reduction may be also granted depending on the level of local content and labor force to be utilized. The ICMS tax incentives may also be available on the import of raw material, intermediate and secondary products to be used in a manufacturing process within the Zona Franca de Manaus as well a reimbursement of the ICMS due on sales of goods, varying from 55% to 100%.
- Presumed export (exportação ficta) occurs when goods are sold to a nonresident, do not physically leave the country and the transaction is still considered an export for customs, foreign exchange and tax purposes. This benefit only applies in certain specific cases; such as (a) sales to a foreign government (or an international agency to which Brazil is also a member country) to be delivered in Brazil on behalf of the foreign party, (b) the good is to be totally incorporated in Brazil in a finished product that will be exported, (c) the good is to be totally incorporated in a good owned by the nonresident buyer that is already physically located in Brazil under a temporary admission regime, among others.
- FUNDAP is a special state incentive that consists of a deferral of the ICMS due on imports performed by qualified companies located in the state of Espírito Santo that, in practice, results in a significant financial benefit.
- Tariff-ex (Ex-tarifário) is another import tax benefit available to imports of equipment in case there is no similar equipment in the country. The tax

- benefit consists of an exemption or reduction of the import tax and is granted after the importer submits and obtains approval from the authorities.
- Linha Azul (Blue Line) is a special customs regime that allows the benefited company to speed-up the customs clearance process. In order to benefit from this regime, the companies must comply with several requirements, which include, for instance, an audit of its external controls over the customs processes.
- RECOF (Regime de Entreposto Industrial sob Controle Aduaneiro Informatizado) and the RECOM (Regime Aduaneiro Especial de Importação de Insumos) - are special regimes under which certain products may be imported (and sometimes acquired in the local market) without taxes (import tax, IPI, PIS and COFINS), if they will be used in the manufacturing of products to be exported. The benefit may also apply to the ICMS. There is a list of products that may be imported under such regimes (mainly parts for vehicles, aircrafts and electronics). There are several requirements that must be met, which include rigid control over the imported inventory. The main advantage of these regimes is that the products may be imported without foreign exchange coverage, i.e., the foreign party may keep title over the products and contract the Brazilian importer for the manufacturing function.
- REPETRO is a special benefit that applies to the imports and exports of goods to be applied in activities of research, exploration, development and economic exploitation of oil and gas in Brazil. The companies that have authorization or concessions to carry out such activities in Brazil may benefit from the regime provided some requirements are met and previous authorization is obtained from the federal tax authorities. There are basically three types of benefits (a) temporary import of foreign equipment without import tax, IPI and PIS and COFINS; (b) import of raw material, parts and pieces to be used in the manufacturing of goods to be exported (drawback); and (cd) presumed export, which allows the Brazilian suppliers of goods to sell them to foreign parties with the ebefits applicable to exports with the possibility of keeping the goods in the country. This last type of *REPETRO* needs to be combined with a subsequent temporary import of the goods. ICMS benefits may be also available, depending on the provisions of ICMS legislation in force in the State where the activities are to be carried out.

Chapter 8

Labor law and payroll taxes

Introduction

The Labor Law Consolidation encompasses the Labor Law Code and amendments introduced by the Federal Constitution/88. The following is a summary of the principal Consolidation items of general interest. Labor inspectors regularly enforce the numerous detailed requirements covering such matters as record-keeping and payment of overtime and benefits. It is essential that the personnel department staff be sufficiently knowledgeable about labor laws to deal with these matters.

General requirements

Terms of employment

Since the law establishes most provisions of an employment contract, it is not common to have an extensive written contract with lower-level employees. Employees have a work booklet (CTPS) which the employer signs stating the position and salary thus establishing the formal labor contract (see the section below on documentation). Special terms of employment for a variety of occupations are set forth in the law.

A foreign employee may not be admitted unless he presents his Foreigner Identity Card (issued by the Brazilian authorities). All employees must be registered in the Employees Register of the firm and have their work booklet signed by the employer.

Documentation

The terms of employment must be recorded on the employee's work booklet and in the official employee register of the company. An annual return must be filed with the local office of the Ministry of Labor, reporting the total number of employees and specifying the number of foreigners and minors employed.

Working conditions

Employers are required to make reasonable provisions for the comfort and convenience of their employees. Appropriate dining facilities must be provided on premises where more than 300 persons are employed. An industrial company may not begin operations until the working conditions have been inspected and approved by the government authorities.

Working hours

The work day is eight hours, and the standard work week is forty four hours. Shifts are limited to a six-hour period. Employees have a right to a weekly rest period of 24 consecutive hours.

Transfer of employees

An employee may be transferred to a new location if the arrangement is justified by the requirements of the organization. If the assignment is temporary, the employee must receive an increase in payment of at least 25%. Moving expenses must be paid by the employer.

Experimental period

Employees may be hired for an experimental period, which may not exceed 90 days.

Termination of employment

After the experimental period, in case of dismissal of the employee without just cause, the employer will have to pay a penalty equivalent to 50% of the amount deposited in the employee's FGTS account (retirement fund). From this amount, the employee will receive 40% and 10% will be deposited as social contribution to the government.

Employment may be terminated by either the employer or employee with a thirty-day prior notice. The dismissal of any employee who has been employed for more than one year must be ratified by the labor union.

Litigation

A culture of labor litigation in Brazil and a rigid labor law framework create potential pitfalls for companies with employees or outside service providers. Brazilian labor courts admit oral evidence to prove the existence of an employment relationship and favor settlements as a means of resolving disputes. The statute of limitations to claim rights under employment contracts is five years, however the suit must be filed within two years of severance.

Employee remuneration

Remuneration periodicity

Employees must be paid in Brazilian currency on a monthly basis or in a shorter time period if stipulated by the employment contract.

Therefore, salaries are generally referred to in terms of a monthly salary as opposed to an annual salary. The salary amount is paid 13 times during the year (see details below).

Fringe benefits

Other than health insurance, the only non-salary benefits commonly encountered are programs which grant tax incentives to companies that pay part or all of employees' cost of meals or transportation. In addition, large companies normally have pension plans and life insurance policies.

Additional salary

There are jobs that require additional salary, as follows:

- Overtime when overtime is governed by collective bargaining or private agreement, the overtime rate must be stipulated at 50% over regular pay.
- Night shift work night shift work must be remunerated at a rate at least 20% higher than equivalent daytime work.
- Hazardous work Employees subject to a hazardous work environment may claim a salary increase of 30%.

• Unhealthy work – If the work environment is considered unhealthy, depending on the level of potential harm to health and well-being, the salary may be increased by 40% (maximum), 20% (medium) or 10% (minimum).

Minimum wage

The minimum monthly salary is currently equivalent to R\$ 300. Apprentices who are less than 18 years old may not earn less than half of one minimum wage salary during the first half of the apprenticeship and two-thirds of one minimum wage during the second half. Minors who are not registered as apprentices are entitled to the full minimum wage salary.

Deductions and reductions

Employers are not permitted to make any deductions from the employees' compensation other than for salary advances given or those deductions prescribed by law and collective bargaining agreements, such as withholding taxes, social security contributions and union dues. Employers may not reduce salaries except under extraordinary circumstances.

Equal opportunity

There are general provisions in Brazilian law prohibiting employment discrimination based on gender, religion, race or other nonmaterial factors. The only affirmative action programs relate to the employment of individuals with physical handicaps.

Labor law provides that all work of equal value must be remunerated at the same rate regardless of the nationality, age, gender or marital status of the employee who performs identical functions. However, differences in length of service, if over two years, may be taken into account to justify different salary levels. Companies that have a career-track plan, may have differences in salary levels in accordance with seniority and merit.

Labor rights

Vacation

Upon completion of each twelve-month work period, employees are entitled to a paid vacation of up to thirty calendar days, of which at most ten days may be indemnified in cash. In addition, a vacation bonus equivalent to one-third of the employee's monthly salary must be paid.

Employees should not accumulate two or more years of vacation entitlements, otherwise the excess must be compensated at twice the normal rate of pay. If an employee is dismissed (other than for just cause) he or she must be compensated for unused vacation time.

Thirteenth month's salary (Christmas bonus)

Every year employers are required to pay a bonus equal to one-twelfth of the salary earned in the month of December (plus an average of the variable allowances paid during the year) for each month of service during that calendar year. This bonus must be included in the basis for calculating retirement fund (FGTS) and social security (INSS) contributions, 50% of the bonus must be paid until November, 30 (normally when vacations are taken), and the remainder must be paid until December, 20.

Family allowance

For each child under fourteen years of age or qualifying dependent, employees are granted a supplementary monthly allowance of up to approximately US\$ 2 per dependent according to the salary level. This supplement is not subject to either social security contributions (INSS) or income taxes.

Profit sharing

Profit sharing agreements are not mandatory. However, if implemented in compliance with the formalities of the law (Law 10,101/00), profit-sharing payments are not subject to payroll taxes, but attract personal withholding income tax. These payments are also not included in the labor rights calculation basis. For corporate tax purposes, the payments are fully tax deductible.

Payroll taxes

Retirement fund (FGTS)

Each month the employer must contribute the equivalent of 8.5% of the employee's total salary for FGTS purposes. While 8% is deposited under the employee's name in an account at the government bank, 0.5% is deposited to a fund managed by the Brazilian government. The employee may only use this fund under special conditions; such as if he is dismissed without just cause or retires.

The FGTS is not applicable to payments to independent professionals and is not mandatory for directors that are not employees.

Social Security (INSS) - Employer's contribution

The employer's contribution rates applied on gross salaries is 20%, increased by minor charges which may gross up the total rate to approximately 29%. The employer's contribution rates are applied to gross salaries without limit. Principal rates are shown below.

Employee's contributions must be collected and deducted by the employer. All contributions must be paid to the appropriate government agencies during the following month. Payment in arrears is subject to interest and fines which can be as high as 50% of the amount due. Companies in arrears with their social security contributions are prohibited from making bonus payments or dividend distributions to shareholders, or distributing participation in profits to partners, shareholders or directors. In addition, these companies are barred from bidding for government contracts.

Item F	Percent of Salary
1.General INSS contribution	20.0
2.Worker's Compensation insurance *	3.0
3.Education contribution	2.5
4.Rural Fund contribution (INCRA)	0.2
5.Apprenticeship program contribution (SENAI/SENAC/SENA	<i>T)</i> 1.0
6.Social Work contribution (SESI/SESC/SEST/SENAR)	1.5
7.Social Contribution	0.5
8. SEBRAE (Small Business Adm.)	0.6

The total employer's contribution is limited to 28.8%, as the maximum third funds contributions (indicated in items 3 through 8) is of 5.8%. These contributions vary according to the entity's activities. Moreover, the contributions foreseen for apprenticeship programs are not cumulative; being this also the case of the Social work contributions.

^{*} Employers are obliged to provide accident insurance for their employees contracted with the INSS. The size of the premiums is based on the total payroll in the same manner as the social security contributions are calculated, and are paid together with the social security contributions. The monthly premium rates range from 1% to 3%, depending on the risk of the company's activities. Benefits under worker's compensation insurance include survivor's benefits, sickness insurance and disability pensions.

Social Security (INSS) – Employee's contribution

The employee's contribution (between 8-11%) is subject to a cap (only the first R\$ 2,801.56 are taxable) and must be withheld at source monthly by the employer.

The employees' contribution paid by directors of corporations is calculated on a "base salary". Self-employed workers are subject to the same rules. Companies are required to withhold a flat rate of 20%, on these payments.

Social security benefits

Brazil's social security system provides only minimal benefits. In fact, the absence of an adequate "safety net" of social benefits to protect employers in general is one of the major sources of social problems. There is no regular unemployment insurance other than unemployment pay, restricted to a maximum of three minimum wage salaries over the first six months of unemployment. Sickness benefits, disability and senior pensions are very small for the vast majority of Brazilians. In addition, a significant proportion of the population is engaged in occupations for which access to the social security system is limited.

The state health care system is fairly rudimentary and is generally overloaded. Accordingly, the majority of employees have access to private health insurance plans provided by corporate employers or trade unions.

Basis for calculation

Benefits paid by the state to the insured are calculated on the "benefit wage" (salário de benefício). The benefit wage is the part of the employee's salary on which the employer's social security contributions are calculated. The rules for calculation depend on the nature of the benefit.

Sickness insurance

The employer pays for an employee's salary during the first 15 days of sick leave. If the insured is unable to work after a fifteen-day absence, the benefit wage is paid to the insured by the *INSS* for the duration of the sick leave. This insurance may be converted into a disability pension.

Old-age pension

This benefit is paid to men over 65 and women over 60, provided they have made 180 monthly contributions. For farm-workers, the age threshold drops to 60 years for males and 55 years for female workers.

Retirement pension

An early retirement pension is granted if a male employee has worked for 30 years (25 years for women). The maximum pension is available after 35 years of service for men and 30 years for women.

Other benefits

Benefits include, among others, maternity and funeral insurance, a family-assistance for workers that earn up to R\$ 623.44, disability pension, calculated in a similar manner to the thirteenth month salary, etc.

Government inspection

Upon request, employers must submit to government inspectors all accounting records and other documentation to demonstrate compliance with social security rules.

Union contributions

Employers' contributions are paid in January and are calculated on the basis of the registered capital of the company as per a progressive chart prepared by the Union.

The Union contribution, amounting to one day's wages, is paid by all employees once a year. It is deducted from the employee's salary in March.

Foreign workers

Two-thirds of the employees of all companies must be Brazilian citizens, both in terms of numbers and total payroll. Exceptions may be made for skilled professionals and technicians in the event that Brazilians are not available for a particular position. Portuguese citizens as well as foreigners residing in Brazil for over ten years, who have a Brazilian spouse or child born in the country, qualify as Brazilian citizens for the above purposes. There is a debate as to whether this provision of the Labor Law Consolidation has been revoked by the Federal Constitution/88.

Immigration and visa requirements

All foreigners coming to work in Brazil must obtain a valid visa. Generally, visas are issued to the directors and employees of a foreign company, an individual establishing a significant new investment in Brazil or to new transferees of a foreign company with existing operations in Brazil, where the transferee has skills which are not available in the Brazilian labor market In practice, the latter requirement is not rigidly applied.

Therefore, sponsoring companies must obtain residence visas and work permits for expatriate personnel. Experience varies depending on the type of job position, the industry in which the company operates and the current labor policy. Spouses of employees who enter on a temporary visa are not automatically entitled to a work permit.

The work visas issued to foreigners are either temporary visas (valid for up to two years) or permanent visas (with no time restriction on residence). Temporary visas can be renewed for a further two years. Permanent visas may be issued to the directors of entities with at least US\$ 50 thousand or 200 thousand in equity investments (Please see further comments in Chapter 2).

Foreign companies who wish to employ foreign citizens must provide the following documents and information to the Ministry of Labor:

- the amount of registered capital of the local company;
- the number of Brazilian and foreign employees in the local company;
- the justification for the employment of the applicant;
- name and passport number of the applicant;
- information on salary and benefits;
- power-of-attorney, for representation of the applicant before the Ministry of Labor;
- résumé (C.V.), diploma and academic transcripts
- the employment contract;
- a completed application form;
- a health certificate.

Restrictions on the activities of foreign nationals

The Federal Constitution/88 ensures equal protection of the basic rights of liberty, personal security and property ownership to both Brazilian nationals and foreign residents. However, foreigners are prohibited from engaging in certain activities, are limited as to the amount of rural land they may own, and may not own property in frontier areas (Please see further discussion of this in Chapter 12).

Split payroll

Employees who are foreign nationals and work for foreign-owned corporations may legally receive part of their remuneration offshore. Brazilian income tax must be paid on total income (Please see Chapter 9) on a worldwide basis. Visa issuance consequences must also be considered.

Chapter 9

Taxation of individuals

Basis of assessment

Residents of Brazil, whether Brazilian or foreign nationals, are subject to tax on their worldwide income. Individuals reporting foreign income received may recognize a foreign tax credit for the respective taxes paid, provided there is a tax treaty or a reciprocity agreement in place between Brazil and the particular foreign country. The credit taken must be net of any refund and supported by original documents evidencing payment to the foreign taxing jurisdiction.

Income subject to tax includes all monetary compensation and fringe benefits. For foreigners working in Brazil this includes, among others, the cost of travel for family home leave, allowances for housing, education, automobiles, medical and other living expenses. In addition, any reimbursement of taxes paid is included in taxable income. Non-monetary fringe benefits, such as the use of a company car or country club membership, are also included in taxable income. No distinction is made between personal expenses reimbursed by the company to the employee and personal expenses paid directly to a third party by the company. Moving allowances are generally non-taxable but in certain cases may be treated differently.

Tax rates

Brazilian companies making payments to individuals must withhold the personal income tax on a monthly basis in accordance with the progressive tax rate table below.

Progressive personal income tax table

Monthly income	Tax rate	Deduction from the	
		amount of tax due	
Up to R\$ 1,257	Exempt	R\$ 0	
Between R\$ 1,257 and R\$ 2,512	15%	R\$ 188	
Above R\$ 2,512	27.5%	R\$ 502	

Allowances and deductions

The following deductions from the taxable income, among others, are allowed:

- Dependents Up to R\$ 126/month per dependent (per dependent)
- Social security contributions (INSS)
- Alimony payments made in accordance with a divorce ruling issued by a Brazilian court
- Education expenses Up to R\$ 2,373/per year (per dependent)
- Not reimbursed medical and dental expenses
- Contributions to Brazilian private pension plans (limited to 12% of annual taxable income)

Please note that education and medical expenses as well as private pension plan contributions may only be deducted from the taxable income in the annual income tax return. They are not considered in the monthly withholding tax calculations.

When preparing the annual personal income tax return, most taxpayers may elect to recognize the tax deductions either (a) according to actual expenses observed the limitations set out in the regulations or (b) based on a presumed deduction method (deduction equivalent to 20% of the taxable income limited to R\$ 11,167).

Foreign income - carnê-leão

The withholding tax mechanism only applies to payments made by Brazilian companies to individuals. The tax due on foreign income is calculated in accordance with the same progressive table, but the individual itself (or a service provider) must compute and pay the tax through the regime so-called carnê-leão

The deadline for both the reporting of the foreign income and the payment of the corresponding tax is the last working day of the month following the month when the income was received. Foreign tax credits can in general be used to offset the Brazilian tax liability.

Annual income tax return

An annual income tax return must be filed by the last working day of April reporting the income earned in the previous calendar year (January 1 to December 31).

All Brazilian tax residents are required to disclose their worldwide personal assets and liabilities held as of December 31 of each year. Although part of filing obligation, there is no tax assessed on the gross or net assets of a fiscal resident.

Taxation of capital gains

Real estate capital gains are taxable at a 15% rate. For Brazilian residents the amount of the gains is reduced by 5% for each year that the property was held prior to 1989. If a similar transaction has not occurred within the previous five years, if the residential real estate is sold for a price lower than or equal to R\$ 440,000 and if the individual does not own other real estate, the capital gains are exempt from taxation. There is also an exemption if the taxpaver uses the sales proceeds are used to purchase another real estate within the following six months.

Capital gains from the sale of stock negotiated in the Brazilian stock exchange are exempt from tax if the proceeds are lower than R\$ 20,000, in a particular month. If the proceeds from sales in a particular month exceed this amount, the capital gains are subject to either to a 15% or a 20% tax rate. Capital losses may be used to offset capital gains on a monthly basis. Any unused losses may be carried forward.

Capital gains from stock not negotiated in the Brazilian stock exchange are subject to a tax rate of 15% if the proceeds in a particular month exceed R\$ 35,000. Capital losses may not be used to offset capital gains.

Capital gains on the sale of all other personal property either held inside or outside of Brazil, are subject to a tax rate of 15% if the proceeds exceed R\$ 35,000, in a particular month.

The tax on all type of capital gains must be paid by the last day of the month following the month of the sale.

Gains from the sale of foreign stock or personal property that was acquired prior to becoming a Brazilian resident is not taxable.

Concept of residence

Permanent visa

Individuals transferring to Brazil on a permanent visa are subject to tax as residents from the date of arrival. Permanent working visas are generally granted only to applicants who will perform management activities as business-administrators, general managers or directors of Brazilian professional or business companies duly appointed as so in the their articles of incorporation. The Brazilian company has basically two options to formalize the recruitment of an individual with a permanent visa (i) with an employment contract, where the company will pay a monthly salary and will incur in other labor charges, as well as being included in the Brazilian company's payroll; or (ii) without an employment contract, where the company will pay a pro labore remuneration in Brazil.

Temporary visa

Individuals transferred to Brazil with a temporary visa to work as an employee of a Brazilian entity are considered residents for tax purposes as of the date of arrival and as such taxable on their worldwide income.

If an individual enters for any other purpose on a temporary visa and does not have an employment contract with a Brazilian entity he will be working under a technical agreement for the rendering of technical assistance in Brazil, but remain as an employee of the parent company. In this case the individual's tax status for the first 183 days of physical presence in the 12-month period beginning with the date of arrival will be that of a nonresident.

Business visa

A business visa holder is allowed to remain in the country for 90 days (renewable) and would only be able to conduct business as allowed under the rules applicable to the holder of this type of visa. For these purposes, the short-stay business visa is applicable to persons who wish to travel to Brazil

for short-term professional purposes, mainly business discussions that do not involve payment of wages/ salary or financial compensation from a Brazilian entity.

Repatriation process

Upon departure from Brazil, a fiscal resident must report his income and pay any taxes until that date. The taxpayer must file a final income tax return and obtain a tax clearance certificate (granting nonresident tax status) that will enable him to request Central Bank permission to repatriate all assets held in local currency, provided these assets have been properly reported in the annual tax returns.

Chapter 10

Accounting practices in Brazil

Introduction

Accounting practices in Brazil are governed by the Corporation's Law (Law 6,404/76) and regulations from the Comissão de Valores Mobiliários – CVM (Brazilian Securities Exchange Commission) for publicly-held companies. There are two accounting frameworks in Brazil: one stated by the Corporations' Law and one stated by the Conselho Federal de Contabilidade -CFC (Federal Council of Accountants).

The Brazilian Institute of Independent Auditors (Instituto dos Auditores Independentes do Brasil – IBRACON) also publishes its interpretations of generally accepted accounting principles in Brazil, which have been endorsed by the CVM and CFC.

All companies are required to prepare financial statements in accordance with the Corporations' Law. The CFC and IBRACON accounting principles, which represent a separate accounting framework, may also be required to be applied in the preparation of financial statements, depending on the company's specific circumstances.

Brazilian companies are required to prepare annual financial statements that include balance sheet, income statement, statement of retained earnings

(usually included in a statement of shareholders' equity), statement of changes in financial position and notes to the financial statements.

For publicly-held companies and financial institutions, two-year comparative financial statements must be published in the Official Gazette and in at least one major newspaper. Publicly-held companies with investments in subsidiaries must also prepare and publish consolidated financial statements (in addition to their own financial statements). Companies subject to the supervision of the Brazilian Securities Exchange Commission (CVM) must also submit their audited financial statements for appreciation of the CVM. In case the company is engaged in a regulated activity, such as financial institutions, pension funds or insurance companies, it is also required to submit audited financial statements to the Central Bank of Brazil, SPC (Agency of Complementary Social Benefits) or SUSEP (Superintendence of Private Insurance), for example.

Comprehensive adjustment for inflation

For many years, Brazil's economy has shown high inflation rates and as a consequence, an adjustment for inflation was required on contracts and financial statements of the companies, in order to correct eventual financial distortions.

However, since 1997, as the three-year cumulative inflation rate fell below 100%, Brazil is no longer considered a hyperinflationary country, according to international accounting standards. In this sense, since 1996 adjustment for inflation on financial statements is no longer adopted.

Brazilian generally accepted accounting practices (GAAP)

Accrual basis

The accrual basis of accounting is mandatory, unless specific regulation states otherwise.

Equity accounting method

Equity accounting is a method of accounting whereby the investment in a subsidiary is initially recognized at cost, however adjusted thereafter for post-acquisition changes in the investor's participation in the subsidiary's net equity.

According to Brazilian GAAP, the following investments, if relevant, must be evaluated according to the net equity method:

- Investments in controlled entities (controladas) An entity is considered controlled if the controlling entity, directly or through other subsidiaries, holds ownership interest which give it preponderance in corporate decisions and the power to elect the majority of the managers.
- Investments in affiliated entities (coligadas) An entity is considered affiliated to another, when it has management influence or holds 20% or more of the subsidiary's share capital.

An investment is relevant if:

- the individual investment is equal to or higher than 10% of the net equity of the investor; or
- all investments in controlled or affiliated entities together are equal to, or higher than 15% of the net equity of the investor.

It is important to mention that an affiliated company for these purposes is an investee in which the investor holds 10% or more of the share capital, without management control.

An investee is equivalent to an affiliate when:

- the investor retains 10% or more of the voting shares without control, independently of the participation in the total capital (considered as affiliated by the CVM); or
- the investor directly retains 10% of the share capital, without management control.

The equity accounting method is used for the valuation of the relevant investment in each associate and/or its equivalent. In other words, equity method is required in case the investor has effective influence in the management of the investee, or if it retains directly or indirectly more than 20% of participation in the shareholding control.

Investments other than equity basis

Investments in unrelated companies must be evaluated according to the cost method, less eventual provisions for losses in value, in case this is considered to be a permanent investment.

Special purpose entities

Brazilian accounting rules determine that participation in Special Purpose Entities (SPE) should be evaluated by the equity method. The consolidated financial statements of publicly-held companies should include, in addition to the subsidiaries, individually or jointly, the SPE, when the essence of their relationship with the publicly-held company indicates that the activities of these entities are controlled, directly or indirectly, individually or jointly, by the publicly-held company. This accounting practice complies in all relevant aspects with SIC-12 as published by IASB.

Fixed assets and depreciation

Fixed assets are accounted for according to acquisition or construction cost less depreciation, amortization, or depletion. The write-down of costs by way of depreciation, amortization, or depletion must be recorded periodically. Revaluation is permitted and should be reviewed regularly if adopted.

Deferred charges

Deferred charges are expenses which will benefit future years, such as research and development expenses. These items should reflect costs incurred less amortization.

Amortization is usually recorded on a straight-line basis, over a minimum five-year period and a maximum ten-year period, starting when normal operations initiate or in the year the deferred charges begin to benefit current operations (capitalized pre-operating expenses).

Deferred charges should be written off in case the projects or activities that gave rise to these charges are abandoned, or as soon as it is known that such activities will not produce sufficient revenues to cover their amortization.

Other items which should be included in deferred charges are leasehold improvements and the cost of banking licenses acquired.

Tax incentive investments

To encourage investments in certain underdeveloped regions and selected industries, the government has created some tax incentive plans, whereby a portion of corporate income tax payable can be directed toward the purchase of an approved tax incentive investment.

The full amount of the income tax liability, including the portion related to tax incentive investments, is charged as tax expense. Upon formal receipt of the right to the tax incentive investments in a subsequent accounting period, a credit is granted directly to shareholders' equity.

Current and long-term liabilities

Payables, accrued and charges, known or calculable, including the provision for corporate tax on income for the period, must be stated at their full values as of the balance sheet date. Foreign currency liabilities must be adjusted for exchange rate fluctuations and converted into Brazilian currency at the exchange rate on the balance sheet date.

Contingencies

A provision is generally established only when the likelihood of a loss is probable. In case the likelihood is possible, disclosures on the notes to the financial statements are required. There are specific regulations regarding the provision of tax contingencies. Contingent assets recognition is very restrictive. Only certain contingent assets can be recognized.

Interest on equity

Law 9,249/95 introduced the possibility of charging and paying interest on a company's net equity to its owners or shareholders. Calculated on shareholders' net equity accounts, with the exception of amounts credited to revaluation reserves which have not been taxed, the interest rate, which is based on a long term interest rate set by the government (TJLP), is deductible for corporate income tax and social contribution tax on profits purposes.

Interest is subject to a 15% withholding tax. Payment or credit to shareholders is subject to the existence of profits or retained earnings in an amount equivalent to twice the interest charge. Pursuant to IBRACON and CVM rules, interest on equity is charged directly against retained earnings without affecting the year's results.

Deferred taxation

Deferred tax assets should be recognized as temporary deductible differences only when they are likely to be used against future taxable profits. Such appreciation should be based on the company's history of profitability which shows whether it has had taxable income in at least three of the last five fiscal years. Projections of future taxable income have to be provided by management.

Deferred tax assets and liabilities are classified as either a long-term asset or a long term liability and are transferred to current assets or current liabilities when appropriate.

Lease financing and operational

Brazilian accounting rules establish that:

- The lessee should record financing leases as fixed assets and should be identified as lease financing in the balance sheet at the total amount of the lease considerations added by the residual amount, which should be also recorded in current or non-current liabilities. The lease receivable should be recorded in current or non-current assets by the lessor.
- Operational leases should be recorded as rental expenses by the lessee and as fixed assets by the lessor.

However, accounting for financing leases, despite being required by CFC, is not permitted by the Corporations' Law. Thus, this accounting practice is not being applied due to conflict of legislation. Therefore, in practice all lease transactions are normally considered operational.

Lessors are subject to specific financial institution legislation governing their accounting, which is done in two stages: first, entries required by tax legislation are stated, and second, entries designed to eliminate distortions raised by tax requirements are recorded.

Significant differences between Brazilian and foreign GAAP

The major differences between Brazilian and foreign generally accepted accounting practices are as follows:

Start-up expenses

All costs of a company that occur in the pre-operating stage, besides costs normally capitalized as fixed assets, are capitalized as deferred assets. These deferred assets are amortized over a minimum period of 5 years, as required by tax legislation, and a maximum of 10 years, as from the start-up date.

IFRS (International Financial Reporting Standards) requires that pre-operational expenses incurred by a company must be immediately accounted for in the income statement, unless they are of a nature which permits capitalization in fixed assets.

Research activities

IFRS require that all costs associated with research activities should be expensed and sufficiently disclosed. However, this is not the general practice in Brazil.

Leases

According to adopted practices in Brazil, all leases are considered operating leases. Sales revenues originated from a sale and leaseback transaction should be recorded at nominal value, regardless of the circumstances. Certain disclosures are required in explanatory notes.

However, such procedures differ from IFRS treatment, which defines that a finance lease transfers substantially all the risks and rewards related to ownership of the asset from the lessor to the lessee. All leases other than finance leases are considered operating.

Segment reporting

Disclosure by segments is not required in Brazil.

Intangible assets

Amortization of intangible assets should be in accordance with the return associated with the asset. However, it usually follows the tax legislation which requires a minimum amortization period of five years (and a maximum of 10 years, pursuant the Corporations' Law).

According to IFRS, goodwill in a business combination related to intangible assets are not deductible, although subject to tests of impairment on an

annual basis. Intangible assets with a determined period of life should be amortized over such period, and subject to test of impairment only when indication of a reduction in the fair value exists.

Financial instruments

The accounting practices adopted in Brazil do not require recognition of certain financial instruments and derivations at fair value as required by IFRS. The sole requirement consists of disclosures of the market value of the financial instruments and derivations in the notes to the financial statements.

Additional differences related to US GAAP

Marketable debt and equity securities

Under Brazilian GAAP marketable debt and equity securities are generally stated at the lower value between cost and market value.

Under US GAAP, in accordance with SFAS 115 ("Accounting for Certain Investments in Debt and Equity Securities"), companies engaged in sectors which do not have specialized accounting practices, should register marketable securities at:

- amortized cost (debt securities held to maturity);
- market value with gains and losses reflected in income (debt and equity securities classified as trading account securities); and
- market value with gains and losses reflected in equity (debt and equity securities classified as available for sale).

Prior period adjustments

Under Brazilian GAAP, prior period adjustments encompass corrections of errors in previously issued financial statements and the effects of changes in accounting principles.

Under US-GAAP, prior period adjustments are effectively limited to the correction of errors

Brazilian GAAP does not allow the restatement of prior period financial statements to provide consistency in reporting, which is required under US GAAP in certain circumstances.

Tax incentive investments

These investments, which are approved by the government for underdeveloped regions of Brazil or for specific projects, are available without additional costs upon the payment of taxes. Under Brazilian GAAP, the investments should be recorded as an asset, with a corresponding credit to a reserve in shareholders' equity.

Under US GAAP, the credit should be registered as income, and, if the underlying value of the investment is not defined, a provision should be made accordingly.

Earnings per share

Under Brazilian GAAP, earnings per share are computed based on the number of shares outstanding at the end of the year.

Under US GAAP, the earnings per share calculation is based on the weighted average of shares outstanding during the period, taking into account ordinary shares equivalents and may have to be prepared both on a primary and fully diluted basis.

Statement of cash flows

Under Brazilian GAAP, the company should present a statement of changes in financial position which describes the sources and applications of funds in terms of changes in working capital.

Under US GAAP, a statement describing the cash flows used in operating, investing, and/or financing activities, is required.

Financial instruments

Under Brazilian GAAP, aside from Central Bank rules applicable only to banks, financial instruments are not marked-to-market although limited disclosure is required under pronouncements of CVM.

Revaluation of fixed assets

Revaluation of historical costs of fixed assets is permitted under Brazilian GAAP. Revaluation surpluses are credited to a revaluation reserve within equity.

Under US GAAP, revaluation of historical costs of fixed assets is not permitted, except in connection with business combinations accounted for the specific use of the purchase method.

Bookkeeping requirements

All companies and individuals engaged in commercial activities must record and maintain proper accounting books in Portuguese, apply Brazilian GAAP on a consistent basis and include appropriate disclosures. Additionally, there is a list of legally required official books and ledgers which must be maintained by commercial and manufacturing businesses, according to the nature of their activities.

The journal book (Diário) and general ledger book (Razão) are the basic accounting books for legal and tax purposes, in which all business transactions must be registered. Financial statements must be transcribed in the journal book at least once a year.

The other auxiliary books are subsidiary for the information contained in the journal and ledger, e.g a book for income tax control registrations (LALUR) that is used to record adjustments to accounting profit for income tax purposes.

Additionally, there is a general chart (COSIF) with specific codes required for the accounts of financial institutions, which must be used for Central Bank reporting and financial statement preparation purposes.

Some other formalities must be observed when keeping the official records, such as the following:

- the official books must be stated in Portuguese and values must be recorded in Brazilian currency. There are no restrictions to show equivalents on foreign currency, although such figures are considered merely for illustrative purposes, except for the case where the origin of the transactions is in foreign currency;
- blank lines, interlining, or alterations of any kind are prohibited, and invalidate the document as proof of a particular transaction in connection with claims or lawsuits;
- the entries of all transactions in the journal book must occur in chronological order. In practice, however, this book may be used to record

monthly totals of transactions entered in subsidiary journals such as cash books, sales day books, or purchase day books, provided that all subsidiary books are properly registered;

- the inventory registration must be written up each year-end to in order to record accurate information related to inventories of final products, raw materials, and intermediary products;
- the use of codes (i.e., the use of numbers instead of headings) for accounting entries in the journal book is permitted in case the codes are filed with the Registry of Commerce.

Most companies generate accounting books electronically, using specific software designed to comply with legal and tax requirements.

Certain minimum information should be disclosed by corporations in their balance sheet and income statements. Assets and liabilities are presented in order of liquidity.

The income statement must disclose the following income and expense items:

- gross income associated with the sale of goods and services, sales deductions, discounts, and sales taxes;
- net proceeds derived from the sale of goods and services, cost of goods and services sold, and gross profit;
- sales, administrative, and financial expenses (less income), and any other operating expenses;
- operating income (or loss) and non-operating results;
- income for the year before income taxes;
- income taxes:
- profit sharing programs for employees and directors, contributions to employees' pension and welfare funds;
- net income: and
- net income per share (outstanding at the end of the period).

For tax purposes, group consolidations are only carried out using the net equity method which does not allow for the compensation of tax losses among group companies.

Publicly -held companies must also issue a management report containing basic information about the company.

Required financial statements

The following annual financial statements must be prepared and published by Brazilian publicly-held companies: balance sheet, income statement, statement of retained earnings and statement of changes in financial position.

The financial statements must be followed by explanatory notes and analytical exhibits in order to expose the financial position. Comparative figures for the preceding year must also be presented.

According to the Corporations' Law and accounting regulations, corporations must disclose, where applicable, the following information in the notes to their financial statements:

- The main accounting policies used to prepare the financial statements, including the method used to evaluate inventories and calculate depreciation, amortization and depletion, the basis for provisions covering expenses and risks, as well as expected losses on the disposal of assets;
- basis for consolidation:
- major categories of all significant accounts, inventories, and fixed assets;
- details of investments in other companies;
- increases in value of fixed assets as a result of revaluation:
- pledges of assets, guarantees given to third parties, and other contingent liabilities:
- interest rates, maturity dates, and guarantees for long-term loans;
- the number, types, and classes of the company's shares;
- dividend distribution policies;
- prior year adjustments;
- significant events occurred subsequently to the balance sheet date that have or might have a material effect on the company's financial position or results.

A group of companies formally registered and a publicly-held corporation with all its subsidiaries must present consolidated financial statements.

Companies not publicly-held (and that are not financial institutions or equivalent) are not required to publish their accounts or to engage auditors.

Audit requirements

The Federal Council of Accountants (CFC) regulates the accounting profession. Accountants must register with regional agencies before beginning activities and signing audit reports.

Publicly-held companies, financial institutions, insurance companies, and some other entities must contract independent auditors registered with the CVM. The auditors should attend the annual shareholders' meeting to provide information in connection with the audit performed during the year.

The auditor must declare in the audit report its opinion on whether the financial statements present a fair view of the company's financial position and the results of the operations. Independent auditors, qualified at CVM, are liable for damages incurred by third parties in case of acts relied on their audits.

The CVM requires that publicly-held corporations re-issue financial statements and related reports, in case they are found to be misleading or if other changes are considered necessary.

Latest developments

Rotation of auditors

All Brazilian publicly-held companies and financial institutions are required to change their auditors once in every five years, following Instrução CVM 308.

Law 3.741/00

A draft law which revises and updates the Corporations' Law accounting requirements, entitled Law 3,741/00 is currently under consideration by the Brazilian government. The main proposed changes are:

• large companies, regardless of their legal structure, would be required to publish their financial statements on an annual basis (currently, only publicly-held companies are required to publish their financial statements);

- publicly-held companies would be allowed to publish summarized financial statements, with the complete financial statement still being required to be sent to the authorities;
- requirement to prepare a statement of cashflows instead of the statement of changes in financial position;
- companies would no longer have the option to perform "spontaneous revaluations" of assets;
- marketable securities would be required to be valued at market value rather than lower between cost and net realizable value.

Chapter 11

Banking & Finance

Financial system

The enforcement of the banking and financial sectors is a key element in economic planning and policy. Accordingly, Brazil's banking industry has become accustomed to a high level of government regulation. The extent of such regulation often comes as a surprise to foreigners. For example, not only are Brazilian banks subject to the usual type of controls on banking operations (lending limits, credit expansion controls, supervision by central banking authorities, etc.) but they are also, on occasion, bound by government directives on such varied matters as maximum interest rates for certain types of loans, requirements to extend a minimum percentages of their loans to small and medium-sized companies and maximum percentages to foreign-owned entities, as well as prescribed methods of revenue recognition on specific types of transactions. Seldom is any major or minor economic policy put through without extensive directives and circulars to the banks from the monetary and banking authorities.

The Central Bank of Brazil (BACEN) has the primary responsibility for regulation and supervision of financial institutions in Brazil. The Brazilian Securities Exchange Commission (CVM) and Federal Revenue Service (SRF) also have limited regulatory and supervisory influence over banks. The three regulatory authorities are subordinated to the same political leadership, and do cooperate in matters of common interest.

The banking industry today

The framework of the Brazilian banking industry evidences that it has been dominated by institutions controlled by government. In 1996, the Caixa Econômica Federal and the Banco do Brasil (majority-owned by the federal government) held approximately a 33% share of total commercial, multiple and saving banks' assets. A significant proportion of the activities of the federal and state banks involves the re-lending of government-subsidized, low interest-rate loan funds to agriculture and industry. When development banks such as BNDES are included, the government's participation increases substantially.

Statistics should not, however, obscure the fact that the Brazilian private banking scene is characterized by dynamic development and growth. Despite erratic government policies, private banks have rapidly expanded their activities. Product lines have been diversified (e.g. into leasing and the development of a short-term commercial paper market) in response to the growing needs of increasingly sophisticated customers. Banks have expanded their branch systems to meet the needs of both the burgeoning major cities and the small towns that have benefited from the agricultural booms of recent years.

During the 1990s the banking industry experienced significant changes. New technologies, the stabilization of the economy and a consequent fall in inflation led to industry consolidation and a shift in business activities.

Skillful seizing of the opportunities provided by high interest rates, the scarcity of credit due to the government's anti-inflation policies, and the float on deposits and collections, generated high yields for private banks during most of the 1980s and 1990s. These profits have been used to develop modern made-in-Brazil electronic banking equipment, to enable the banks' holding companies to diversify into other activities and to strengthen the private banks' capital base.

With the decline of inflation over the last decade, credit became more abundant and credit card use picked up exponentially. A traditional source of Brazilian credit for consumers has been the use of post-dated checks. This practice is still in force, even with low inflation, and constitutes an informal type of retail credit. At the same time, banks are directing more credit to previously neglected sectors, such as small and midsized companies, individual consumers and real estate financing. The expansion of credit could be even stronger if it were not for the high interest rates that are part of the official monetary policy.

Foreign participation in the banking industry has recently grown. The increased interest of foreign banks in the Brazilian financial market, in addition to the general conditions for foreign investments already mentioned result in two important factors. First, after decades of being rather closed to foreign direct investments Brazil has changed its policy. Second, it is perceived that at some moment in the near future the very high local interest rates should decrease, when the demand for credit will probably increase substantially, since Brazil has a rather low loan/gross domestic product ratio.

Type of banks

Currently, approximately 180 private commercial banks (including multiple activities banks) operate in Brazil, of which around 80 have total deposits in excess of US\$ 100 billion. In addition to commercial banks, there are around 30 government commercial and development banks and public savings and loans institutions, 20 investment banks, and many other financial institutions. It is normal business practice to maintain banking relationships with a number of different banks in order to have access to several alternative sources of financing.

State and regional development banks

Some Brazilian states and regions (e.g. the Amazon region) have established development banks whose objectives are to assist specific segments which are important to the state or regional economy. These banks accomplish this primarily by helping resident companies to obtain access to BNDES (Federal Development Bank) programs. Some of these development banks have incentive programs for particular local needs.

Multiple banks

As of 1988 the Central Bank has allowed financial institutions to operate as multiple activities banks (bancos múltiplos). A banco múltiplo is a single bank authorized to conduct a wide range of retail and wholesale banking transactions, which are performed through different portfolios, including foreign exchange, stock market activities, savings and loans, the management of individual savings and the financing of housing and public works through the housing finance system. Previously, financial institutions

were required to specialize in specific activities, e.g. commercial banking, investment banking, consumer finance, brokerage, etc., which are commented on below.

The activities permitted for bancos múltiplos depend on the portfolios they manage, since the rules applicable to the specialized institutions are automatically extended to the corresponding portfolio of bancos múltiplos, except for the banks with a leasing portfolio which are not allowed to issue debentures.

Bancos múltiplos presently have by far the largest share of deposit and loan banking operations. At the end of 2001, only the four largest private banks (Bradesco, Itaú, Unibanco and ABN Amro Real) together with the foreign HSBC Bank had a net worth of US\$ 26.5 billion and more than US\$ 207.619 billion in total assets.

Commercial banks

A commercial bank (banco comercial) is authorized to conduct retail and wholesale banking and foreign exchange transactions. Commercial banks were the oldest and most important type of financial institution until the creation of bancos múltiplos. They are the principal private sector deposit takers and have a monopoly on the operation of demand deposits. The commercial bank is normally the lead institution in a financial conglomerate. In recent years most commercial banks have been converted into bancos múltiplos and have expanded their range of products and scope of services.

Commercial banks may issue certificates or receipts of deposit, offer different types of financing in domestic or foreign currency, participate in the securities and money markets and manage mutual funds and securities investments on behalf of third parties. Leasing activity is forbidden for commercial banks.

Banks are not permitted to pay interest on demand deposits. Demand deposits are an essential product for a retail bank, because they are a conduit for various other products: money market, funds, collections, etc.

Virtually all banks that hold demand deposits also issue credit cards and bank cards, the main objective being to economize front-end processing costs. The leading worldwide credit card networks are represented in Brazil, and there

are also many proprietary cards. The card operators are not classified as financial institutions in Brazil; they merely manage the cards on behalf of the associated banks. However, in some cases the card operators rather than the banks assume the credit risk, and accordingly keep the interest spread, in contrast to the usual arrangement in OECD countries.

To protect creditors, banks are prohibited from issuing deposit certificates at a discount, or repurchasing their own deposits before maturity. However, a bank will frequently have a securities dealer subsidiary which is allowed to deal in its parent's deposits.

Investment banks

A banco de investimento differs from a commercial bank in that it may not accept demand deposits, but may undertake stock market activities.

They are privately owned institutions established in accordance with the Capital Market Law of 1965 to act as suppliers of medium and long-term working capital to corporate borrowers. They obtain their funds through fixed-term certificates of deposit, from re-pass operations (domestic currency loans based on foreign currency input loans) with government development banks and agencies, from foreign banks under Resolution 63 arrangements (foreign currency loans), and through the issuance of debentures. Most investment banks operate as part of financial conglomerates, and their loans are typically to service the larger, longer-term needs of the conglomerate's major customers. Underwriting and lease-back operations may be also part of their activities.

Savings banks

Under this heading are a number of institutions that are principally involved in the collection of individual savings and the financing of housing through the housing finance system. The principal institutions in this sector are the government owned Caixa Econômica Federal and Nossa Caixa Nosso Banco of the São Paulo state, following other state caixas, as they are usually referred to savings and loans banks (sociedades de crédito imobiliário), and savings and loans associations (associações de poupança e empréstimo).

Savings deposits (Caderneta de Poupanca) are the traditional means of savings for the working classes and occasionally become attractive for sophisticated investors.

Personal home loans have brought high losses to the Brazilian financial system in past years, because of the very great mismatch in the tenor of lending and borrowing, coupled with politically motivated caps on loan repayments. In the successive economic shocks of the 80s, the government routinely froze, or even worse, deflated loan repayments, and at the same time remunerated saving accounts at top of the market rates in order to discourage excess consumer demand.

Consumer credit companies

The financeira provides loans to individuals to purchase consumer durable goods and automobiles. Some of the largest companies are operated by the automobile industries and major department store chains.

Financeiras also provide financing to industrial companies for the purpose of purchasing locally manufactured machinery and equipment (financing cannot be granted for the purchase of foreign manufactured equipment). Funding is obtained via the sale of bills of exchange (letras de câmbio) in the money markets and in the interbank market, which for all practical purposes function like time deposits.

Leasing companies

In terms of overall size, the leasing industry is expanding remarkably as a source of corporate and individual financing. In 2002 around 70 companies were operating in the sector and the present value of the contracts currently in force was US\$ 4.5 billion.

Development banks

Many Brazilian states and regions have established development banks whose objectives are to assist specific segments which are important to the state or regional economy. These banks accomplish this primarily by helping resident companies obtain access to BNDES programs. Some of these development banks have incentive programs for particular local needs. Created to promote economic development, but subject to political influences, these state-owned banks are in periodical need of assistance from the federal government.

Representative offices

Foreign banks wishing to offer banking services abroad can establish a representative office in Brazil. Representative offices cannot pursue any banking activities other than putting potential Brazilian borrowers in touch with the foreign parent bank, and acting as the local representative of the parent bank. Loans must be funded and booked outside Brazil, and the office cannot accept deposits or undertake other banking-related liabilities in any form. Representative offices can receive commissions paid locally in Brazilian currency. These commissions are covered by the main terms and conditions of the loans, which are expressed in foreign currency, and are subject to BACEN approval.

Capital market

The Brazilian stock exchange market is regulated by the Brazilian Securities Exchange Commission (CVM). Active financial futures and options on commodities such as metals, grains, meat, and currencies are also traded on the exchange.

In light of high rates of inflation, personal funds available for investment have traditionally been applied in real property and in index-linked savings deposits, both of which have generally provided a return at least in line with inflation. Conversely, the return on equity shareholdings has historically not kept pace with inflation over prolonged periods, although high real returns have been recorded in 1991, 1993 and 1996. Also, a checkered history, involving periodic speculative booms, has caused the general public to be somewhat wary of investing in the stock market. More recently, after a weak performance in 1995, the yield from investment in stock surpassed in 1996 and 1997 the return of the investment in the money market and volume of investments increased with an important foreign participation.

Future markets in Brazil include:

- Futures. The parties of an operation put and/or call commitments for future settlement on a given date. The contract value positions originate daily gains or losses for the respective positions, demanding margin guarantee deposits when necessary.
- Spot and future options. One party acquires from the other the right to purchase or sell the commodity, or its future contracts, up to or on a specific date, at an agreed price.

- Forward contracts. Similar to futures options, but do not provide for adjustments until settlement of the contract.
- Spot contracts for immediate settlement of certain commodities, Which give the futures and options markets reliable information on actual present prices for cash transactions.
- Currency Swap. A financial hedge through which two parties agree to exchange future payments in different currencies, with no exchange of principal. Consequently, settlement is made through payment of the amount corresponding to the exchange difference between the referential currencies in the period. These operations may be carried out on stock exchanges or directly between financial institutions.

Securities dealers and brokers

Corretoras de Títulos e Valores Mobiliarios and Distribuidoras de Títulos e Valores Mobiliarios undertake virtually the same activities, namely, securities brokerage. The two types of entity are distinguished because corretoras have a seat on a stock exchange, where as distribuidoras do not. These firms are authorized to trade for their own account as well as for clients and may manage mutual funds and investment clubs.

A distribuidora is often the securities dealer of the Brazilian financial conglomerates. Through the distribuidora, the other financial institutions in the group sell their financial paper (certificates of deposit and acceptances) to the market. Similarly, when such paper matures, the distribuidora purchases it from the market. The distribuidora places group paper in the market for a fee received from the issuing company, engages in trading such paper for its own account, and may also hold paper of the issuing company for its own portfolio yield purposes.

Funding usually comes from the distribuidora's own capital or from deposits from banks outside the group. A distribuidora cannot borrow from other members of the financial conglomerate.

One of the principal advantages the distribuidora brings to the financial conglomerate is that it can open branch offices with greater freedom than the other members of the conglomerate. Thus, for example, the conglomerate can use distribuidora offices to sell the financial paper of the commercial bank in areas where the commercial bank does not itself have a branch.

Mutual funds and portfolio administration

Brazil's high interest rates create a strong incentive to invest available liquidity in interest-bearing assets (demand deposits do not earn interest). Mutual funds are a popular alternative, particularly for individuals. In addition, investors have a choice between fixed-yield funds (fundos de renda fixa) and stock market funds (fundo de ações).

They generally are open ended funds with or without a grace period and a minimum deposit and withdrawal amounts, in order to restrict processing costs. Their investments are focused on certain types of assets, depending on the tax and regulatory regime they adopt. They must follow rules concerning diversification of investments, submission of daily information to the Central Bank of Brazil (BACEN), bookkeeping and publish their semi-annual accounts. Stock market funds are also regulated by the Brazilian Securities Exchange Commission (CVM). The manager or sponsor of a mutual fund must be a financial institution. There is a great diversity of funds as well as portfolios to suit investors' preferences as to type of investment, taxation and risk.

The principal types of funds include:

- stock market funds:
- money market funds;
- foreign capital investment funds.

Funds can be managed by securities brokers and dealers, in addition to banks and finance companies. Banks have an advantage over the retail and money market funds, in that customers can conveniently use the branch network to transfer between funds and demand deposits.

The fund managers typically collect administration fees on the funds' net worth. Also, if they operate demand deposits they benefit from the float generated by transfers to and from the funds.

The fund administrators are not legally responsible for the credit or trading losses of the fund. Naturally, they are responsible for losses due to fraud or mismanagement. A majority of unit holders can, in theory, decide to choose a new manager. In practice, if dissatisfied, they sell out and invest in a different fund.

Stock market funds. These funds are regulated by the CVM since they invest most of their cash in publicly traded shares and usually government bonds and term deposit certificates. They can operate in futures and options markets.

Quotaholders are subject to a grace period, rather low minimum investment and withdrawal requirements, as well as withholding tax on income. The return is variable depending on the manager's policy, which may be aggressive – investing more in emerging country equities or companies which participate in the stock market, or even very conservative – hedging risks through options and box operations to approach the market interest rate.

Money market funds. These funds, which are regulated by the Central Bank, basically invest their cash in interest earning securities of the public and private sectors. There are the *Fundos de Curto Prazo*, for very short term investments, which substitute the interest bearing bank accounts since demand deposits cannot pay interest. The rules concerning diversification and compulsory application of cash are rather strict.

All money market funds may be established and managed by investment banks, consumer finance companies, multiple banks with any of these portfolios and dealers or brokers. The Fundos de Aplicação Financeira may also be managed by commercial banks.

Share issues by foreign companies

The Federal Monetary Council has the power to restrict the access of foreign owned companies to the capital markets in times of balance-of-payments crisis, and the Securities and Exchange Commission may introduce general requirements for the minimum size of public offerings. Currently, these restrictions do not apply. In fact, less than forty foreign companies are quoted on the stock exchange (out of a total of approximately 900). Of these foreign companies, virtually all have sold only preferred shares to the public.

A foreign investor wishing to make a public offering of shares is free to do so, provided that the offering complies with the rules of the CVM and the stock exchanges, as well as with the relevant legal provisions. Advice on public offering procedures can be obtained from investment banks, which are required by law to act as conduits for public offerings, and from brokerage firms. The issue of Brazilian Depository Receipts (DRs) is now authorized (see below).

Foreign investment in the stock exchange

In the past few years, the Brazilian government has enacted measures designed to encourage foreign investment in securities, for the purpose of strengthening stock markets.

In 1987, the Central Bank of Brazil issued Resolução 1,289, which sets forth the regulatory framework for foreign investment in the Brazilian securities market. Five annexes were included in this Resolution describing the different conduits for foreign portfolio investment.

Recently, Resolução 2,689 of January 26, 2000 eliminated four of those annexes. The only remaining route is known as "Annex III.

The "annexes" introduced by Resolução 1,289 have been replaced by a single surviving conduit for non-resident investors with tax savings opportunities.

Annex III. This vehicle is designed for larger investors and has more requirements. The securities portfolio is jointly managed by the foreign institution and the Brazilian investment firm. The foreign institution is publicly-held and issues shares or quotas representative of its capital assets. The first fund organized under Annex III (Brazil Fund) had an initial capitalization of US\$ 100 million.

Fixed rate funds. In 1993, fixed rate funds were established by Central Bank Resolução 2,034 to channel foreign investment into Brazil's wide array of fixed yield investments. This investment option is also being phased out.

Other investment mechanisms. Other investment vehicles available to foreign investors include debt/equity conversion funds. Several holding period and diversification requirements make these vehicles somewhat less attractive than others, such as mutual funds dedicated to investments in federal government bonds (witch gains are tax-free), real estate funds, equity funds (fundo de investimento em participações), etc.

Sources of finance

The Brazilian government has from time to time placed restrictions on the expansion of lending by financial institutions in order to control the level of money supply. Moreover, government policy has directed the banking system to lend a majority of scarce local currency funds to export, agriculture, small and

medium-sized businesses, and other sectors that it is seeking to promote as priorities over the public sector and multinational companies. This has meant that. at times, access to these loans has been very costly. Section 3 of article 192 of the Constitution limits real interest rates to 12% per year although the section does not define how real interest rates are measured, nor has the Central Bank or the banking industry ventured to establish this definition. Until regulated by Congress, section 3 remains without effectiveness.

Another disadvantage of local currency loans has been their very short-term nature. Due to the instability of inflation and interest rates, investors show a very strong preference for liquidity. Similarly, banks avoid mismatching maturities of loans and deposits. As a result, most of these loans (other than for agriculture or small business) are contracted for terms of 30 days or less. With the introduction of the Real in July 1994 and the expectations of low inflation rates, lending terms have been increasing.

However, there are a number of mechanisms whereby a business can obtain access to the wholesale banking services of international banks, including banks not established in Brazil. Brazilian companies can borrow in dollars, either directly from foreign-based banks (Law 4,131 loans) or via pass-through arrangements with Brazilian banks (Resolution 63 loans).

Alternative sources of longer term borrowing are project loans from the government's development banks and leasing. Development bank loans are preferentially directed to Brazilian-owned companies, but under certain circumstances foreign capital companies are eligible for these loans. They generally have a term of 2 years or more, but with floating interest rates or rates linked to the U.S. dollar exchange rate if the funds for the loan are obtained abroad. Naturally, all longer term loans are subject to some kind of indexation, usually linked to inflation and or funding costs.

The principal sources of bank lending generally available to foreign capital companies are the following:

Borrowing in local currency

Real borrowing is generally short-term and normally requires promissory notes (notas promissórias) or trade bills as collaterals. Some form of liquid collateral against non-performance is usually required.

Loans - foreign currency direct borrowing

In this type of lending, foreign currency loans are made directly from foreign banks to Brazilian corporate borrowers. A Brazilian bank may intervene as agent, for which it receives a fee, but in general the Brazilian bank assumes no credit risk; it merely puts potential borrowers in touch with foreign correspondent banks. Foreign loans must be registered with the Central Bank for approval of the terms and interest rate.

Debentures

The use of debentures as a source of funding is a relatively recent development in Brazil. Between 1979 and 1982 the total of debentures sold increased from a very small base by significant multiples. This expansion was, however, largely due to the fact that until late-1982 debentures were not subject to restrictions applicable to other forms of credit, and the majority of issues were taken up by banks. With the inclusion of debentures in bank lending limits, the expansion of debentures slowed considerably.

Debentures can be convertible or non-convertible. Interest rates are expressed as an adjustment for inflation plus floating interest subject to renegotiation every three to six months. The rate is geared so as to be attractive to investors and to be below the cost of alternative bank borrowings. At the interest rate renegotiation dates, either party (issuer or holder) can obtain early redemption of all or part of the issue. Issues are subject to prior scrutiny and approval by the CVM, but significant flexibility exists as far as the security offered to the prospective purchasers is concerned.

The attraction factor with debentures as a source of funding in Brazil is mainly that they can be less costly and provide longer-term financing than is usual for bank borrowings, and that they are an available source of local currency funding that is not directly subject to government control over availability, as is the case with bank credit. There has been discussion from time to time, without practical results to date, regarding the creation of a secondary market for commercial debt instruments such as debentures.

Commercial paper and bonds

Brazilian companies may issue abroad short-term commercial paper or long-term bonds or notes. The Central Bank has absolute discretion in approving such operations. Their analysis will focus on the terms and financial conditions proposed by the issuing agent.

The advantages of using commercial paper instead of a normal loan is the fact that it does not normally affect the country risk, thus reducing the cost of borrowing.

Short-term borrowing for exports uses the more traditional exchange contract advances (where exporters anticipate the sale of foreign exchange with the bank). More recently, the use of export notes, which are a papers based on future export contracts issued by exporters for a discount at banks, has increased.

Leasing

Leasing as an alternative mode of financing the acquisition of long-term assets is fairly widely accepted, not least because of the efforts of certain large, Brazilian-owned private commercial banks, which have moved quickly to offer this product through their widespread branch networks. Assets financed range from buildings and industrial turnkey projects (generally handled by the large companies owned by or affiliated with international banks), through the medium-range financing of high technology equipment, computers, and machine tools (handled by all types of companies), to the small-scale retail leasing industry (dominated by specialist domestic companies and the automobile manufacturers).

Special factors that have encouraged the expansion of leasing in Brazil, in addition to the general cash flow benefits that make leasing an attractive option to the typical company, include the following:

- cross-border leasing transactions may qualify for reduced income tax withholding;
- all lease contracts are recorded by the lessee as operational leases and consequently the installments are tax deductible expenses;
- leasing represents one of the few available means for foreign-owned entities to obtain long-term financing of domestically produced equipment, since such entities are generally unable to obtain government development bank financing.

Central Bank Resolução 2,309 of August 28, 1996 provides for two types of leasing:

- financial leasing, whereby the payments and other contractual charges owed by the lessee are normally sufficient for the lesser to recover the cost of the leased property and obtain a return on the funds invested; the maintenance, technical and operating services are paid by the lessee; the option price is freely negotiated and can be an immaterial price; and
- operational leasing, whereby:
- the payments cover the full cost of making the asset available to the lessee;
- the present value of payments is not greater than 90% of the cost of the asset (in calculating the present value financial charges must be included):
- the term of the contract is less than 75% of the useful life of the asset;
- there is no quaranteed residual payment;
- maintenance, technical assistance and other such related services may be assumed by either the lesser or the lessee.

The lesser of a leasing operation taking place within Brazil must be a leasing company, or a bank or financial institution with leasing portfolio, approved by the Central Bank.

Leasing operations involving directly or indirectly related parties, as well as those contracted with the manufacturer itself will not be considered leasing operations for tax purposes.

Domestic leasing operations with related parties are only permitted in the case of banks authorized to engage in leasing.

Leasing entities must have a duly organized technical department supervised by one of their officers to implement leasing operations.

Leasing companies must be structured as a corporation and follow the rules established for financial institutions, as applicable. The name of the company must include the expression "arrendamento mercantil", which may only be used by entities qualifying as such. Minimum capital requirements apply.

Special rules for cross-border contracts. The lesser of a cross-border leasing operation does not need to be a financial institution licensed to operate in Brazil, however, all cross-border leasing operations must be

registered with the Central Bank of Brazil. The import of assets under leasing arrangements is subject to special customs rules.

Depository receipts

DRs are receipts which represent the shares of a company floated in a stock exchange located outside its country of origin. DRs, or their offshoots known as ADRs or IDRs, are becoming of great use to Brazilian corporations who wish to increase the liquidity of their shares. Thus, a certain number of shares of the company issuing DRs are deposited with a Brazilian financial institution. The acquisition of DRs is subject to registration at the Central Bank of Brazil. This registration allows the remittance abroad of dividends or income from the sale of the shares. Investors have the option of canceling the DRs and converting them into direct investment in the Brazilian company. Nonresident companies may now issue DRs on Brazilian exchanges. Brazilian Depository Receipts are governed by Central Bank Resolution 2763/00, and investments in DRs must be registered with the Central Bank of Brazil.

Chapter 12

Insurance industry

Introduction

Currently the Brazilian insurance market, considering general insurance, personal insurance (especially life and health insurance), private open pension plans and capitalization securities, represents approximately 3% of the Brazilian GDP. When compared with other countries that reach from 6% to 7%, it is verified that the difference is related mainly to the large volume of personal insurance.

An agenda for structural changes is being discussed in various segments, some already in Congress, aiming at increasing the size of the market, among which the following aspects are most prominent: breaking the monopoly on reinsurance operations, privatizing work accident insurance and reducing the tax burden on certain types of insurance, especially life insurance. Currently, the Brazilian insurance market faces innumerable challenges, such as, for example, the levels of fraud in claims and the increase in the level of competition.

The insurance companies in Brazil work most strongly in the field of property risks. The main portfolios sold are automobile insurance, which represents more than one third of the volume of premiums collected, life and health insurance, as well as fire and civil liability insurance.

The Brazilian insurance market can be divided into the following segments:

- Insurance companies: They may sell general, life and health insurance.
- Open complementary pension entities: They work with pension-type benefit plans and may also sell personal insurance.
- Capitalization companies: They sell capitalization securities. These securities are representative of deposits received from participants. Upon maturity, a variable portion from 50% to 100% of the amount deposited is redeemed with interest and monetary updating. During the period of time between the acquisition of the security and its maturity, the bearer of the security participates in raffles for prizes.
- Health plan operators: They work exclusively with health insurance for individuals and legal entities. These operators, and the insurance companies that specialize in health insurance, differently from the rest, are supervised and regulated by the National Agency for Supplementary Health (ANS), an agency subordinated to the Ministry of Health.

Currently there are approximately 180 insurance companies in Brazil, including capitalization companies and open pension entities, a little more than 65 thousand insurance brokers, a little more than two thousand operator companies registered with ANS, represented by approximately 15 insurance companies specialized in health, 550 dental companies and the rest, which are health plan operators.

Market structure and regulatory agencies

Insurance market

The National Council of Private Insurance (CNSP) is responsible for defining the quidelines and rules for private insurance. The president of CNSP is the Minister of Finance and he is supported by representatives from the Ministry of Justice, the Ministry of Social Welfare, the Federal Agency of Private Insurance (SUSEP), the Central Bank of Brazil (BACEN) and the Brazilian Exchange Securities Commission (CVM). CNSP is also the agency that decides on the loose ends in the field of insurance in the last instance, regulates the compulsory insurances and establishes the limits for insurance operations in Brazil.

Reinsurance activities in Brazil are the exclusive duty (monopoly) of IRB-Brasil Resseguros SA, a government controlled, mixed capital company that regulates coinsurance, reinsurance and retrocession.

SUSEP is the regulatory and inspection agency for the insurance, capitalization and open private pension market, and is responsible for the authorization of, inspection of and intervention in companies in the event of the malfunctioning of any component of the market. It is also responsible for authorization for opening insurance companies, private open pension entities and capitalization companies, for the regulation of insurance operations, approval of insurance plans that are placed on the market and inspection of the insurance brokers, who should be duly accredited by SUSEP.

Health market

The insurance companies specialized in health and the operators work under the supervision of the National Agency for Supplementary Health (ANS), a government agency linked to the Ministry of Health that is responsible for regulation, control and inspection of supplementary health assistance activities.

The purpose of ANS is to enforce the public interest in supplementary health assistance, to regulate the operators, including their relationships with providers and consumers, and to carry out activities related to health in Brazil.

Basic rules for the Brazilian insurance market

Establishment of companies

The establishment of insurance and capitalization companies and complementary pension plan entities depends on prior authorization by SUSEP. The requests for approval should contain minimum elements, such as indication and identification of the future controllers, with proof that they have financial capacity compatible with the undertaking; presentation of the structure of the controlling group and of the holders of qualified stakes; proof of the origin of the funds; proof of the good standing of these controllers before the supervisory agency in Brazil and abroad, if applicable, as well as indicating the other investments held in Brazil or made with other Brazilian companies by the future controllers, when it is the case.

After receiving prior approval, the shareholders should submit the articles of incorporation for approval, so that the company may be incorporated. The authorization granted by SUSEP will be subject to proof of the inexistence of registration constraints on the administrators and controllers, and payment of the minimum required amount of capital.

Authorization to operate will be granted through a SUSEP Ordinance published in the Official Gazette.

The company/entity will be subject to extrajudicial liquidation, and will not be subject to composition with creditors nor bankruptcy, except in the latter case, if the assets are not sufficient to pay at least half of the unsecured creditors (those whose credits have no real guarantee or legal preference) or when there is substantiated evidence of the occurrence of bankruptcy crime.

Registration of operators

To operate in the supplementary health sector, authorization is needed from the ANS, which occurs after registration of the operator, registration of the product and presentation of the business plan, provided that there is no incompatibility or inconsistency in this information.

In the event of cancellation of the registration, the company may not stop operating if it has clients in its portfolio. The existence of clients also impedes cancellation of the registrations of the products.

Operating limits – solvency margin

The solvency margin for insurance companies will correspond to the sufficiency of the adjusted net equity to cover an amount equal to or greater than the following values:

- 0.20 times the total net revenue from premiums issued in the last 12 months; or
- 0.33 times the annual average of all retained claims in the last 36 months.

For the calculation the operations for all the lines, except individual life and contributions for open private pensions, will be computed. The companies should present the calculation upon the closing of the financial statements as of June and December.

For insurance companies specialized in health, the solvency margin corresponds to the sufficiency of the net assets (net equity adjusted for additions and exclusions) to cover an amount equal to or greater than the following values:

- 0.20 times the annual average of the total sum of the last 36 months of 100% of the net revenue from premiums issued of the prepaid type and of 50% of the net revenue from other types of premiums issued;
- 0.33 times the annual average of the total sum of the last 60 months of 100% of the retained claims of other types.

For the operators of private health assistance plans, the solvency margin represents a supplementary reserve to the technical reserves that the operator should have available to support the fluctuations in its operations, and they should correspond to the sufficiency of the net assets to cover an amount equal to or greater than the following values:

- 0.20 times the annual average of the total net pecuniary considerations issued in the last 36 months;
- 0.36 times the annual average of the total net indemnity events in the last 60 months.

For the calculation of the solvency margin of the insurance companies the operations of all the lines will be computed, with the exception of individual life and open private pension plan contributions.

The insurance companies should present the calculations upon the closing of the financial statements for June and December.

Operating limits – minimum capital

The minimum capital needed for insurance and capitalization companies and open private pension entities to operate in Brazil is constituted by a fixed amount corresponding to the authorization to operate in determined insurance groupings and a variable amount to operate in each region of Brazil.

Insurance companies - The minimum capital for an insurance company, authorized to operate in the non-life insurance grouping throughout Brazil would not be less than R\$ 7,2 million. The fixed amount of the minimum capital required for an insurance company to obtain authorization to operate is R\$ 1,2 million for selling non-life insurance. The variable amount of minimum capital required depends on the region of Brazil where the company operates or is going to operate.

Capitalization companies - The minimum capital for a capitalization company, authorized to operate in all regions of Brazil would not be less than R\$ 10,8 million. The minimum amount of capital required to obtain authorization to operate is R\$ 1,8 million. The variable amount of minimum capital required depends on the region of Brazil where the company operates or is going to operate.

Insurance companies operating with life insurance and complementary pension plans, and open complementary pension plan entities -

The minimum capital for insurance companies operating with life insurance and complementary pension plans, and open complementary pension plan entities authorized to operate death benefit, income and life plans in all regions of Brazil would not be less than R\$ 7,2 million. The fixed amount of minimum capital required to obtain authorization to operate is R\$ 1,2 million. The variable amount of minimum capital required depends on the region in Brazil where the company operates or is going to operate.

Insurance companies specialized in health – The minimum capital for an insurance company in all regions of Brazil would not be less than 8,400,000 Fiscal Reference Units (UFIR). The fixed amount of minimum capital required for the insurance company will correspond to the authorization to operate in certain insurance groupings and the variable amount will depend on the region in Brazil where the company operates or is going to operate.

Operators of health assistance plans – For the operators of health assistance plans for profit a minimum amount of capital will be required, calculated on the multiplication of a variable factor K (obtained in Table A of Appendix I of RDC Resolution 77/01), for the base capital of R\$ 3,1 million.

Chapter 13

Corporate governance in Brazil

Introduction

Like most countries, corporate governance is currently one of the most debated issues among Brazilian companies. In fact, in 2004, KPMG Brazil carried out a research related to the subject and found out that 44% of the companies consider this an important topic and one of the three current priorities in management issues.

The general understanding that corporate governance practices need to be reviewed, as well as the relationships between investors, regulators, directors, executives and other stakeholders, has also motivated some initiatives in this area.

Such initiatives have been developed mainly by the Brazilian Securities Exchange Commission (CVM), the São Paulo Stock Exchange (Bovespa) - the most important stock and derivatives trading floor in Latin America – and the Brazilian Institute of Corporate Governance (IBGC).

In order to create more effective and updated corporate governance policies in Brazil, the entities mentioned above are examining and ruling the main topics associated with the issue, which are compliance, remuneration, independence, and market confidentiality. Such policies aim to guarantee minority shareholders' rights, transparency of ownership and control, equal treatment for shareholders and disclosure practices.

Brazilian Securities Exchange Commission – CVM

Resulting from recent studies and analysis, CVM has issued, in 2002, the so-called "CVM Recommendations on Corporate Governance", which contains the main directives associated with good practices of corporate governance.

However, the provisions of CVM Recommendations are only guidelines for Brazilian companies that want to comply with good practices of corporate governance. Non-compliance with such practices is not subject to penalties. In fact, the adoption of such practices is considered a higher behavior standard compared with those required by corporate law.

It is important to mention that as of the CVM Recommendations some international corporate governance concepts were adapted to Brazil's reality, especially with respect to the fact that in Brazil companies with a defined controlling group prevail. Additionally, it was emphasized that some important corporate governance concepts are already part of Brazil's corporate regulation and are not mentioned in the CVM Code.

For illustrative purposes, the main aspects of the CVM Recommendations are:

- General shareholders' meetings must be set on dates that do not prevent shareholders' attendance. In case complex issues are to be discussed, the meeting must be set at least thirty days in advance;
- Shareholders agreements must be available to all shareholders;
- The company should adopt procedures to publicly release the list of current shareholders and share participation of them;
- Company articles of incorporation should clearly regulate shareholders' voting and representation procedures;
- The board of directors should have five to ten technically qualified members. At least two members with experience in finance and accounting practices;
- The board of directors should create their own by-laws, determining main duties and frequency of meetings;
- The board of directors should make annual formal evaluations of the chief executive officer's performance;
- The company should immediately allow holders of preferred shares to elect a representative to the board of directors;

- The chairman of the board and the chief executive officer shall not be the same person;
- The majority of share capital, regardless of type or sort, should be the criteria for decision making, with each share representing one vote;
- The board of directors should ensure that transactions with related parties are clearly reflected in the financial statements of the company and are totally documented and implemented under market conditions;
- The company's articles of incorporation should state that shareholders with preferred shares shall receive voting rights in case the general meeting does not declare payment of dividends to them. Besides, if the company does not pay dividends for three consecutive years, non-voting shares should be given right to vote;
- The company's articles of incorporation should establish that divergences between shareholders and the company or between controlling shareholders and minority shareholders shall be solved by arbitration;
- Companies with more than 50% of their capital represented by preferred shares should not issue new shares of the same kind;
- The company should release, every quarter, management reports reflecting factors that most influenced its results and indicating the main internal and external risk factors to which the company is subject;
- The fiscal council should have a minimum of three and a maximum of five members. The fiscal council's majority should not be elected by the controlling shareholder;
- An audit committee formed by members of the board of directors, and at least one person representing minority shareholders, should rule the hiring of the independent auditor;
- The company should adopt IASB or US GAAP for its accounting standards, analyzed by an independent auditor.

São Paulo Stock Exchange – BOVESPA

The São Paulo Stock Exchange has innovated by creating the so-called Novo Mercado. The Novo Mercado is a listing segment of the stock exchange market specially established to negotiate shares issued by companies that voluntarily adopt corporate governance and disclosure practices, aside from minimum standards required under Brazilian legislation.

The main assumption of Novo Mercado is that shares' valuation and liquidity are positively influenced by the level of safety associated with shareholders' rights and by the quality of information provided by companies.

The Novo Mercado also adopts arbitration panels for resolution of eventual conflicts that may arise between investors and companies, which offers a safer, faster and specialized alternative to investors.

Such rules, consolidated in the "Listing Regulation," enhance shareholders' rights, improve quality of information provided by the company and offer a more specialized alternative to solve conflicts.

The main innovation in terms of regulations, in the Novo Mercado, is the requirement that corporate capital may only be represented by ordinary shares

In summary, the publicly-held companies that participate in the Novo Mercado have the following additional obligations:

- Public share offerings shall be made through mechanisms that benefit capital dispersion;
- Circulation of a minimum portion of shares representing 25% of corporate capital;
- Provision of same sale conditions to transfer shareholding control held by majority shareholders to the minority ("Tag Along" rights);
- Establishment of a one year mandate for all members of the board of directors:
- Annual balance sheet made according to US GAAP or IAS GAAP;
- Improvement of accuracy of information provided quarterly by the companies, including consolidation of financial statements and special audit revision:
- Implementation of a public offer to buy all shares of the company outstanding for their market value, in case of closing capital or canceling the registration in the Novo Mercado;
- Adoption of disclosure rules on negotiation of assets or derivatives issued by the company on behalf of controlling shareholders;
- Adoption of an arbitration panel for solution of conflicts.

In addition to the new practices of the Novo Mercado, BOVESPA has also segregated companies as Level 1 Company or Level 2 Company, according to the degree of commitment assumed by the company.

BOVESPA also publishes a list (index) of companies in the Novo Mercado, qualified according to performance of the shares and by levels of compliance with the corporate governance rules – IGC – Corporate Governance Stock Index. It also states what companies are considered in the Level 1 or Level 2 of Novo Mercado.

The adoption of the *Novo Mercado* Regulation demonstrates a company's efforts towards the improvement of relationship with its investors, and potentially increases assets' valuation.

Corporate Governance Brazilian Institute - IBGC

The IBGC (www.ibgc.org.br) is a private organization entirely created to promote corporate governance in Brazil. It is the main representative of such practices.

The third edition of the "Best Practices of Corporate Governance" was issued in 2004. The main objective of this study is to provide guidelines to all kinds of companies eventually interested in increasing their value, improving corporate performance, facilitating access to capital at lower costs, and contributing to the long-term survival of the company.

The study is divided into six sections (ownership, board of directors, management, independent auditing, the fiscal council, and conduct and conflict of interest) and addresses four basic principles: Transparency, Fairness, Accountability, and Corporate Responsibility.

Chapter 14

Other considerations

Consumer rights

The Consumer Protection Code was approved in 1990, by Law 8,078/90. Although legal provisions governing the liability of manufacturers and retailers for the safety of their products existed previously, there was no specific law dealing with consumers' rights until then.

The Consumer Protection Code defines the consumer as "any legal entity or individual who acquires or uses a product or service as final user".

Other sections of the Code expand this definition to include in the protective scope of the law any victims of an event that causes a loss ("innocent bystander"). In this sense, legislation protects not only the original purchaser, but any user of the product.

The doctrines of "strict liability" as well as of "disregard of legal entity" have been adopted by the Code. Among the parties that may be liable are those responsible for the design, manufacture, distribution, sale and import of the product.

Other important matters covered by the Consumer Protection Code are:

Information

The consumer must be fully informed about the purchased products and services. In addition, the manufacturer is required to provide the public with clear and precise information about any dangers related to its product. Even if the manufacturer finds out about a danger after the release of the product, he must advise authorities and publish warnings in the media, otherwise the company may suffer administrative sanctions and criminal action.

All information on imported products must be provided in Portuguese, together with the full name and address of the importer.

Credit reports

A consumer has the right to correct erroneous or outdated credit data.

Publicity

The Code provides for fines, prison terms and counter-publicity, which entails the publishing of ads in the same media used to divulge false or misleading advertising.

Contracts

Public agencies have the right to the prior review of standard form contracts.

In addition, the Code establishes specific rules for sales contracts. For example, "small print" has been barred, and restrictions to the consumer's rights must be larger than standard type.

Further, in case a product is purchased outside the seller's commercial establishment, the consumer may cancel the sale within seven days, return the product, and receive his money back. Tying arrangements have been prohibited.

Class actions

These actions are restricted to consumer protection cases.

Of particular interest to foreigners are recent cases where Brazilian courts have understood that the Brazilian subsidiary or representative is responsible for the repair of products under warranty, even though they were purchased abroad from the parent entity.

Environment

Brazil has strict environmental laws and regulations.

The Federal Constitution/88 was the first in the country's history to address environmental protection. It assigned to federal, state and municipal authorities the duty to protect the environment, take action against pollution and safeguard local fauna and flora.

The basic laws governing the environment in Brazil are Law 6,938/81, Law 7,735/89 and Law 9,605/98.

The federal government has established a system of national conservation areas. There are four main categories of conservation areas that receive federal protection: national parks, biological reserves, natural monuments and wildlife sanctuaries.

In addition, there are four secondary conservation areas that are subject to substantial, although reduced, protection: ecological stations, scenic rivers, park roads and forest reserves.

These conservation areas are generally free from human intervention other than scientific, cultural or leisure activities.

A third level of conservation areas includes national forests, indigenous reserves, fauna reserves and hunting reserves, receives partial protection and allows some human activity.

A fourth level of conservation areas falls under state or local jurisdiction and includes state parks and biological reserves.

Finally, a fifth level of conservation covers areas declared world heritage sites.

The federal government agency in charge of the administration of Brazil's national parks system is the IBAMA (Instituto Brasileiro do Meio-Ambiente e Recursos Naturais Renováveis). It submits environmental legislation bills for congressional approval, receives contributions from bilateral and multilateral aid sources for various projects and furnishes technical support for enforcement, training and education.

Brazil also has a growing citizen movement, which has been increasingly channeled through non-governmental organizations, which presently number over 1,400. The movement focuses on educating private sector polluters about the benefits of environmental protection and the costs of non-compliance to the applicable rulings.

There are some environment reports that must be submitted to the environment authorities whenever a Brazilian company establishes or expands an industrial installation. The analysis of these reports is recommended in case of acquisition of businesses that may generate pollution, because Brazilian law establishes strict liability for damages of this nature.

Brazilian environmental practice defines an environmental impact as a change to the physical, chemical and biological properties of an ecosystem, which directly or indirectly affects the health or safety of the local population, its social or economic activities, the surrounding fauna and flora, landscape conditions or the state of natural resources.

Sanctions against violators of environmental laws may be civil (providing pecuniary damages), criminal (providing prison terms in case of serious offenses, fines, restrictions of rights and imposition of service rendering to the community applicable for legal entities) and administrative (including warnings, temporary suspension of activities, temporary interdiction and permanent interdiction).

The criminal liability is applicable not only to the parties directly involved in the damage but also to any agents who are aware of the criminal conduct but do not impede its practice. These agents can be directors, officers, technical body members, auditors, managers, legal representatives or proxies of a legal entity.

Intellectual property

Industrial property

Industrial property protection in Brazil is currently ruled by Law 9,279/96 (Industrial Property Law). The main innovations of this law include patents for medicines, chemical, pharmaceutical and food products. Additionally, current legislation recognizes well-known brands.

At the international level, the protection of industrial property in Brazil is enhanced by the Berne Convention, the Patent Cooperation Treaty (PCT), the Paris Convention and the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS) of which, among others, Brazil is a signatory country.

The federal government established the Federal Intellectual Property Agency (INPI) in 1970, to rule and enforce on the matter of industrial property rights, including patents, trademarks and other such intangible registrations.

Trademarks

Trademarks are words, names, letters, symbols or devices that are used by manufacturers or merchants to identify their goods and distinguish them from those manufactured by others.

The registration of a trademark with the INPI is required to guarantee the protection of ownership rights in Brazil.

Four kinds of trademarks are legally protected: (i) industry trademarks used by manufacturers to distinguish their products; (ii) trademarks used by merchants to identify their merchandise; (iii) service marks used to protect services or activities; and (iv) general marks used to identify the origin of a series of products or services that are individually distinguished by specific marks.

Application for trademark registry may be effected by Brazilian and foreign individuals and entities, upon presentation of supporting documents to the *INPI*. The registration process may take from two to five years.

The protection of a trademark by the applicant is effective in Brazil ever since the filling of the documents within the INPI. However, only upon the issuance of the registration certificate, the applicant will be entitled to exclusive rights on the trademark and to the usage of the registration symbol.

Trademarks that have not been registered previously, with certain exceptions, can be registered.

Unless the lack of use can be justified, the non-use of a registered trademark for an uninterrupted five-year period will invalidate the registration.

A registration is valid for 10 years and is renewable for successive ten-year periods.

Owners may negotiate the right of trademarks or license them to others, subject to due registration of the respective agreement within the INPI.

Well-known trademarks are protected by the Industrial Property Law, regardless of registration within the INPI.

The Paris Convention establishes an exclusive priority term of six months, as from the date of the application in the country of origin, for the owner to apply for registrations of this same trademark in other countries which are signatories of this Convention. The same provision is applicable in Brazil.

Trade names, differently from trademarks are registered with the local state Commercial Registry or with the local Civil Registry of Legal Entities, depending on the case.

Patents

In order to create legal protection to inventions, utility models and industrial designs according to the Industrial Property Law, they must be patented in Brazil. The essential requirements for the granting of a patent in Brazil are absolute novelty, industrial nature and inventive nature.

Considering that Brazil is a signatory to the Paris Convention, citizens of other signatory countries which have filed for patents in their home country, have the exclusive right to apply for patents during a certain period of time (as from the date of registration in the country of origin) depending on the nature of the industrial property: industrial designs and models - six months; inventions and utility models - 12 months.

Once a foreign patent is published, it is considered to be in the public domain and cannot be registered in Brazil.

A patent is valid from the date of filing the request for protection for the following periods: inventions – 20 years; utility models – 15 years; and industrial design - 10 years.

A patent holder must use the patent commercially within two years after registration with the INPI or authorize others to do so, under penalty of forced licensing or lapsing of the patent.

The following cannot be patented (i) products which violate morals, good custom, security, as well as public order or health; (ii) products which result from the transformation of an atomic nucleus; (iii) living beings, except micro-organisms; (iv) scientific theories and surgical techniques; (v) computer software; among others.

The patent is extinguished, becoming of public domain, in the following cases (i) by the expiration of its legal term; (ii) if the owner waives the patent; (iii) failure to lawfully utilize the patented material; (iv) lack of payment of applicable annual contributions; (v) absence of an attorney to represent the foreign owner in Brazil; or (iv) if it is administratively cancelled or judicially annulled.

Patents may be licensed or assigned by their owners. Law provides that the manufacture of a product or use of processes covered by a patent, without authorization of the patent owner, shall constitute a patent infringement.

Technology transfer

All of the acts or agreements involving transfer of technology, such as patent license agreements, trademark license agreements, technology transfer agreements and contracts for rendering of technical and scientific assistance services, must be registered with the INPI, in order to be enforceable against third parties.

Royalty and fee payments may not be remitted abroad, unless the underlying agreements are approved by the INPI and registered at the Central Bank of Brazil.

The INPI registration is also required, among other requirements, for tax deductibility of the corresponding expenses.

Copyrights

Law 9,610/98 (Copyright Law) governs copyrights in Brazil. It protects creative works of inspiration expressed by any means as intellectual property.

The Copyright Law considers the author of the work as the owner of, or entitled to the copyright (unless proof is given to the contrary).

Registration of copyright is optional in Brazil. Hence, it is not required for the enforceability of the copyright against third parties. Copyright infringement is punishable by imprisonment and civil damages may be awarded to the plaintiff for violations of Copyright Law.

Software

Legal protection to computer programs is currently governed by Law 9,609/98 and also by Copyright Law. Foreign software may qualify for protection, regardless of registration, as long as its country of origin grants similar rights to Brazilian software.

The registration with the INPI of foreign software prior to marketing is no longer required. However, registration is usually recommended to facilitate the protection of the underlying copyright against third parties, in which case the data submitted to the INPI shall be considered confidential.

The referred law sets forth that the use of the software in Brazil will be object of a license agreement and in the absence thereof, the tax document referring to the acquisition or licensing of copies shall be considered legal evidence for the regular use of the software.

Software protection is granted for 50 years as of January 1 of the year following its publication, release or creation, regardless of its registration with the INPI. During the period before expiration, the owner or licensee will be required to provide technical assistance.

Franchising

Franchising activities are ruled in Brazil by Law 8,955/94. Franchising agreements shall be registered with the INPI in order to be enforceable against third parties.

Antitrust rules

The Federal Antitrust Agency (CADE) is the Brazilian agency responsible for protecting the free market economy and ensuring fair competition.

Two other agencies assist CADE in examining administrative cases: the Economic Law Secretariat (SDE) and the Economic Supervision Secretariat (SEAE). The SDE, an agency of the Justice Ministry, is responsible for initiating investigations and issuing an opinion on the legal aspects of a case. The SEAE, an agency of the Economy Ministry, issues opinions on the economic topics of a case. Final decision on the cases is a CADE prerogative.

The Antitrust Law (Law 8,894/94) defines 24 four anti-trust violations, including tying arrangements, boycott and price fixing, market division, combined bids, underselling, dumping, overpricing and abusive profits.

In addition, the Law states that a company or group of companies is presumed to hold a dominant position when it controls 20% of its market. Although dominance of a particular market is considered a violation, the law allows the company to justify its position through proof that greater efficiency or productivity led to this situation.

Merger and acquisition contracts which may limit or harm competition and any other form of corporate grouping in which any of the participants has stated in its latest balance sheets an annual gross revenue higher than R\$ 400 million, must be submitted to CADE for examination within 15 days after the occurrence thereof.

Private parties may seek redress in court, concurrently with the administrative process.

The Antitrust Law has adopted the concept of the consent decree from U.S. antitrust law and also allows preliminary injunctions. Sanctions include substantial fines and shall be applied for companies and also for managers directly or indirectly liable for their company's violation.

Arbitration

Individuals and entities capable of entering into contracts can have their disputes related to negotiable equity rights resolved through arbitration, according to the terms of Law 9,307/96 (Brazilian Arbitration Law).

This Law states that the arbitration convention can be entered into by the parties through: (i) the arbitration clause (cláusula compromissória); or (ii) the arbitration commitment (compromisso arbitral).

The arbitration clause is the convention whereby the parties of an agreement undertake to submit to the arbitration eventual disputes that may arise from their contractual relationship. The arbitration commitment is the convention whereby the parties submit a dispute to the arbitration of two or more individuals. It can be judicial (through a specific instrument to be attached to the court files) or extrajudicial (through a public instrument or a private agreement signed by the parties).

The parties may freely choose the rules of law to be applied to the arbitration, as long as there is no violation of good customs and public order. They may also stipulate that the arbitration will be based on the general principles of law, customs and usages and the rules of international trade.

Furthermore, the arbitration clause or commitment shall elect the rules of an arbitral institution or specialized entity to be responsible for the arbitration.

Arbitrators shall be appointed by the parties and may rule on matters of fact or of law. The decision issued by the arbitrators can not be subject to judicial review, appeal or ratification.

Foreign arbitral decisions

Brazil is a signatory to the Convention of New York of June 10, 1958 on the recognition and enforcement of foreign arbitral decisions. The ratification by the Superior Court of Justice (STJ) is an essential condition for the decision rendered outside the national territory to be recognized or enforced in the country.

It is important to stress that the ratification shall be denied in exceptional circumstances, as in cases when the matter of the dispute is not able to be solved by arbitration according to Brazilian law, and when the arbitration decision offends Brazilian public policy.

Bankruptcy

Introduction

Law 11,101/05 is the new Brazilian Bankruptcy Law, also known as Corporate Recovery Law. Enforceable since June 9, 2005, it rules judicial and extrajudicial recovery, as well as the bankruptcy of legal entities and individuals engaged in business activities.

The new Brazilian Bankruptcy Law brought substantial changes to the credit ranking priority in the bankruptcy process. This ranking shall be followed in the payment of the creditors once the assets of the bankrupted are realized.

The new rating is: (i) labor credits, limited to 150 minimum wages by creditor; (ii) secured guarantee credits (up to the vale of the secured asset); (iii) tax credits, except for tax penalties; (iv) credits with special privilege; (v) credits with general privilege; (vi) unsecured credits; (vii) contractual, legal, criminal, administrative and tax penalties; and (viii) subordinated credits.

The new Brazilian Bankruptcy Law does not apply to governmental and mixed-capital companies, public or private financial institutions, credit cooperatives, consortiums, private pension funds, private health care entities, insurance and capitalization companies and equivalents.

Purposes and innovations

The new bankruptcy law prioritizes the recovery of companies rather than their bankruptcy, provided that the continuance of their activities is economically viable. This innovation aims to safeguard the interests of the creditors, to maintain job positions and to preserve the social function of the companies.

In general, the new law states that succession on the tax, labor and civil obligations of a debtor in bankruptcy or judicial recovery by the acquirer of its assets, business activities or goodwill will not be applicable.

Judicial recovery

The judicial recovery substitutes the preventive reorganization institute (concordata preventiva) and its adoption is conditioned to certain requirements elected by the law.

When the judicial recovery is granted, the debtor is entitled to a period of 180 days of suspension of almost all lawsuits and collection procedures against it (excepting for tax collections that may obtain more flexible payment conditions).

Within 60 days of the publication of the decision that approved the debtor's judicial recovery request, the debtor must submit to the court a judicial recovery plan comprising: (i) a detailed description of the proposed recovery actions; (ii) a demonstration of the economic feasibility of the plan; and (iii) an economic-finance appraisal report and an appraisal report on the debtors equity, effected by a capable professional or specialized company.

After the presentation of the judicial recovery plan by the debtor, the judge will approve the judicial recovery upon the verification of accomplishment of all legal requirements. However, if one or more creditors present formal opposition to the terms of the plan, the judge will call a General Meeting of Creditors in order to enable the creditors to deliberate on the approval or non-approval of the plan.

The judicial recovery will be converted into bankruptcy when: (i) the debtor fails to submit a recovery plan within the deadline set in the law; (ii) the General Meeting of Creditors disapproves the judicial recovery plan; and (iii) the debtor fails to satisfy any of its legal obligations related to the judicial recovery plan within a period of two years counted from the date of the approval of the judicial recovery by the judge.

Extrajudicial recovery

In the extrajudicial recovery, the debtor proposes a recovery plan to some or all of his creditors. Some credits are not suitable for extrajudicial recovery plans, such as tax, labor and prepayment of foreign exchange contracts credits.

The extrajudicial recovery plan may be submitted to a court of law for ratification. In such a scenario, the interference of the judge is limited to the verification of the legality of the procedures adopted by the parties.

The ratification, by the judge, of the extrajudicial recovery plan does not avoid eventual lawsuits or collection procedures against the debtor, neither avoids the filing of bankruptcy by creditors not contemplated in the plan.

Chapter 15

Brazilian transfer pricing

Brazilian transfer pricing rules

Transfer pricing rules have been in place in Brazil since 1997. With the exception of the comparable uncontrolled price method (PIC and PVEx), which is the only method available to test both import and export transactions, none of the other methods consider comparability factors or reflect the objective of reaching an arm's length result.

Although the names of the methods coincide with methods specified in the OECD Guidelines, such as the resale price method (PRL) or cost plus method (CPL), their application is unique to Brazil and driven by predetermined profit margins that range from 15% to 60%, regardless of the nature of the taxpayer's business or industry.

The main characteristics of Brazilian transfer pricing rules can be listed as follows:

- Regardless of the shareholding relationship between the parties the rules are applicable to transactions between a Brazilian entity and its exclusive distributor.
- The rules are also applicable to transactions between an entity or individual taxpayer resident or domiciled in Brazil and any corporate or individual taxpaver, whether or not related, resident or domiciled in a country that does not have income taxes or levies income taxes at 20% (listed low-tax jurisdictions) or less or imposes restrictions on the exchange of information regarding shareholding structure.

- The Brazilian provisions do not foresee the "best method rule". The taxpayers are allowed to choose the method that provides the best results from their perspective.
- The APA (Advanced Pricing Agreement) is not foreseen in the local rules. Although there is a provision which permits changing the margins fixed by law, this administrative procedure is not commonly adopted.
- Safe harbors are available only for export transactions and aim at facilitating compliance for exporters.
- Neither benchmark research nor a basket approach is available in the rules, as the price analysis should be made per transaction with no function analysis.

Service agreements

Service transactions are also subject to transfer pricing rules, although the rules do not provide specific methods. The rules are not applicable to the payment of royalties, nor to fees for technical, scientific, administrative or similar assistance, provided that the agreement is registered with the INPI (Federal Intellectual Property Agency).

Interest

Interest paid or credited to a related party, arising from a loan contract that is not registered with the Central Bank of Brazil, shall be deductible from taxable income limited to an amount that does not exceed the LIBOR rate for six-month US Dollar deposits plus an annual spread of 3%. This is also the minimum. interest that should be charged when the Brazilian party is the lender.

The Ministry of Finance can change the percentages mentioned in the transfer pricing calculation methods under certain circumstances.

When compliance is required

The transfer pricing analysis must be prepared by local companies on an annual basis and general information must be disclosed in the annual income tax return. The detailed calculations should be kept by the taxpayer to be delivered to the tax auditor when required during an audit.

Penalties

Failure to present the documentation permits the tax authorities to arbitrate the price by using one of the methods provided by law. There is no penalty for not presenting the documentation. The penalty and interest are only applied when the transfer pricing adjustment results in additional corporate taxes

Import transactions

In order to verify the adequacy of the prices practiced in import transactions from related parties, Brazilian taxpayers may choose one of the following methods:

Comparable uncontrolled price method (PIC): A reference price is arrived at by calculating the average of similar or identical purchase and sale operations between unrelated parties, on the Brazilian market or the market of other countries, under similar payment conditions.

Resale price method (PRL): A reference price is arrived at by calculating the average resale price for transactions with unrelated buyers less unconditional discounts granted, taxes and contributions on sales, commissions, brokerage fees paid and a profit margin of 20% (on the resale price).

Resale price method II (PRL II): A reference price is arrived at by calculating the average resale price for transactions with unrelated buyers less unconditional discounts, taxes and social contributions on the sales, commissions and fees paid, plus a profit margin of 60% on the resale value after deducting the value added in Brazil.

Cost plus method (CPL): A reference price is arrived at by calculating the average cost of production in the country where the products were originally produced, plus taxes and charges imposed by that country on exports and a profit margin of 20%.

Export transactions

The Brazilian regulations foresee three safe harbors which aim to facilitate compliance with transfer pricing rules by exporters. In the event of the occurrence of one of the following hypotheses, the taxpayer may benefit from the safe harbors provided by law:

- a. When the average sales price for the goods, services or rights is greater than 90% of the average sales price for the same goods, services or rights on the Brazilian market during the same period under similar payment conditions:
- b. When the net income from exports during the calendar year does not exceed 5% of total net income during the same period; and
- c. When a corporate entity demonstrates that it has calculated net pre-tax profits from income from exports to related companies, equivalent to a minimum of 5% of its total income. As from 2002, the corporate entity must have attained the average profitability for the current year and the two preceding years.

Safe harbors (a) and (b) above are not applicable when the individual or corporate entity is resident or domiciled in a listed favorable tax jurisdiction. Also, safe harbors do not imply the definitive acceptance of the value of the revenue recognized based on the price practiced, which may be contested, if inappropriate, in a written notification by the tax authorities.

When none of the safe harbors are applicable, the taxpayer should test the transactions by adopting one of the methods provided by law, as follows:

Comparable uncontrolled price method (PVEx): Comparison of the sales price with the average sales price on exports to non-related parties for equivalent or similar identical goods, services or rights, during the same tax year and under similar payment conditions.

Wholesale price method (PVA): Comparison of the sales price with the wholesale market price of similar or equivalent goods sold on the wholesale market of the country to which the product is exported, under similar payment conditions, less sale taxes in that country and a profit margin of 15% on the wholesale price.

Retail price method (PVV): Comparison of the sales price with the average price of similar or equivalent goods sold between unrelated parties on the retail market of the country to which the goods are exported, under similar payment conditions, less sales taxes in the that country and a profit margin of 30% on the retail price.

Cost plus method (CAP): Comparison of the sales price with the average purchase cost of the exported goods, services or rights, plus Brazilian taxes and a 15% profit margin.

Special rule for export transactions undertaken in 2005

With respect to the export transactions undertaken during fiscal year 2005, the Tax Administration issued a rule aimed at reducing the impact associated with the appreciation of the Real in relation to foreign currencies over the last two years. The rule applicable to 2005 permits the adjustment of export revenues by the multiplication factor of 1.35. This adjustment has no impact other than for transfer pricing purposes.

Chapter 16

KPMG in Brazil

KPMG is a multidisciplinary firm offering audit, tax, financial advisory services, risk advisory services and human resources advisory services. Quality and integrity are fundamental in all that we do.

History

The name KPMG was created in 1987, after the merger between Peat Marwick International (PMI) and Klynveld Main Goerdeler (KMG), and the individual member-firms. Spanning three centuries, the history of the organization has been marked by the names of its main founders, whose initials form the name "KPMG".

K represents Klynveld. Piet Klynveld founded the accounting firm Klynveld Kraavenhof & Co. in Amsterdam, in 1917:

P represents Peat. William Barclay Peat founded the accounting firm William Barclay Peat & Co. in London, in 1870;

M represents Marwick. James Marwick founded the accounting firm Marwick, Mitchell & Co. with Roger Mitchell in New York, in 1897;

G represents Goerdeler. For several years, Dr. Reinhard Goerdeler was the President of Deutsche Treuhand-Gesellschaft and later of KPMG. He was one of the supporters of the merger to form KPMG.

In 1911, the merger between William Barclay Peat & Co. and Marwick Mitchell & Co. gave rise to Peat Marwick International (PMI), a worldwide network of accounting and consulting firms.

In 1979, Klynveld merged Deutsche Treuhand-Gesellschaft with McLintock Main Lafrentz, an international firm offering professional services, to form Klynveld Main Goerdeler (KMG).

In 1987, the merger between PMI and KMG, and their member firms occurred. Now all of the member firms throughout the world have adopted the name KPMG exclusively or have included it in their corporate names.

Today

Accounting standards worldwide are undergoing profound changes. The regulatory area is being transformed. KPMG, the clients we serve, the regulatory bodies and capital markets are all facing a series of huge challenges. Even with these significant changes, our global financial results were excellent in the year 2005: our income reached US\$ 15.7 billion, and this represents an increase of 16.7% compared to the previous year.

This general overall performance is due, in part, to the significant growth in our functional services - Audit, Tax and Advisory, and our five business lines in our three geographic regions.

Our regional strategy, which combines the practices of countries from three distinct geographical regions, has enabled us to accumulate resources and share best practices in the most effective manner and to the benefit of our clients, as well as to achieve greater efficiency in our infrastructure and support services.

The results reflect significant growth in all three of KPMG's geographic regions worldwide. Recorded revenues in KPMG's Americas region were US\$ 5.67 billion, and KPMG's Asia Pacific revenues were US\$ 1.92 billion. in 2005 - each representing annual growth of 15%. The largest growth, in 2005 was in KPMG's Europe. Middle East and Africa region (includes India). which recorded revenues of US\$ 8.10 billion, an increase of 18.4%.

KPMG in Brazil - continual growth

During 2005 we grew 17% compared to the previous year, reaching revenues of US\$ 88 million.

We have ten offices located at strategic points in Brazil and a staff of over 1,300 professionals. Every year we hire young talent from various areas, through our recognized trainee program.

Our mission is to transform knowledge into value for the benefit of our clients, our people and the capital markets.

Our commitment towards the community includes actions such as our Little Citizen Project and also includes our commitment towards our professionals, providing means for personal and professional development. We believe that expectations and opportunities for growth are an excellent way to contribute towards our community.

The Firm's head office is located in the city of São Paulo, while its other offices are in:

- Belo Horizonte (MG)
- Brasília (DF)
- Campinas (SP)
- Curitiba (PR)
- Jaraguá do Sul (SC)
- Manaus (AM)
- Porto Alegre (RS)
- Rio de Janeiro (RJ)
- São Carlos (SP)

Global services

KPMG provides services in three large business areas:

- Audit
- Tax
- Advisory

The integration of these areas enables us to offer effective and extensive support in the management of complex business processes.

AUDIT

Focus on quality

The audit of the financial statements assumes great importance for the stability of the capital market. Investors expect independent, impartial audits of the highest quality. These elements are present in our processes and our staff. Continual training and teaching fully compensate for the changes in audit regulations and accounting standards.

Meticulous work and knowledge of the sector (consumer, retail, financial, industrial, etc.) are also essential. We are committed to providing the operational and financial resources necessary to support our teams as they search for facts and offer solid and balanced professional analyses in order to provide reliable audits.

The results of our work rely on our belief in:

- Training: It provides the necessary techniques and facilitates professional skepticism.
- Audit methodologies: They identify fundamental objectives and ensure good audit conclusions.
- Technology: It accelerates collecting information, enables critical comparison of data and improves contextual analyses.
- Compliance tools: They help to meet the requirements of regulatory and professional bodies.
- Cultural values: They encourage ethical decision making.

We understand our role on the capital market and as a validating agent of accounting information.

TAX

Focus on reducing the clients' tax charges and compliance with tax obligations

Taxation affects all sectors of the economy. Whether or not a company is expanding, operating on the domestic market or overseas, taxation affects the general business strategy.

The priority of our tax area is to align its services to the needs of organizations. It helps clients to improve cash flow, ensuring compliance with tax obligations

and implementing tax structures that are effective for business. The discernment and knowledge of our professionals are the basis for the values that enable this work to be realized.

Our professionals combine technology and experience to achieve positive final results in a consistent manner. We invest in state of the art technology to support them in assisting clients throughout Brazil, offering high-quality services and confidence.

The KPMG Brazil Tax Area is qualified to advise on:

- Corporate Taxes
- Indirect Taxes
- Tax Planning
- Transfer Pricing
- Mergers and Acquisitions
- International Tax Services
- Labor Legislation
- Tax Financial Services
- International Executive Services
- Tax Committees
- Due Diligence
- Business Structuring
- Outsourcing

ADVISORY

Adding values and perceptions

We offer a complete line of risk advisory and financial advisory services to help companies achieve their fundamental objectives in any economic environment. We help the most important companies to reduce risks, assume challenges related to finances and implement strategies to improve results.

Financial Advisory Services (FAS)

The international capital markets and the negotiations that drive them are becoming increasingly complex. Our FAS services provide solid, independent advice aimed to provide the tools and information necessary for decision-making that defines the success of a transaction.

Corporate Finance

Corporate Finance stands out for its involvement in merger and acquisition processes, assisting buyers and sellers, of both Brazilian and/or international origin. Market research, seeking investors and/or businesses, preparing relevant documentation and approaching potential buyers/sellers are services that are undertaken efficiently and in an integrated manner. KPMG Corporate Finance coordinates and leads the negotiations and the subsequent conclusion and financial closing of the transaction.

Structured Finance

The Structured Finance area offers integrated strategies for the problems faced by agents from the public and private sectors on structuring projects. Its services include advice on structuring Public-Private Partnerships (PPP), project finance, financing acquisitions, securitization of receivables, financing structures for real estate planning, structuring services for debt financing and evaluation of concessionaries for public services.

Restructuring

This area provides a variety of services, including debt renegotiation, advisory services on the sale of overdue credits, credit advice, business restructuring, advice on insolvency and contingency planning, financial and business analysis, insurance management, administration of bankrupt estates, management, liquidation and bankruptcies.

Forensic

The Forensic area helps companies to evaluate their vulnerability to risks and investigates frauds, and also provides risk prevention services for disputes, collective actions, expert reports and support for checking insurance claims.

Transaction Services

The Transaction Services area provides advice on matters related to due diligence, vendor due diligence and other strategic questions for companies and organizations involved in mergers and acquisitions, sales and restructuring. The focus is on creating value, reducing risks and conceiving successful transactions, both locally and internationally.

Risk Advisory Services (RAS)

Our RAS services help companies to meet their growing demand for solutions related to performance and risk, through our vision of risk and how to comply with regulations. The RAS practice recognizes the challenges and understands the delicate balance that companies need to achieve between risk management and business performance, while at the same time making every effort to retain the confidence of investors and create value in the long term.

Information Risk Management (IRM)

Information Risk Management (IRM) services in Brazil focus on the risks inherent to the information systems used to support our clients' business objectives. IRM's main services include evaluating information security. benchmarking risks and information technology controls (ITRMB); evaluating external and internal vulnerabilities; analyzing business processes; preparing and reviewing security policies and classifying information; system integration controls; planning business continuity; IT master plan (PDI); reviewing user profiles for ERP systems; and e-business services - evaluating controls in electronic trade environments.

Internal Audit Services (IAS)

Internal Audit Services (IAS) provides various services related to risk management and corporate governance, such as: risk evaluations, internal audit and corporate governance:

Improving performance (IRBS)

This team offers advisory services to improve the performance of organizations, assisting in aligning businesses with market regulations, the management of risks tied to the companies' systems and controls and improving processes through the use of management tools.

Human Resources Advisory Services

The human resources management advisory services area provides personalized services for each client, whether for contracting new talent (Executive Search) or in evaluating talents that are already part of the company (Assessment). We have teams located in São Paulo, Rio de Janeiro and Curitiba, serving clients in Brazil and in countries on the American continent.

As part of the process for developing and retaining talent, KPMG helps its clients to train their new leaders (Coaching Development) and to improve performance and adapt to the organizational environment (Executive Coaching).

This area provides services during the delicate time when a company needs to lay off some of its employees, without affecting the motivation of the remaining staff, and it offers support during the transition when redundancies occur either individually (Career Counseling) or in groups (Downsizing & Rightsizing).

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