



# Investment in Brazil

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The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

# 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 June 2008. 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 assisting you with the handling of your investment planning.

July, 2008.

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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** - comprised mostly of the Amazon Basin; also consists of the states of Acre, Amazonas, Roraima, Rondônia, Pará, Amapá and Tocantins.

**Northeast** – comprised of the states of Maranhão, Piauí, Ceará, Rio Grande do Norte, Paraíba, Pernambuco, Alagoas, Sergipe and Bahia.

**Central West** – comprised of the states of Mato Grosso, Mato Grosso do Sul, Goiás and the Federal District.

**Southeast** – comprised of the states of Minas Gerais, Espírito Santo, Rio de Janeiro and São Paulo.

**South** – comprised 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 reaching 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, Brazil had a population of approximately 184 million people in 2007 (157 million in 1996 and 170 million in 2000).

**The relative areas and populations of the five regions described earlier according to the 2004 census were as follows.**

Region	Area	Population	GDP
North	42%	7.8%	5.3%
Northeast	18%	27.7%	14.1%
Southeast	11%	42.6%	54.9%
South	7%	14.6%	18.2%
Central West	22%	7.03%	7.5%

The North and Northeast are the underdeveloped regions of the country. Most industrial and commercial activities are concentrated in the South and Southeast regions. 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).

**The major capital cities of Brazil and related states by population, in accordance with the 2007 IBGE population report, are:**

<b>Capital</b>	<b>Population (millions)</b>	<b>State</b>	<b>Population (millions)</b>
São Paulo	10.88	São Paulo	39.82
Rio de Janeiro	6.09	Rio de Janeiro	15.42
Salvador	2.89	Bahia	14.08
Belo Horizonte	2.41	Minas Gerais	19.27
Fortaleza	2.43	Ceará	8.18
Brasília	2.45	Federal District	2.45
Curitiba	1.79	Paraná	10.28
Manaus	1.64	Pernambuco	8.48
Recife	1.53	Rio Grande do Sul	10.58

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 more 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 forty years from 50 to 88%, 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 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 comprised 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 also 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 protective 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 2007, the last year for which there is official data, was R\$ 2.6 trillion (approximately US\$ 1.659 trillion at the exchange rate in force on July 31, 2008).

According to *IBGE* statistics, unemployment was 9.3% in 2007 (7.4% in December). However, *DIEESE*, which is a data institute supported by the labor unions, estimates unemployment for January 2008 at 13.6% in São Paulo. 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 2007 was US\$ 40 billion. This surplus is basically attributed to the record number of export and import transactions, respectively, US\$ 160.6 billion and US\$ 120.6 billion. At the date of this publication, Brazil had more than enough foreign exchange and private credits abroad to settle all foreign public and private debt.

No doubt this was important in Standard & Poor's and Fitch Ratings' decision to raise Brazil's rating to "Investment Grade".

## **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*), under which 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**

Transportation, utilities and telecommunications are of fundamental importance due to 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, which has already occurred, and ports is 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, Rio de Janeiro, Brasília, Belo Horizonte, Porto Alegre, Recife and Teresina, and alternative transit systems are being developed in other major cities. Commuter bus services remain the principal means of public transportation.

## **Oil and gas**

The Brazilian economy is being driven by strong worldwide economic growth, particularly in the emerging markets, which is directly impacting the investors' level of confidence in the Brazilian market.

The impact of this growth is bringing new horizons to the Brazilian oil and gas industry, which, in spite of constant changes caused by the volatility of prices, contention of costs, technological advances, regulations and access to capital and financing, is encouraging more and more investors to lay their bets in this sector.

The direct consequence of the price highs for a barrel of petroleum has been the search for new reserves. These new discoveries have increased the optimism of the energy sector that there is sufficient petroleum to meet world demand. It is within this context that Brazil is becoming more and more prominent, consolidating its image as one of the preferred destinations for

foreign investments, capable of participating in important alliances with international petroleum exporters and capable of alleviating pressure on price highs as a result of the length of its coastline and the potential for its reserves, which currently total around 16,888 million barrels, according to the Brazilian Agency for Petroleum, Natural Gas and Biofuels (*ANP*).

The recent Brazilian discoveries in the pre-salt area located off the coast are considered as the largest discoveries in the world since 2000 and the largest discoveries in the West since 1976. Market analyses made by KPMG based on the growth of the main companies in the sector in the last 10 years have revealed that the present capacity of the Brazilian petroleum industry represents only 3% of what it will be in 25 years time. On analyzing the financial position of the Brazilian companies in the past and making a simple projection for the future it is possible to forecast that the sector in Brazil should double in size every five or six years.

In monetary terms the petroleum and natural gas industry has grown by more than 300% since 1977, which means that the sector's contribution to the GDP has grown from 2.75% to around 10% in 2006. For the period from 2006 to 2010 the investments that have been reported to *ANP* by the current concessionaires total US\$ 33.8 billion, a figure that may grow considerably as a result of the discoveries (Source: *ANP*).

A supply of skilled labor at a competitive cost is another great advantage. Within this scenario Brazil is one of the most attractive countries for investments in petroleum and natural gas.

Its attractiveness is enormous, considering that Brazil, according to *ANP* data, has 29 sedimentary basins, equivalent to 7.5 million km<sup>2</sup> (approximately 2.5 million km<sup>2</sup> under the sea). However, less than 4% of these basins are under concessions for exploration and production. From 1997 to 2006 the proven reserves of petroleum have jumped from 7.1 billion to 12.1 billion barrels and the reserves of natural gas have increased from 228 billion cubic meters to 348 billion cubic meters. In the same period the production of petroleum has increased from 306 million barrels to 629 million and production of natural gas has increased from 9.8 billion cubic meters to 17.7 billion cubic meters. These figures indicate just how promising the Brazilian reserves are.

## 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 needed 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 sooner, there have also been advantages such as the gains in design, construction, operation and management 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 900 *PPPs* contracted, with a total value over £60 billion. A number of countries have followed this example and are adopting *PPPs*. Following this trend, Law 11,079/04 (Federal *PPP* Law) was enacted in Brazil. In addition, various Brazilian states (such as Minas Gerais, Santa Catarina, São Paulo, Goiás, Rio Grande do Sul, Bahia, Ceará, Sergipe, Pernambuco, Distrito Federal and Rio de Janeiro) have also issued their own state level *PPP* laws, which are very similar to the Federal *PPP* Law.

In general terms, *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 end users, a subsidy 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 years.
- 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 financiers 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 public administration projects in the eyes of the investors and the private financiers. This allows the application of internationally accepted *PPP* principles, which assures better quality in the public services for the users in a continuous, long term manner.

Since the Federal *PPP* Law was enacted on December 30, 2004, several *PPP* projects have been contracted in Brazil. By 2007, six *PPP* contracts, with total investment adding up to more than US\$ 1.2 billion, had been signed in the road and water sectors:

- São Paulo State Metro Line 4 *PPP* (2006)
- Bahia State Sewage Treatment *PPP* (2006)
- Pernambuco State Paiva Urban Access *PPP* (2006)
- Minas Gerais State MG-050 Highway *PPP* (2007)
- Rio Claro Municipality Sewage Treatment *PPP* (2007)
- Rio das Ostras Municipality Sewage Treatment *PPP* (2007)

Several other *PPPs* are being structured in the road, water, rail, airport, prison, sport and leisure, public buildings and education sectors of Brazil and should be tendered and finalized in the near future.

## Chapter 2

# Establishing a Business in Brazil

### Benefits of locating in Brazil

Brazil presents a prime opportunity for potential investors:

- The current population of approximately 184 million (according to data published by *IBGE* in 2007), of which almost half is under 20 years of age, is projected to reach more than 259 million by the year 2050.
- The spread of modern agricultural methods is 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 a stable economy and has been successful in controlling inflation.
- Has 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, potential foreign investors will have no difficulty in obtaining skilled professional assistance for the preliminary stages. They will also 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 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 main 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.
- 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 include:

- 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 natural gas.
- The growth of an urban working class with expanded disposable income.

Overall, the best advice for potential investors in Brazil is to look at the past experience and future plans of foreign companies already operating 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 is 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, airlines with domestic flight concessions, sanitation and the 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 businesses in border zones.

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. In general terms, incentives granted are associated to tax, or funding costs.

## Acquisition of real estate

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

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 holding real estate located in the national territory apply for the individual or corporate taxpayer registration number (*CPF or CNPJ*).

Furthermore, Brazilian regulation provides for special restrictions in case foreigners are interested in purchasing properties located near the coast, at the border or at specific locations considered as conflicting with national security.

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 may only acquire rural property under certain circumstances including:

- a) foreign individuals are free to acquire rural property from inheritance rights;
- b) foreigners are limited to acquire land equivalent to 50 rural modules maximum; however, acquisitions ranging from 3 rural modules to 50 rural modules are subject to prior approval from *INCRA* (Brazilian Agency in charge of rural property issues);
- c) the acquisition of more than one property larger than 3 rural modules is subject to specific approval from *INCRA*. In addition, when a sole property is larger than 20 rural modules, its acquisition is contingent upon the approval of a planning for exploration of the land.

Taking into account that the ownership of large areas of Brazilian land have been in dispute since colonial land grants were made, it is very important to ascertain that the seller has valid title of the area. This verification can be made at the real estate registry. If the seller has been in possession of the land 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 the 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.

### **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.

In most cases, distribution and sales representation save costs when compared to the incorporation of a local branch or subsidiary. However, these alternatives may be accompanied by a lack of control of the foreign investors over the way third parties distribute or sell their products in Brazil and deal with their trademarks.

Both distribution and sales representation activities must be entered into by written agreements signed by 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 National Industrial Property Agency (*INPI*).

## Distribution activities

The Brazilian Civil Code (*BCC* Law 10,406/02) brings relevant rules to distribution and agency activities. These activities are very similar. The difference, according to the *BCC*, is that under distribution activities the distributor possesses the products subject to such activity.

Before the new *BCC* 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 distributions of automotive vehicles and parts 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 is 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, on a regular basis and without an employment relationship.

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

Pursuant to the *BCC*, if the term (duration) of the agreement is not formally established, it shall be considered as undetermined and its termination would require a 90 day prior notice.

## Sales representation

Differing from the distribution arrangement, 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 *BCC* applicable to contractual issues.

Sales representation may be understood as an intermediating activity, in which the sales representative (entity or individual), on a regular basis and not in an employment relationship, 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 a labor relationship between the contracting parties or a permanent establishment of the foreign represented party for tax purposes.

It is recommended that a sales representation agreement comprise of, among other provisions: (a) a description of the products being represented; (b) the term of the representation; (c) indication of the territory such as a state or region; (d) the total or partial guarantee of exclusive representation in that territory, if applicable; (e) the conditions for the payment of commissions/fees; (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 cannot be less than 1/12 of the total remuneration earned during the period when the representation was effective.

## Branches

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

A branch is a division, office or other unit of business located at an address different from the main office or headquarters. It is a lateral extension or subdivision. In this sense, a foreign parent company with a branch in Brazil may have unlimited liability for the debts of the latter.

In general, a business unit (branch) of a foreign company located in Brazil requires prior approval from the federal government by presidential decree, which is a 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.

Presently, the most common markets with branches in Brazil are airline companies and financial institutions.

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

In general, foreign investors tend to incorporate a subsidiary rather than set up a branch in Brazilian territory due to the following: (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 establishing a subsidiary in Brazil is fairly simple and much less time consuming when compared to establishing 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).

According to the Brazilian Civil Code (*BCC*), legal entities may be classified as *sociedades simples* or *sociedades empresárias*. In general, entities that perform business activities are considered *sociedades empresárias*, while those involved with intellectual, artistic, scientific, and literary professions are 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 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 due to its 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 an *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 20 days to have a subsidiary duly incorporated in Brazil, as a *Limitada* or as an *SA*. However, some specific operating licenses that might be required may take six months or more.

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

### ***Limitadas* (Limited Liability Companies)**

#### **Structure**

The *sociedade limitada*, commonly referred to as a *Limitada*, used to be the most convenient form of incorporation for 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 *BCC*. 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 quotaholders' meetings.

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 a company (US\$ 200,000 or US\$ 50,000, if the company commits to hire at least ten employees in the two years ensuing its incorporation), applying for import/export licenses or registrations, or the incorporation of a financial institution for which the SA form is 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 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.

## Quotaholders' rights

The voting rights of the quotaholders are proportional to their capital holdings.

Other rights legally guaranteed to the quotaholders 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 *BCC*, foreign investors may find problems implementing it with the Central Bank of Brazil.

### Other issues related to the *Limitadas*

The articles of incorporation of the *Limitada* must be filed with the Registry of Commerce.

The transformation of a *Limitada* into an *SA* or vice versa may be carried out through a simple legal procedure. The applicable laws state that all shareholders/quota holders 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 an *SA* in Brazil is governed by Law 6,404/76 the Corporations' Law, amended by Laws 9,457/97, 10,303/01 and 11,638/07. 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 the compliance with the following preliminary requirements:

- Subscription by at least two 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 with 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.

In the same manner as *Limitadas*, no minimum capital requirements are imposed on an SA, except in specific cases such as obtaining a permanent visa for a nonresident to manage the company, applying for import/export licenses or registrations, or the incorporation of a financial institution for which the SA form is mandatory.

SAs may issue shares with or without par value. If the corporation establishes a par value for any of its shares, it 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 and the issuance of preferred shares is limited to 50% of the total shares of the corporation.

Preferred shares grant their holders preferential rights with respect to dividends and/or reimbursement of capital, with or without a premium. Regardless of having priority rights in the reimbursement of capital, with or without premium, preferred shares will only be accepted for trading in the securities market if they enjoy at least one of the following preferences or benefits:

- (i) the right to have an interest in the dividend to be distributed, corresponding to at least 25% of the net income for the year, to be calculated according to specific criteria;
- (ii) the right to receive a dividend for each preferred share, which must be at least 10% higher than the dividend assigned to each ordinary share; or
- (iii) the right to be included in the public offering for the sale of control, in addition to the right to receive dividends that are at least equal to the ordinary shares' dividend.

Additionally, the by-laws must precisely indicate preferences or benefits assigned to the preferred shareholders without voting rights, or with restricted voting rights. Normally, depending on the privileges that they enjoy, preferred shares are subject to certain restrictions.

#### **Bearer shares are not allowed.**

The SAs corporate capital may be increased after the payment of 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 whose articles of incorporation provide for future capital increases up to authorized limits. The council must have a minimum of three members who must be individuals and shareholders.

Decisions must always be made under majority voting. Members of the administration council may be nonresidents as long as a resident in Brazil is elected as a 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 two 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 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 objectives.

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 the articles of incorporation or by the 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 included 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 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 a basis for distribution of an interim dividend out of current year profits.

### **Other issues related to SAs**

A shareholder may be represented at a general meeting by a proxy holder appointed less than one year before, who is a shareholder, a corporate officer or a lawyer. In a publicly held corporation, the proxy holder may also be a financial institution. A condominium shall be represented by its investment fund officer.

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:

#### **Joint venture partnership (*Sociedades em Conta de Participação*)**

Joint venture partnerships are entities without legal personality, although they are subject to the same taxation rules.

They are, therefore, companies existing only between the parties, but not in relation to third parties who deal exclusively with the appearing partner, who has unlimited responsibility over the partnerships' debts.

The management of the company falls exclusively upon the appearing partner, since he is the one responsible for the company's business, and he must, at the end of the contractual term, present the corresponding accounts to the other participating partners.

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

#### **Dual partnerships (*Sociedade em Comandita*)**

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*), who has unlimited responsibility over the entity's debts.

#### **General personal partnerships (*Sociedade em nome coletivo*)**

This is a type of legal entity in Brazil where its partners are jointly and unlimitedly responsible for the obligations of the entity before third parties. In this regard, the enterprise is exploited for the account and risk of the partners and they can only limit their responsibilities for the entity's obligations between themselves. At least two partners are required, one of whom must manage the entity and reside in Brazil.

## 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.

The government also needs a positive current account to provide hard currency funds for, among other reasons, servicing and amortizing the foreign debt. This is still a relevant national concern, even though Brazilian reserves in foreign currency (estimated at approximately US\$ 200 billion in May 2008) have recently exceeded total foreign debt for the first time in history.

Keeping domestic interest rates higher than interest rates overseas produced obvious long-term disadvantages for a country that has historically been a net foreign debtor. However, it has been successful in attracting foreign capital. Interest rates have decreased over the past years, although they continue to be very high by 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 the foreign exchange market, the Central Bank issued new foreign exchange provisions, effective as of March 2005 (*Resolução 3,265/05* and *Circular 3,280/05*).

The new legislation (*RMCCI – Regulamento do Mercado de Câmbio e Capitais Internacionais*) basically unified the foreign exchange market by integrating the regulations governing 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 associated with implementing 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 nonresident party may be liquidated in foreign currency, provided appropriate documentation is presented to the financial institution responsible for the operation. Such transactions were previously controlled directly by the Central Bank.

According to the *RMCCI*, for example, 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 greater 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 Central Bank pre-approval or approval. In these cases, private financial institutions may implement the remittances provided.

The entry of capital into Brazil must be registered with the Brazilian Central Bank through the declaratory electronic system *RDE-IED (Registro Declaratório Eletrônico de Investimentos Externos Diretos)*. The proper registration of foreign direct investments is very important in enabling the future repatriation of capital and remittance of dividends, interest on equity and capital gains.

Lack of proper registration used to generate *tainted capital* (unregistered foreign capital). However, new foreign exchange regulations, in force since 2006, introduced new rules which reduced the exchange controls and restrictions on foreign investors. Law 11,371, published in November 2006, established

a mechanism to regularize *tainted capital* in Brazilian currency existing prior to December 31, 2005, provided it was recorded in the accounts by June 30, 2007. From 2006 onward, the registration must be made by the last business day of the subsequent year in which the registration should have taken place.

In addition, Law 11,371 also established that Brazilian entities or individuals are allowed to keep export revenues in foreign currency in bank accounts abroad, provided they observe the limitation set forth by the National Monetary Council (*CMN – Conselho Monetário Nacional*), which is 30% of total revenue. Nevertheless, the Brazilian Government recently announced several actions in order to stimulate exports and reduce the effects of the dollar devaluation. These actions include the elimination of the 30% limitation, allowing exporters to hold abroad the full amount of revenues derived from export deals.

It is important to keep in mind that the nonresident individual or legal entity holding export revenues abroad must declare them to the Brazilian Federal Tax Authority (*RFB – Receita Federal do Brasil*) and needs to keep proper accounting records and documentation for operations with such funds.

The Brazilian Central bank tracks foreign currency transactions involving the export of goods and services and provides this data to the Brazilian Federal Tax Authority.

Another change brought by Law 11,371 is allowing the use of Brazilian currency (*Real*) when purchasing merchandise 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 (CC5)**

In the past, Brazilian bank accounts owned by nonresidents were used to remit local currency abroad. This was especially useful when remittances in foreign currency were restricted. This was known as the international transfer of *Reais* or CC5 transactions (due to the fact that they used to be regulated by a Central Bank rule named *Carta circular* n. 5, which has since been revoked).

A nonresident company could then open its own “CC5” 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 time, due to abuses and subsequent closer Central Bank scrutiny, it became very difficult to open new accounts and operate existing accounts.

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

### **Financial transactions (RDE-ROF)**

Most cross-border financial transactions such as loans, rentals, leases as well as agreements involving transfer of technology (royalties, know-how, technical assistance, etc.) must be posted in the Central Bank online electronic registration system *RDE-ROF (Registro Declaratório Eletrônico de Operações Financeiras)* to enable 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 Central Bank reserves the right to convert the portion of an interest remittance it considers above market into the early return of principal.

### **Foreign direct investments**

Foreign capital in Brazil is governed by Law 4,131/62 and Law 4,390/64. According to the laws, “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 registered in Brazil 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 allowed, in principle, but the Central Bank is very reluctant in accepting them. Proper valuations are required and discussions with the Central Bank are recommended.

### *RDE-IED registration*

All foreign direct investments must be registered with the Central Bank online electronic system named *RDE-IED*. The registration is essential, in order to enable the future remittance of dividends and to assure the eventual repatriation of the original capital.

The registration of foreign capital must be made within 30 days from the date it enters Brazil except in the case of capital contributions with goods, which must be registered within 90 days as of customs clearance. Periodically, certain information such as the Brazilian entity financial statements and changes in shareholding must be recorded online and registered with the *RDE-IED*.

According to the provisions of *Circular 2,997/00*, the foreign investment to be performed and registered is not subject to preliminary review or verification by the Central Bank, being thus declaratory and performed through a statement.

This means that the Brazilian investee and/or the representative of the foreign investor are responsible, themselves, for the registration of foreign investments.

To be registered as a 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 invested in the acquisition of shares or quotas.

### **Payments of dividends and interest on equity**

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

However, it is important to mention that companies with negative net equity are not allowed to remit dividends or interest on equity until all the losses are absorbed by profits.

### **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 transfer abroad based on prevailing rules are used by nonresident creditors to acquire an ownership interest in the capital of a company in Brazil.”

The registration of a foreign direct investment resulting from debt conversion, however, does require certain documents and procedures such as (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, the period to which they refer and the respective rates and calculations (ii) a binding statement from the creditor agreeing to the conversion, and (iii) the intervention of a financial institution licensed by the Central Bank to perform a simultaneous exchange transaction.

### **Portfolio investments (*RDEPortfolio*)**

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 *RDEPortfolio*. Please note that the investor must observe Central Bank and *CVM* (Brazilian Securities Exchange Commission) rules. For instance, it is necessary 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 function as tools for the interpretation and correct application of current legislation. Accordingly, court precedents do not serve as a 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 of 1988. Three jurisdictions and tax collection levels are defined by 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 *Receita Federal do Brasil - RFB*, 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*). They are 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 generally 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 in the chapter on 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 date determined by the *RFB* – normally the last business day of June. The income tax return must also be filed when 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: actual profit, presumed profit and 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 net taxable income. It applies at a basic rate of 15%, plus a surtax of 10% on 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.

*CSLL* is also a federal tax levied on net taxable income and is applied at a rate of 9%. It is not deductible for corporate income tax purposes. *CSLL's* tax base is similar to the tax base of the corporate income tax, although some specific adjustments may be applicable to one tax and not to the other.

The *CSLL* rate for financial institutions, private insurance and capitalization companies applicable to taxable events occurring from May 1, 2008, is 15%.

### Actual profit system

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

Taxpayers under the actual profit system may choose to calculate taxes on a quarterly or annual basis. The choice must be made at the beginning of each calendar year and is valid for the entire fiscal year. Under the annual actual profit system, 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.

The main exclusions from taxable income include dividends received from other Brazilian entities 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 Accounting Practices in Brazil). Main inclusions relate to nondeductible accounting provisions and non-deductible expenses.

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

- 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 contains 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 preoperational phase of a new plant, and expenditures on company reorganization, should be deferred for future amortization.
- Startup 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 for tax assessment and non-tax related fines are not tax deductible. Fines for late tax payments are 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 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 (a) do not have total revenues in the preceding year higher than R\$ 48 million, (b) are not financial institutions, similar entities or factoring companies, (c) do not earn foreign profits, income or gains (i.e. directly or through foreign subsidiaries) and (d) do not 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 predetermined 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 are 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 12% and 32%, respectively.

Illustrative calculation:

<b>Income Tax</b>	<b>\$</b>
Gross Sales	1.000
Presumed Profit for income tax (8%)	80
Financial revenue	500
Total Presumed for income tax	<b>580</b>
Income tax due (app. 25%)	145

<b>Social contribution</b>	<b>\$</b>
Gross Sales	1.000
Presumed Profit for social contribution (12%)	120
Financial revenue	500
Total Presumed Profit for social contribution	620
Social contribution due (9%)	55.80

It should be noted that under the presumed tax system losses carry forwards may not be utilized to reduce 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 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, the method

is a type of punishment applicable in situations provided for by law. The income tax paid on the arbitrated profit is definitive and cannot be offset against future payments. The arbitrated profit system is similar to the presumed profit, but with higher percentages to be applied over the gross sales. In addition, penalties may be charged by tax authorities.

### **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 judicial court.

### **Penalties and fines**

The penalty for past due federal taxes is currently set at 0.33% per day up to 20% depending upon the period in arrears. Interest on past due federal taxes is charged at a floating rate (*SELIC*) plus 1%.

Assessed tax deficiencies are generally subject to a 75% fine, which may be reduced to 37.5% if settled within 30 days. In the case of absence or underpayment of monthly advances of income tax or social contribution tax on income, the applicable fine is 50%, even if tax loss has been verified in the annual calculation. 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, under two regimes: cumulative and non-cumulative.

Historically, *PIS* and *COFINS* were charged at 0.65 and 3%, respectively, for most companies 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* and *COFINS* tax provisions were implemented in December 2002 (Law 10,637/02) and December 2003 (Law 10,833/03). As a result of such rules, the *PIS* and *COFINS* rates were increased from 0.65 to 1.65%, and from 3 to 7.6%, respectively, and a credit mechanism was introduced.

According to this new non-cumulative mechanism, taxpayers may generally recognize *PIS* and *COFINS* credits corresponding to 1.65% and 7.6% over certain costs and expenses. Such credits may be used to offset *PIS* and *COFINS* due on their 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* levied on certain inputs. These inputs include: (a) products purchased for resale; (b) 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, and for some revenues deriving from telecommunications, transport and software development services, which are generally subject to a 0.65% tax rate for *PIS* and 3% tax rate for *COFINS* with no credits available. Financial institutions are subject to a 4% *COFINS* rate.

Companies with revenues subject to the cumulative system and other revenues subject to the non-cumulative system will be required to calculate *PIS* and *COFINS* separately in both systems.

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

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, and real state, among others.

Additionally, as of May 1, 2004, the import of goods and services are also 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 manufacturing of goods. In many aspects, it operates like a value added tax, which is charged on the value aggregated to the final merchandise. As a general rule, *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* also has 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 nonessential 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, *IPI* on imports is charged on the CIF value plus certain customs expenses and import tax.

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

Brazilian tax legislation defines “manufacture” as any process that modifies the nature, operation, finishing, presentation or purpose of a product, or 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 *IPI* triggered by subsequent transactions. Under certain circumstances, excess *IPI* tax credits that cannot be offset against *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*.

*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 interstate transportation services and communication services.

In general, when transactions involve two different states, the rates are 7% (when the purchaser is located in the states of the North, Northeast and CenterWest regions or in the state of Espírito Santo) or 12% (for purchases located in the South and Southeast regions). For transactions within the same state and in the case of imports, the rates may be 17, 18 or 19%. 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, the *ICMS* tax base is equal to the *CIF* value plus the applicable import tax, *IPI*, certain customs expenses, the *ICMS* itself and *PIS* and *COFINS* due on the import.

*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 *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., 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 it is a municipal tax, the services subject to the *ISS* are listed in 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 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 service fees paid to the nonresident.

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

When the provision of the service also involves the provision of goods, *ISS* applies on the total price of the service, except when there is a specific provision determining the applicability of *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 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, the residence of the beneficiary and 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% contribution levied on payments due to nonresidents in the form of royalties, technical and administrative 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 payer 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 *CIDE* paid on royalties for the use of trademarks or trade names which reduces the tax's effective rate.

Law 11,452, enacted on February 27, 2007, established that royalties for a software license are no longer subject to this levy. This provision is retroactive to January 1, 2006, which enables recognizing tax credits for *CIDE* payments done over software license fees.

*CIDE Combustíveis* is another contribution levied on the import and sale of oil and gas-related products including ethanol. The manufacturer, the formulator and the importer are the taxpayers of *CIDE Combustível*, according to Law 10,336/01.

## *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 Federal Government by decree and become effective immediately. The tax base varies according to the taxable event and the financial nature of the transaction.

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

<b>Transaction Type</b>	<b>Tax Range</b>
Credit transactions	0 - 1.5% per day
Securities transactions	0 - 1.5% per day
Insurance transactions	0 - 25%
Exchange transactions	0 - 25%
Gold transactions	1% (payable on the first sale transaction)

For loan transactions in Brazilian currency, the *IOF* is levied on the average daily balance or on a transaction basis, at 0.0079% (0.0041% plus an additional 0.0038%) a day when the borrower is a legal entity and 0.0120% (0.0082 plus an additional 0.0038%) when the borrower is an individual, limited to 365 times the daily rate applicable for loans with determined maturing dates.

For insurance, *IOF* tax rates range from 0% to 7.38%, and the applicable rate is 7.38% for most transactions.

Regarding securities transactions, the *IOF* tax rate varies from 0% to 1.5% according to the type of investment.

It is important to note that if the securities are traded by means of foreign investments in the Brazilian financial and capital markets, the liquidation of the corresponding foreign exchange contract is subject to *IOF* at a rate of 1.5%, except for variable-rate income investments (e.g. stocks negotiated in the stock exchange).

However, the liquidation of foreign exchange contracts for the remittance of dividends and interest on equity abroad, either related to fixed-rate or variable-rate investments in the Brazilian financial and capital markets, is *IOF* zero-rated.

Currently, for foreign exchange transactions, the *IOF* tax rate ranges from 0% to 5.38% depending on the type of transaction. The rate is 0.38% for most transactions.

*IOF* is zero-rated on foreign exchange operations related to the inflow of revenue derived from the export of goods and services and outflow of funds derived from the import of goods. The import of services, however, is subject to *IOF* at 0.38%.

### *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 video works with commercial purposes.

## **Other state taxes**

### *ITCMD*

*ITCMD* (*imposto sobre transmissão “causa mortis” e doação 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 state legislation.

### *IPVA*

*IPVA (imposto sobre a propriedade de veículos automotores)* is a state tax levied on the ownership of motorized vehicles (cars, trucks, boats, etc.). The tax base is the value of the vehicle with rates varying according to state legislation.

## **Other municipal taxes**

### *IPTU*

*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 it.

### *ITBI*

*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, spinoffs, capital contribution in kind, etc.).

## **Anti-avoidance rules**

Brazilian tax legislation (National Tax Code) 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 ordinary law and administrative regulation in order to be fully effective from a legal perspective.

## **Tax incentives**

A wide range of government incentives is available for startup 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 tax exemptions or reductions, rather than cash grants.

### **Federal, state, and local 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. As an exception, 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 high rates of banking interest. Under these circumstances, subsidized rate financing has 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 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 development in the Northeast region. The geographical definition of the Northeast region 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 setup, modernization, extension and diversification projects in the region. The main benefit is a reduction of the income tax due over the tax benefited income (*lucro da exploração*) of 25% until December 31, 2008, and 12.5% from January 1, 2009, through December 31, 2013.

Also, companies that have their projects approved for the setup, modernization, extension and diversification of businesses recognized as priority for regional development may benefit from a 75% reduction of income tax during a 10 year period (the project must be presented and approved before 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 (*microregiões*).

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

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

- Financial income that exceeds financial expenses
- Revenues and losses related to shareholders' interest
- Non-operating income
- Foreign sourced 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 state tax incentives that significantly reduce the effective tax burden.

### ***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, but later expanded to include a wider range of electronic products and telecommunication equipment.

The *PPB* benefit is granted to Brazilian companies that have a 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 *IPI* and *ICMS*.

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

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

For *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 *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 a 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 with the purpose of fostering research and development and technological advances.

Tax benefits apply for most companies investing in technology innovation and include:

- Accelerated and boosted depreciation in the acquisition of new equipment (R&D destined) for income tax purposes.

- *IPI* tax reduction and accelerated and boosted depreciation for certain equipment;
- Accelerated amortization for certain intangibles and R&D expenses.
- Benefits relating to withholding tax on royalties and trademark and patent registration fees paid to non-residents are provided by the law but subject to further regulation to be enforced.
- Part of the expenses is entitled for double deduction in the income tax basis.

Technology innovation is defined as the creation of a new product or manufacturing process as well as the inclusion of new functionalities or characteristics to a product or process, which results in incremental improvements and in an effective quality or productivity increase, resulting in more competitiveness in the market.

Companies enjoying these benefits may not be entitled to enjoy other benefits such as the *PPB* (minimum manufacturing process).

### **RECAP – Export Companies**

According to Law 11,196/05, under the *RECAP* regime (*regime especial de aquisição de bens de capital para empresas exportadoras*), companies that calculate *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 three 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 export of information technology services called *REPES* (*regime especial de tributação para a plataforma de exportação de serviços de tecnologia da informação*) and another directed towards hardware sales (programa de inclusão digital).

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

Please note that IT service companies are usually subject to the cumulative *PIS* and *COFINS* regime with respect to software

development, software licenses 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 sale of certain hardware equipment until 2009.

### **REMICEX - Tax incentive for package manufacturers and exporters**

Decree 6,127/07 and Normative Instruction 773/07 regulate *REMICEX*, a tax incentive established by article 49 of Law 11,196/05. *REMICEX* sets forth that revenues from sales of packaging materials by Brazilian manufacturers to foreign resident buyers, even when delivered domestically, are exempt from *PIS* and *COFINS* taxes provided the related product is subsequently exported within 180 days.

In order to enjoy this tax benefit, the taxpayer should require an authorization from the Internal Revenue Service Receita Federal do Brasil (*RFB*) and observe specific regulation.

### **PROVEÍCULO - Incentive program in connection with automotive producer investment**

The program established by the State of São Paulo – *ProVeículo* – through State Decree 53.051/08 intends to stimulate investment in machinery, equipment, cars, busses, trucks and agricultural machinery occurring in the state. Not every company can be granted with this benefit, as it is only for those that produce machinery or vehicles and are classified under chapter 84 and 87 of the NBM/SH (Merchandise Brazilian Name- Harmonized System) and also present an investment plan to modernize its plants, build a new plant, develop new products or improve its business in São Paulo State.

According to the mentioned Decree, its beneficiaries will be granted with the right to use *ICMS* credits accumulated before November 30, 2010, to pay for acquired goods to be used in the company's investment project, to pay for the *ICMS* on the import of goods intended for the fixed asset (since the customs clearance takes place in São Paulo), as well as to transfer the *ICMS* credit to another taxpayer of an investment project. In order to be granted with the benefits, the global amount of investment must be at least R\$ 30 million, among other requirements.

Moreover, if all of the requirements of the mentioned Decree are met, more benefits such as the deferral of *ICMS* on the import of goods intended for the fixed asset may be granted.

## Benefits for information technology and information and communication technology companies

The enacted Provisional Measure 428 grants new benefits for companies in the Information Technology sector beginning in May 2008. These benefits apply to companies from the aforementioned sector seeking to improve their professional capability to develop new software.

Through this Provisional Measure, the Brazilian Government allows some companies in the Information Technology sector to have their professional development costs and expenses excluded from net profit in calculating actual profit, with no detriment to their normal expenses deductibility. This Provisional Measure has also created other benefits, including ones related to social security contributions.

## Growth acceleration package (*PAC*)

Growth Acceleration Package on January 22, 2007, the Federal Government enacted Decree 6,025 which introduced the Growth Acceleration Package (*PAC*), a program aiming to encourage Brazil's economic growth, particularly through the increase of national infrastructure. The Federal Government expects to accelerate the country's economic growth (up to 5%) in the next four years. The intention is to raise the country's investments in infrastructure to US\$ 232 billion.

According to the Federal Government, during 2007, approximately R\$ 16 billion of the R\$ 16.5 billion forecasted for this period was spent under *PAC* actions.

In addition to such infrastructure investments, the *PAC* sets out a general framework for the intended economic program, with different tax measures to stimulate future private and public investments, mainly in the Logistic and Energy Sectors. *PAC* also sets out tax incentives for R&D in the Digital Television Sector (*PATVD*) and semiconductor products – Electronic Chips (*PADIS*). From a tax perspective, *PAC* points out different tax measures, some of them already proposed and others to be drafted and discussed. Please note that there are design changes still pending approval by the Brazilian Government.

## Corporate income tax reductions

Certain expenditures made by the corporate taxpayer in specific cultural, audiovisual, children funds donation, and meal programs may also generate reductions in the amount of corporate income tax payable according to the actual profit method. These reductions, however, are subject to individual and global limits varying from 1% to 4% of the amount of tax due.

## Chapter 5

# International Tax Matters

### Permanent establishment

Only companies incorporated in Brazil are generally subject to taxation as residents. In principle, Brazilian companies must register for tax purposes. Companies that carry out taxable activities in the country, but have not properly registered for tax purposes, 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 also a lack of guidance from the tax authorities, and we are aware of only a few administrative precedents (tax assessments) on the matter. This may be because in certain cases, the tax burden on nonresident's income is even higher than the eventual resident's 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)<sup>1</sup>.

Also, the New Brazilian Civil Code (*NBCC*) prohibits foreign entities to operate in Brazil without authorization. In principle, authorization is granted by means of establishing a branch, which is taxable in Brazil in the same manner as a Brazilian legal entity.

<sup>1</sup> Please refer to our more detailed comments below on the taxation of service fees.

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: the foreign company has an unregistered branch or office.
- Consignment: sales are made under consignment and proper accounting records are not kept by the consignee in Brazil.
- Binding agent: 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, the Czech Republic, Denmark, Ecuador, Finland, France, Hungary, India, Israel, Italy, Japan, Luxembourg, Mexico, the Netherlands, Norway, the Philippines, Portugal, Slovakia, South Africa, South Korea, Spain, Sweden and Ukraine.

Treaties with Venezuela, Paraguay and Russia have been executed but are pending final approval from the National Congress.

Brazil had 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 on payments to nonresidents:

Interest – 15%

Interest on equity – 15%

Royalties – 15%

Technical service fees 15%

Nontechnical 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-January 1996 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, Belize, Bermuda, British Virgin Islands, Campione d’Italia, 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 added to this 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 as it is deductible for Brazilian tax purposes while considered as remuneration for the investor based on shareholder's net equity.

In general terms, interest on equity is calculated by applying the daily *pro rata* 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.

The 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 (25% withholding tax might be applied as well if the recipient is located in a low tax jurisdiction). 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 (moreover, in this case other tax consequences might arise considering that other Brazilian taxes might be charged).

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 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 the 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 net revenue. For example, royalties for trademarks are limited to 1% of net revenue and royalties for patents are limited to a percentage of 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 not subject to 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 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 (*professionais liberais*) or artists.

Non-technical services are subject to 25% withholding tax while technical services are subject to 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. *ISS* rates can vary from 2% to 5%, depending on the municipality regulations.

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

### **CPMF tax**

The federal *CPMF* tax was abolished in 2007 and is no longer imposed on banking transactions from January 2008, onwards. *CPMF* used to be charged on all payments made by a Brazilian entity or individual using the funds deposited in a bank account at 0.38%. However, due to recent changes in regulations, please note that certain previous *CPMF* taxable transactions may be eligible to *IOF's* taxation, the Brazilian federal tax levied on credit, exchange, insurance and securities transactions.

### **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 assets located in Brazil are involved. 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 significant discussion on which method is the correct one. Therefore, proper discussion 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 foreign companies, in principle, is not authorized for Brazilian tax purposes (except from branches of the same entity located within the same jurisdiction if certain conditions are met). 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, losses made by the Brazilian entity through a foreign company may not be used to offset Brazilian profits. However, 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 income from Brazilian Federal Government bonds acquired as from February 16, 2006, except for an 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 the fund is composed of at least 98% in Federal Government bonds; and for Investments in Partnership investment funds (*Fundo de Investimentos em Participações*), emerging company investment funds (*Fundo de Investimentos em empresas emergentes*) and funds that invest in quotas of these funds (the zero % 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 *Resolução* 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.

Finally, it is worth commenting the tax impacts in relation to *IOF*. It is important to mention that the *IOF* tax rates as well as taxable events can be raised or changed by the government by means of a Decree and become effective immediately.

Foreign investments in the financial and capital markets, except variable-rate income (e.g. stocks negotiated in the stock exchange) will be subject to *IOF*

at a rate of 1.5% on the liquidation of the foreign exchange operations. Therefore, the remittance of foreign funds to Brazil with the purpose of acquiring shares of a company listed in the stock exchange remains *IOF* exempted, to the extent that they are considered as variable-rate income investments. Considering the multiple *IOF* taxable events (e.g. foreign exchange transactions, insurance, etc), it is recommended that more analysis of *IOF* be undertaken considering the ever-changing *IOF* regulations.

### **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 *Secretaria da Receita Federal (SRF)*.

## 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.

The Brazilian merger and acquisition (M&A) environment is dynamic in the sense that tax laws are subject to frequent changes, creating not only pitfalls that can frustrate M&A tax advisers, but also tax planning opportunities.

Furthermore, while at times Brazilian tax law is considered firm, it can also provide significant flexibility for Brazilian tax planning.

Overall, there is a relatively high tax burden in Brazil, with complex and interrelated tax provisions. Therefore, good tax planning is essential for the parties involved in any M&A project in Brazil.

In this sense, merger and acquisition transactions commence with preliminary negotiations between the parties on purchase terms and conditions, representations and warranties, and noncompete and indemnification provisions, which may be reflected in a memorandum of understanding providing for further exclusive negotiations and due diligence investigations. As a preliminary discussion 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

The 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 performed will depend on the company form of the target company.

The acquisition of a *Limitada* is effective 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 effective 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 performed privately between the interested parties, in which case the acquisition process will be similar to the acquisition of a privately held company, as 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 shares 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; and
- 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 Antitrust 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 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 incorporation can be obtained with the 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.

While good acquisition due diligence is important 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, complicate the evaluation of Brazilian targets, and sometimes the negotiations, significantly. It is common to observe a number of potential tax contingencies (issues not yet identified/assessed by the tax authorities or included in a tax lawsuit) that may sum to significant amounts. The most common issues encompass:

- Informal practices - income not recorded / false invoices entered in the accounting ledger;
- “Outsourced” or unregistered employees;
- Doubtful / aggressive tax planning;
- Low quality of financial information / controls;
- Inclusion of private / shareholders’ interests with the company’s interests;
- Frequent changes / increases in the tax burden;
- High number of tax lawsuits; and
- Succession risk.

## **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. However, 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 generally 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 normally 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 manufacturing 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.

### 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 (*peessoa 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*. 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). In 2004, Law 10,833/03 introduced a change to Brazilian tax law that is being interpreted as an introduction of the taxation on nonresident's capital gains with respect to the assets located in Brazil even when both parties to the agreement are not 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 target's net equity 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, the premium could be converted into acquisition costs of the fixed assets acquired and recovered through depreciation, while if it related to the value associated with the future profitability of the company, the premium can be amortized.

### **Corporate reorganizations**

Generally, corporate reorganizations (such as *incorporações*, *fusões* and *cisões* as described above) as well as liquidations and capital contributions – including capital contributions of shares – can be accomplished tax free in Brazil, as long as assets are transferred at tax book value and other formalities are met.

However, there may be reasons to structure a reorganization transaction as a taxable transaction (e.g., transfer assets at fair market value). For example, transferring assets as part of a reorganization may allow use of current-year losses that would otherwise become subject to loss limitations, may allow for international tax planning, or may allow for a step-up in the tax bases of assets.

Preservation of tax losses and the succession of tax attributes and liabilities are the most significant issues involved when a corporate reorganization is proposed.

### **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 30 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.

### Dropdown

Dropdown 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 dropdown corporate documents. If assets subject to public registration are transferred under the dropdown (such as real estate, telephone lines, vehicles, among others), it is recommended that a more detailed list be prepared to facilitate the transfer of the proper registrations after the dropdown.

### 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 loss carry forwards of the spun-off company are lost in the same proportion of the split 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.

## Chapter 7

# Trade & Customs

### Overview

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

Even more recently, while the Brazilian *Real* has appreciated against the American dollar, the federal economic policy has managed to maintain a steady growth rate of exports.

According to 2007 data from the Brazilian Ministry of Development Industry and Foreign Trade:

- a) Brazilian foreign trade maintained its strong growth tendency, confirming the advances made in the manufacturing sector and the vigor of an export-oriented production.
- b) Exports reached US\$ 160.6 billion and imports totaled US\$ 120.6 billion, both of which are all-time peak records, resulting in a historical trade flow of US\$ 281.2 billion for the period and a surplus in the amount of US\$ 40.0 billion. These figures clearly show the increasing liberalization of the Brazilian economy and its insertion into global trade. Compared to 2006, exports grew by 16.6% and imports grew by 32.0%.
- c) Exports of all product categories (basic, semi-manufactured, and manufactured) reached record levels in 2007. Exports of basic goods increased by 28.1%, semi-manufactured goods exports were 11.7% higher and exports of manufactured goods grew by 11.9% in comparison with 2006.

It is worth pointing out that manufactured goods accounted for 52.3% of the exports.

- d) The descriptions of the products imported this year show strong correlation with manufacturing investments. Imports of raw materials and industrial supplies and materials represented 49.3% of total imports and capital goods imports represented 20.8%. Imports of consumer goods increased by 34.0%, imports of raw materials and industrial supplies and materials grew by 31.2%, capital goods by 32.7% and imports of fuel and oil increased by 32.1%.
- e) The market diversification process for Brazilian products continued in 2007, and exports to Asian, African, Middle Eastern and Eastern European countries all recorded growth. The European Union and Mercosur, which are already traditional Brazilian trade partners, also increased their purchases from Brazil.
- f) The economic expansion taking place in many industrialized regions throughout Brazil has also been a key factor in the continuing expansion of Brazilian exports.

The increasing participation of non-traditional exporting states in the country's foreign trade shows that the current increase of exports is sustainable.

#### The main products exported in 2007 were as follows:

Products	Amount (US\$ million 2007)	% 2007/2006	% share in Brazilian exports
Transportation goods	23,865	16.6	14.9
Metallurgic products	16,100	9.6	10.0
Oil and fuel	16,042	23.4	10.0
Ores	12,026	23.3	7.5
Soybean & products	11,386	22.3	7.1
Meats	11,095	30.3	6.9
Chemicals	10,914	19.5	6.8
Machinery and equipment	8,724	12.5	5.4
Sugar & ethanol	6,578	-15.4	4.1
Electrical equipment	5,712	-2.3	3.6
Paper and pulp	4,726	17.9	2.9
Footwear and leather	4,389	9.7	2.7

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 reached similar statistics. In 2007, most exports were directed to the European Union, Aladi and United States.

The expansion of Brazilian sales to nontraditional countries or those countries with a small share in total exports has been an important feature in the success story of Brazilian exports. Exports to Eastern Europe, Africa, Latin America, Asia and Oceania have shown an impressive growth.

With respect to operational import and export chains, Brazilian importers and exporters are required to obtain specific registrations. However, in reality, most imports are not subject to pre-licenses, while exports are, in general, tax-free. Brazilian foreign exchange regulations still play a significant role in the operational side due to registration requirements – currency exchange contracts associated with imports and exports are linked with federal tax and customs systems. Penalties may be enforced in cases where a Brazilian importer or exporter fails to settle such contracts in due time.

**The main products imported in 2007 were as follows:**

<b>Products</b>	<b>Amount (US\$ million 2007)</b>	<b>% 2007/2006</b>	<b>% share in Brazilian imports</b>
Total Imports	120,621	32.0	100.0
Intermediate Goods	59,409	31.2	49.3
Capital Goods	25.120	32.7	20.8
Oil and Fuel	20.068	32.1	16.6
Consumer Goods	16.024	34.0	13.3

Source: SECEX/MDIC

**Exports**

Trade policy is conducted by the Chamber of Foreign Trade (*CAMEX*) which works under the Ministry of Development, Industry and Commerce. Exporters must register, usually through the assistance of a forwarder, with *SECEX* - a governmental agency responsible for controlling imports and exports.

Since an export transaction carries 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, which is responsible for controlling the country’s inflow and outflow of foreign currency.

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

Export transactions generally do not require preapprovals, except for transactions involving certain listed products. This list includes animals or products of animal origin, oil, gas, goods containing nuclear and radioactive materials, and weapons, among others.

Certain exports are also forbidden, restricted or subject to specific regulations or preauthorization from the Brazilian government. This applies, for instance, to animals or products of animal origin.

As previously mentioned, Brazilian exporters must register with *SECEX* in order 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.

For exports conducted before February 2007, the inflow of 70% of export proceeds is required:

- (a) up to the last business day of the 12th month subsequent to the shipment of goods or service rendering for operations not subject to Credit Register (*RC*). This is independent of the deadline established in the bills of exchange and the date of effective receipt of foreign currency abroad;
- (b) within 30 days from the date indicated in the respective *RC* for financed operations, including those performed with the exporter's own resources.

For exports conducted from March 2007 onwards, Brazilian exporters of goods and services can maintain abroad the total revenue obtained from their exports. This provision applies, in addition, to the following situations:

- (a) shipping protocol legalized in the register of exports recorded in the Integrated Foreign Trade System (*SISCOMEX*);
- (b) services rendered to persons resident abroad.

## **Imports**

Considering that foreign trade balance is one of the main objectives of federal economic policy, imports have been of critical importance and have played

a significant role in recent years in Brazil. Since the opening of the Brazilian economy at the beginning of the 1990's, when a strong spike on imports ensued what would become the trademark of the last decade, this adverse condition has been largely reversed in recent years by the historical improvements on exports. This is 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 have been reduced across the board 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 import regulations to the extent that imports, with some exceptions, do not require pre-licenses. In addition, 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 also be 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 system adopted), it must be obtained prior to the shipment of products to Brazil and is generally valid for a 90 day period starting 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, and leather, among others, also require preapproval from certain government agencies before the import license is issued.

The import of used products requires pre-licenses, which is normally only granted if a similar product of 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 fines 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. Trading companies may work as outsourced customs brokers, preparing the import and export paperwork and customs clearance, and may also import products on behalf of Brazilian companies.

*FUNDAP* is a special state incentive that consists of a deferral of the *ICMS* due on imports performed by qualified trading companies located in the state of Espírito Santo which, in practice, results in a significant financial benefit.

### **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 used in the manufacturing of finished products to be exported.

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

- Pre-Shipping: it finances the production of goods to be exported in specific shipments.
- Fast Pre-Shipping: it finances the production of goods to be exported within 6 to 12 months.
- Special Pre-Shipping: it finances the domestic production of goods to be exported that are not tied to specific shipments but have a preset time period for such.
- Pre-Shipping anchor companies: it finances the commerce of goods produced by small and medium companies through an export company (empresa âncora).
- Post-Shipping: it 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**

Mercosur is a customs free trade zone comprised of five member countries: Argentina, Brazil, Paraguay, Uruguay and Venezuela.

Signed in 1991, Mercosur currently represents a very attractive market of approximately 250 million people, corresponding to a total Gross National Product (GNP) of approximately US\$ 1 trillion. This makes it one of the four largest economies, right behind the United States, European Union and Japan. The main objectives of the Mercosur, as a global trader, are the total elimination of import tariffs between the members, the increase of the current free trade agreements’ framework and the diversification of the current import and export table of products. These are all objectives that can strengthen

Mercosur's role in the global trade market. Another important goal is to eliminate the exceptions of products included in the free trade agreement (mainly related to 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.

While import taxes have been a significant instrument to protect local industry and regulate the trade of products between the member countries, a program of convergence that reached the Mercosur's Common External Tariff has turned Mercosur into a very open trade market. Import tariffs remain applicable to non-Mercosur member countries, which are generally subject to the same import tax rate in all Mercosur countries.

Therefore, products traded between Mercosur member countries are exempt from 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 and the necessity of the product to the importing country.

Mercosur also has economic agreements with Bolivia, Chile, Colombia, Ecuador, Peru, Venezuela, Mexico and Cuba (associated countries). Products originating 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 also been made to expand the number of country members and enter 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 still pending final approval. Therefore, potential tax benefits on imports from European Union member countries may apply in the near future. Efforts are also being made for Mercosur-India and Mercosur-Israel agreements. They have been under negotiation since January 2004 and December 2007,

respectively. The general rules have already been agreed upon; however, origin rules and associated import tax benefits are still in final negotiations.

### Other agreements

- With respect to the Free Trade Area of the Americas (FTTA/ALCA), efforts are in the direction of achieving a common denominator between the countries in America in order to implement it. However, 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, the latest reports relate to the effect that Brazil (under Mercosur) is one of the world's major producers and exporters of agricultural products, having a relatively low intervention of the government in the sector with support programs focusing on assisting low-income farmers, while only modest agricultural assistance is noted for large exporters. Brazil also plays a very active role in global trade, being involved in a number of cases under WTO dispute settlement either as a plaintiff or a defendant.

- In addition to ALADI and Mercosur, Brazil also has bilateral agreements of economic supplementation with Uruguay, Argentina and Mexico, as well as partial reaching bilateral agreements of economic supplementation with Guiana and Suriname.

The agreements entered into with Uruguay and Argentina essentially refer to cooperation in the automotive sector, which has not been liberalized yet within the Mercosur.

### Origin rules

In general, 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 is listed as the seller of the products.

Origin rules basically require a minimum local added value in the manufacturing country or a change in the tax classification with respect to the product exported when compared to its components. In some cases, both requirements must be met depending on the product traded and the countries involved.

Imports of products originating from Mercosur member countries (Argentina, Paraguay and Uruguay) generally benefit from a 100% reduction of import tax, provided that a minimum local added value of 60% occurred in the exporting country. 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. 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. It is based on internal lists of prices that are not publicly available and are used by Brazilian customs authorities as an initial basis for comparison. There should be no customs valuation issues to the extent that the customs value is within these parameters.

In case the import price does not comply with such rules, the import price base must be justified. To do this, the importer must then fill out a customs valuation form and present proper documentation showing 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 accepted and used method. It consists of adding certain costs and expenses associated with the product to the total cost of the imported product in order to determine a real value that is as close as possible 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

Export revenues are generally tax exempt in Brazil, except for Brazilian corporate taxes.

In theory, an export tax exists, but it is currently only 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), or *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 federal taxes (*IPI*, *PIS* and *COFINS*) are normally easily consumed by exporters as they generally 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 for companies with high level of exports.

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

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

### Imports

Brazil imposes federal, state and, sometimes, municipal taxes on the import of goods and services. The import of goods is subject to *I* (import tax or custom duty), *IPI*, *ICMS*, *PIS* and *COFINS* and other miscellaneous customs duties.

The classification of products under *TEC* (Mercosur's common external tariff) is crucial to determine the applicable rate for most taxes. *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 (*I*) and other miscellaneous fees** – Import tax applies to the 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 *TEC*, and the taxable event is the customs clearance. Other customs fees include minor ones 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)** – *IPI* applicable rates also vary in accordance with the tax classification of the product in the *TUPI* (*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 cases where the subsequent transaction involving the same product or another product in which the imported product was part of its manufacturing is subject to *IPI*. The taxable base is the CIF amount plus the import tax.
- ***PIS* and *COFINS* Imports** – *PIS* and *COFINS* are enforced on the import of products and applied at a combined rate of 9.25% (1.65% and 7.6%, individually). *PIS* and *COFINS* paid on imports may generate a tax credit to be offset with *PIS* and *COFINS* due on domestic transactions provided the importer is subject to the non-cumulative *PIS* and *COFINS* basis. The tax base is the CIF amount plus *ICMS* and *PIS* and *COFINS*. Please note that certain products may be subject to different tax rates.
- ***ICMS* (state type of VAT)** – *ICMS* is also charged on imports. Importers are generally 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 amount plus the import tax, *IPI*, the *ICMS* itself and *PIS* and *COFINS*.

### Special customs systems

Brazilian custom regulations provide a number of special systems 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 systems.

Below is an overview of some available special customs systems:

- **Drawback** grants the beneficiary an exemption from import tax, *IPI*, *PIS* and *COFINS* and exempts 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 system** allows the import of goods staying in the country on a temporary basis with a total or partial exemption from 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 system for manufacturing purposes (*temporary admission to upgrade another product*)** is similar to the regular temporary admission system, but the exemption from taxes is granted on the import of goods to be applied to certain restricted manufacturing processes of products to be exported. In principle, it does not apply in cases where the manufactured goods are sold locally.
- **Temporary export system** allows the export of goods that will be out of the country on a temporary basis with a total or partial exemption from taxes levied on the export, if any, and on the subsequent reimport. This may benefit, for instance, goods that leave the country to sports and cultural events and commercial fairs and exhibitions.
- **Special temporary export system for manufacturing purposes (*temporary admission to be upgraded by another product*)** is similar to the regular temporary export regime and allows the export and reimport of goods that will be subject to certain restricted manufacturing processes abroad. Import taxes are due, however, on the foreign products aggregated to the reimported good.
- **Bonded warehouse (*entrepósito aduaneiro*)** is a special import system whereby the Brazilian party may defer the payment of 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 system, 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** allows companies located in the Manaus Free Trade Zone (*Zona Franca de Manaus*) to benefit from an exemption of *IPI* and *PIS* and *COFINS* for products to be consumed and/or manufactured within the *Zona Franca de Manaus*. The setup 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 used. *ICMS* tax incentives may also be available on the import of raw materials, intermediate products and secondary products to be used in a manufacturing process within the *Zona Franca de Manaus* as well as a reimbursement of *ICMS* due on sales of goods, varying from 55% to 100%.

- **Export Processing Zones (ZPEs)** are planned industrial areas in which established companies have their operations exempt from federal taxes and contributions (*II, IPI*), surcharges on freight for merchant marine renovation, financial and taxes on financial transactions (*IOF*). They also enjoy exchange freedom which means they are not obliged to convert the foreign currency obtained in their exports into reais, provided they send most of their products to the foreign market.
- **Presumed export (*exportação ficta*)** occurs when goods are sold to a nonresident, but do not physically leave the country. The transaction is still considered an export for customs, foreign exchange and tax purposes. This benefit only applies in 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 will be completely incorporated in Brazil in a finished product that will be exported, (c) the good will be completely incorporated in a good owned by the nonresident buyer that is already physically located in Brazil under a temporary admission system.
- **Tariffex (*Extarifário*)** is another import tax benefit available on imports of equipment in cases where there is no similar equipment in the country. The tax benefit consists of an exemption from or reduction of the import tax and is granted after the importer submits and obtains approval from the authorities.
- **Linha Azul (Blue Line)** allows the benefited company to speed up the customs clearance process. In order to benefit from this regime, the company must comply with a number of requirements including an audit of its external controls over the customs processes.
- **RECOF (*Regime de Entrepasto Industrial sob Controle Aduaneiro Informatizado*)** and the **RECOM (*Regime Aduaneiro Especial de Importação de Insumos*)** are special systems 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 *ICMS*. There is a list of products that may be imported under such systems (mainly parts for vehicles, aircrafts and electronics). There are several requirements that must be met, including rigid control over the imported inventory. The main advantage of these

systems 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 on the import and export of goods to be applied in activities of research, exploration, development and economic exploration of oil and gas in Brazil. Companies that have authorization or concessions to carry out such activities in Brazil may benefit from the system 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 exempt from import tax, *IPI* and *PIS* and *COFINS*; (b) import of raw materials, parts and pieces to be used in the manufacturing of goods to be exported (drawback); and (c) presumed export, which allows Brazilian suppliers of goods to sell them to foreign parties with the benefits applicable to exports but with the possibility of keeping the goods in the country. This last type of *REPETRO* needs to be combined with the subsequent temporary import of the goods. *ICMS* benefits may also be available, depending on the provisions of *ICMS* legislation in force in the State where the activities are to be carried out.

### Siscomex carga system

The so-called “Siscarga” system is being implemented to tighten control over imports, exports and in-transit (full and empty) units, as well as empty units being discharged, loaded, or in-transit on any vessel throughout the Brazilian territory.

The implementation of this new system will affect all participants in the supply chain of cargo entering and departing Brazil, i.e., importers, exporters, terminal operators, shipping agencies, shipping owners, Brazilian Customs, and the Brazilian merchant marine.

The new Siscarga system requires that all affected parties must timely adapt their systems to comply with new deadlines regarding the transmission of cargo information, as well as with respect to mandatory fields in certain documents such as the bill of lading. For example, a major change under the new system is the anticipation of when to present documentation for export cargo. All information must now be input into the system at least 48 hours before the cargo arrives in Brazil. The information supplied via the Siscarga system must be 100% accurate, or the cargo will be denied entry and blocked for transport.

## 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 recordkeeping and payment of overtime and benefits. It is essential that the personnel department 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 uncommon 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 hired unless he presents his Foreigner Identity Card (issued by the Brazilian authorities). All employees must be registered in the Employee's Register of the firm and have their work booklet signed by the employer.

The terms of employment must be recorded in 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 or meal vouchers 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 usually 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. However, there are exceptions which apply to specific categories of professionals.

### 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 a payment increase of at least 25%. Moving expenses must also be paid by the employer.

### Experimental period

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

### Termination of employment

After the experimental period, if an employee is dismissed without just cause, the employer must pay a penalty equivalent to 50% of the amount deposited in the employee's *FGTS* account (retirement fund). The employee will receive 40% of this amount and the other 10% will go to the government as a social contribution.

### 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. Historically, Brazilian Labor Law has been notoriously partial to employees,

and Brazilian labor courts allow the admittance of oral evidence to prove the existence of an employment relationship and favor settlements as a means of resolving disputes.

Additionally, employees are not required to assume the costs of litigation, even if claims are not based on circumstances that resulted in a loss to the claimant during the time of his employment. As a result, labor claims tend to cause expenses for the company involved.

Typically, a labor claim is filed against the company by the time the employee's contract is terminated. Brazilian Labor Law allows an employee to file a labor claim seeking rights for the past five years (counting back from the date the claim is filed) for up to two years after his dismissal.

## **Employee remuneration**

### **Remuneration frequency**

Employees must be paid in Brazilian currency on a monthly basis or on 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. Assuming certain requirements are met, such benefits are not considered to be part of the employee remuneration and, therefore, are not subject to the payment of labor rights or social security.

### **Additional salary**

There are certain jobs requiring additional salary, as follows:

- Overtime – When overtime is governed by a collective bargaining or private agreement, the overtime rate must be at least 50% greater than regular pay. Special arrangements may also exist depending on the Union's agreements.
- Night shift work – Night shift work must be paid 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, the salary may be increased by 10% (minimum), 20% (medium), or 40% (maximum) depending on the level of potential harm to health and well-being.

### Minimum wage

The minimum monthly salary is currently equivalent to R\$ 415 but different minimum salary requirements may be granted to specific regions or categories of professionals. 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 salary 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 an employee's compensation other than for salary advances given or those deductions prescribed by law and collective bargaining agreements. These include 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 paid at the same rate regardless of the nationality, age, gender or marital status of the employee performing the function. 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; however, such career plans need to be registered with the Brazilian Ministry of Labor.

### Labor rights

#### Vacation

Employees are entitled to paid vacation of up to thirty calendar days, of which no more than ten days may be taken in cash, upon completion of each twelve

month work period. In addition, a vacation bonus must be paid equivalent to one-third of the employee's monthly salary.

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*)**

Employers are obliged to pay a bonus every year equal to one-twelfth of the salary earned in the month of December for each month of service during that calendar year. This bonus must be included in the basis for calculating unemployment insurance and social security contributions. Part of the bonus must be paid during the year (normally when vacations are taken), and the remainder is paid in December.

If an employee is dismissed (other than for just cause) he or she must be compensated for the unused thirteen month's salary.

### **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\$ 10 per dependent according to the salary level. This supplement is not subject to either social security contributions (*INSS*) or income taxes.

### **Profit sharing**

There is legislation providing that agreements for profit sharing must be worked out between the employer and commissions appointed by the employees. There is debate on whether the payment of profit sharing is mandatory, but there are several companies which have not been paying it.

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 do 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.

## **Prior notice and termination of employment**

Employment may be terminated by either the employer or employee with a thirty-day prior notice. If the employer wants to terminate the work contract without give a thirty-day prior notice, he will be obliged to pay these days as if they were worked.

## **General disclaimer**

The labor rights described above are those entitled to all employees in general, according to the labor law, plus the rights that might be foreseen in the Labor Convention applicable to the company. It is not in the scope of this publication to detail all the rights entitled to an employee; however, the issues highlighted in this publication are the ones that have a higher impact on the life of the company.

## **Payroll taxes**

### **Retirement fund (*FGTS*)**

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

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

Moreover, as mentioned above, when an employee is dismissed without just cause, the employer must pay the employee 40% of the actual balance of the *FGTS* account (an additional 10% is due to the Government).

## **Social security (*INSS*)**

### **Employers' contribution**

Generally, social security contributions must be paid monthly to the *INSS* (Federal Social Security Agency) by companies. The employer's contribution rate, applied to gross salaries without limits, is 20%, increased by minor charges (Worker's Compensation Insurance, plus the Education contribution and the contributions to other governmental institutions such as Funrural, Senac, Sesc and Sebrae) which gross up the total rate to between 26% and 29%.

Payments to individuals working without an employment relationship and service payments (management fees) to directors or managing directors who do not have an employment relationship with the company are subject to *INSS* at a rate of 20%.

### **Employee's contribution**

The employee's contribution (between 8% and 11%) is subject to a low tax limit and must be withheld monthly by the employer based on a specific progressive table.

The monthly contributions paid by employees who receive salaries equal or higher than approximately R\$ 3,038.99 are limited to an 11% rate of the salary amount. Employee's contributions must be deducted and collected by the employer.

All contributions must be paid to the appropriate government agencies in the month following the withholding. Payments in arrears are subject to interest and fines which can be as high as 60% of the amount due. Companies in arrears with their social security contributions are prohibited from making bonus payments, 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.

### **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 employees is generally one of the major sources of social problems. There is no regular unemployment insurance other than unemployment pay, which is restricted to a maximum of three minimum wage salaries over the first six months of unemployment. Health 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 where 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.

### **Health 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 15 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.

### **Retirement 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.

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**

These include, among others, maternity insurance, funeral insurance and disability pension, all of which are calculated in a similar manner to the thirteenth month salary, etc.

### **Government inspection**

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

### **Union contributions**

Employers' contributions are paid in January and are calculated on the basis of the company's registered capital 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 10 years, who have a Brazilian spouse or child born in the country, qualify as Brazilian citizens for the above purposes. However, there is a debate as to whether this provision of the Labor Law Consolidation was revoked by the Federal Constitution/88.

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 and to new transfers of a foreign company with existing operations in Brazil, where the transfer has skills 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. Actually, spouses are not allowed to participate in any paid activity (work) with their visa as spouse.

The work visas issued to foreigners are either temporary visas (valid for up to two years) or permanent visas (no time restriction on residence – the restriction is in regards of the activity that is developed, for up to five years). Temporary visas can be renewed for a further period of two years and changed into a permanent visa after the fourth year. Permanent visas may be issued to the directors of entities with at least US\$ 50 thousand or US\$ 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 in 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.

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**

Brazilian legislation does not expressly foresee the treatment to be applied to cases in which a split payroll scheme is put in place. In practical terms, due to the lack of specific provisions and considering that the general provisions of the social security code are broad, the authorities may understand that the social security would be due in Brazil on top of the total remuneration received. 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, as well as 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 nontaxable 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.

Monthly income	Tax rate	Deduction from the amount of tax due
Up to R\$ 1,372.81	Exempt	R\$ 0
Between R\$ 1,372.82 and R\$ 2,743.25	15%	R\$ 205.92
Above R\$ 2,743.25	27.5%	R\$ 548.82

### Allowances and deductions

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

- Dependents: Up to R\$ 137.99/month 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\$ 2,592.29/per year (per dependent);
- Non-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 as either (a) according to actual expenses while observing 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\$ 12,194.86).

### Foreign income *carne-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 himself (or a service provider) must compute and pay the tax through the regime known as *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 generally 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 the 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 capital gains are reduced by 5% for each year that the property was held prior to 1989. Capital gains are exempt from taxation if all of the following conditions are met: a similar transaction has not occurred within the previous five years, the residential real estate is sold for a price lower than or equal to R\$ 440,000 and the individual does not own other real estate. There is also an exemption if the taxpayer uses the sales proceeds to purchase another piece of 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 a 15% or 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, whether held in Brazil or abroad, are subject to a tax rate of 15% if the proceeds exceed R\$ 35,000 in a particular month.

Gains from the sale of foreign stock or personal property that was acquired prior to becoming a Brazilian resident are 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 stated in 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 labor remuneration in Brazil.

### **Temporary visa**

Individuals transferring 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, are 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 remains an employee of the parent company. In this case, the individual's tax status for the first 183 days of physical presence in Brazil 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.

### **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 Adopted in Brazil

### Financial reporting in Brazil

In January 2000, the Brazilian Securities Commission (CVM) prepared a draft bill of law proposing amendments to Corporate Law No. 6.404/76. This was an effort towards the modernization and harmonization of the existing Corporate Law with fundamental accounting and best international practices, with the aim of promoting Brazil's integration into the current global economic environment.

The initial idea for the amending of Law No. 6.404/76 came from seminars organized by the CVM, with participants from both government entities and private companies and led to a public debate about the matter. This established the roots of a legitimate concerted effort towards revising the existing legislation to ultimately comply with International Financial Reporting Standards ("IFRS").

According to former statements by CVM officials, the main concerns driving this revision process include the following:

- To correct provisions of the 1976 legislation that came to be regarded as unsuitable;
- To adjust the Corporate Law to changes in the economic environment;
- To strengthen the Brazilian public capital markets by implementing international accounting standards.

After seven years of review, discussion and changes by the Brazilian House of Representatives, Bill of Law No. 3.741/2000 was approved by the Economic Affairs Committee and passed into law upon approval by the plenary session of the Brazilian Senate and ultimately sanctioned by the President on

December 28, 2007, as Law No. 11.638, modifying Law No. 6.404/76, which takes effect starting January 1, 2008.

A summary of the main effects of the enactment of this law is as follows:

### Large-sized companies

- Large-sized companies are defined as a company or group of companies under common control, whose total assets, in the previous year, amounted to over R\$ 240 million, or whose total gross annual revenues exceeds R\$ 300 million.
- Beginning from the date of effectiveness of Law No. 11.638/07, large-sized companies, as legally defined, and even if not originally organized as corporations, are now required to have their record activities in accordance with the accounting standards required by Corporate Law, as amended, as well as to prepare financial statements, and submit them to independent audits, also in accordance with the provisions and requirements of that law.
- Based on information collected through a survey conducted and released by Exame magazine in respect of the 2006 “1000 Maiores Empresas” (1000 Largest Companies), approximately 20% of the limited liability companies, as well as 36% of the closely held corporations would classify as large-sized companies for having exceeded the gross annual revenues threshold of R\$ 300 million, and will be subject to the requirements imposed by Law 11.638/07.

### Systematization of accounting standards

- Rules and regulations to be issued by the CVM will be consistent with international accounting standards adopted in the major financial and capital markets. The implication is that a systematization of new financial reporting standards, applicable to the preparation of financial statements and financial reports in general, will gradually converge to full adoption of IFRS. This convergence movement is already ongoing and will be coordinated by the Accounting Standards Committee (CPC).
- The CPC was established at the end of 2005, as the result of a joint collaboration of its participant members, the Federal Council of Accounting (CFC), the Brazilian Association of Public Companies (Abrasca), the Association of Capital Market Analysts (Apimec), the Accounting, Actuarial and Financial Research Foundation (Fipecafi), the Brazilian Institute of Independent Auditors (Ibracon), and the São Paulo Stock Exchange (Bovespa). On November 1, 2007, the CPC issued its first Technical Pronouncement No. 1, which established standards for the accounting of asset impairment charges, and is in line with International Accounting

Standard No. 36. Technical Pronouncement No. 1 has been adopted by both the CFC and the CVM.

- It should be noted that closely held corporations that elect not to adopt the CVM requirements concerning financial reporting, which compulsorily apply to public companies, will only be affected by the new accounting standards to the extent they are adopted and confirmed by the CFC.

### Changes in accounting standards and reporting requirements

- Brazilian accounting standards and new mandatory rules in general seek convergence in areas where previously this did not exist, as follows:
  - Financial instruments and derivatives;
  - Leasing agreements;
  - Equity method of accounting for ownership interests in subsidiaries and affiliates;
  - Corporate transactions involving mergers, consolidation or spin-offs, and those involving transformation to or from the corporate type of a company;
  - Companies are no longer required to prepare statements of changes in financial position, but will be required to prepare a statement of cash flows (with some exceptions).

### Accounting practices adopted in Brazil

Accounting practices adopted in Brazil (“Brazilian GAAP”) are mainly governed by Corporate Law (Law 6.404/76) and the basic conceptual framework is provided by the *Conselho Federal de Contabilidade* (CFC - Accounting Federal Council).

On December 28, 2007, Law 6.404/76 was amended and modified in certain aspects by Law 11.638/07, which is effective January 1, 2008. One of the main objectives of Law 11.638/07 is to approximate Brazilian GAAP to IFRS. Among the modifications introduced by Law 11.638/07 are the following:

- The rules issued by the *Comissão de Valores Mobiliários* (CVM - Brazilian Securities Exchange Commission) for publicly held companies must be based on International Accounting Standards adopted by the primary capital markets of the world.
- Private companies are allowed to adopt the standards issued by the CVM applicable to publicly held companies.
- New criteria for the recognition and measurement of assets and liabilities.
- Companies or groups of companies under common control with assets greater than R\$ 240 million or gross revenue greater than R\$ 300 million are obligated to follow the accounting practices of the Corporate Law, whether

or not they are a publicly held company, and are required to be audited by an independent auditor registered with the CVM.

- The CVM and *Banco Central do Brasil* (BACEN - Brazilian Central Bank) are allowed to establish an agreement with a private entity and provide them with the authority and responsibility of issuing accounting rules. In practice, this rule has existed since 2005 when the CFC implemented the *Comitê de Pronunciamentos Contábeis* (CPC - Accounting Pronouncements Committee).

The CPC is composed of the following institutions:

- *Bolsa de Valores de São Paulo* (Bovespa - São Paulo Stock Exchange);
- *Conselho Federal de Contabilidade* (CFC - Accounting Federal Council);
- *Instituto dos Auditores Independentes do Brasil* (Ibracon - Brazilian Institute of Independent Auditors);
- *Associação Brasileira das Companhias Abertas* (Abrasca - Publicly held Brazilian Companies Association);
- *Associação dos Analistas e Profissionais de Investimento do Mercado de Capitais* (Apimec - Capital Market Investment Analysts and Professionals Association);
- *Fundação Instituto de Pesquisas Contábeis, Atuariais e Financeiras* (Fipecafi - Institute of Accounting, Actuarial and Financial Research).

The entities listed above are represented by two members each and the following institutions have permanent invitations to take part in the CPC board:

- *Comissão de Valores Mobiliários* (CVM - Brazilian Securities Exchange Commission)
- *Banco Central do Brasil* (BACEN - Brazilian Central Bank)
- *Receita Federal do Brasil* (RFB - Brazilian Federal Tax Department)
- *Superintendência de Seguros Privados* (SUSEP - Superintendent of Private Insurance).

Publicly held companies are also under the regulations of the CVM, which enforces pronouncements made by Ibracon and the CPC.

CVM Instruction 457 dated July 13, 2007, determined that in 2010 publicly held companies will have the obligation to prepare consolidated financial statements in accordance with IFRS issued by the International Accounting Standard Board (IASB), which will have to be comparative to 2009.

Publicly and non-publicly held corporations along with financial institutions (except non-publicly held corporations with equity below R\$ 1 million) are obligated to publish two-year comparative financial statements 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 parent company only financial statements.

Companies regulated by the CVM, except banks and other financial institutions, must submit unaudited financial statements, subject to a special review by independent auditors, quarterly and audited financial statements yearly. Banks and other financial institutions have to submit unaudited financial statements for the first and third quarters and audited financial statements on a semiannual basis.

In cases where a 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 Bacen, *Secretaria de Previdência Complementar* (SPC - Agency of Complementary Social Benefits), and *Superintendência de Seguros Privados* (Susep - Superintendent of Private Insurance).

Brazilian Civil Code, regulated by Law 10.406/02, also provides accounting rules for limited liability companies; however, the application of such rules is basically oriented towards small and simple organizations.

### **Brazilian generally accepted accounting principles (BRGAAP)**

In general Brazilian GAAP is based on the accrual method of accounting, unless specific legislation or a rule states otherwise.

Inflationary adjustments have not been required in financial statements since December, 1997.

A summary of the main accounting requirements applicable to public and non-public corporations, and also other entities subject to Law 6.404/76 and the recently enacted Law 11.638/07 is presented below:

## Financial statements required

- Balance sheets, statements of income, statements of cash-flows (introduced by Law 11.638/07), statements of changes in retained earnings or accumulated losses, statements of added-value (introduced by Law 11.638/07) and footnotes;
- Statements of changes in shareholders' equity are required for publicly-held companies.

## *Balance Sheet*

Items in the balance sheet are in general classified as follows:

- Current assets: cash and cash equivalents and other assets realizable during the next year;
- Non-current assets: other assets that will be realized after the next year;
- Investments: equity investments and any rights of any other nature not related to the company's purpose;
- Tangible assets (amended by Law 11.638/07): any tangible asset related to the company's purpose, including assets obtained through third party agreements which transfer the benefits, risk and control of the asset to the company through financial leasing agreements;
- Intangible assets (introduced by Law 11.638/07): rights regarding intangible assets related to the company's purpose or other objects, including acquired goodwill;
- Deferred charges (amended by Law 11.638/07): pre-operating expenses and other expenses related to the company's reorganization which benefits the results for more than one year;
- Current liabilities: any liabilities due within 12 months;
- Non-current liabilities: any liabilities or provisions falling due after 12 months;
- Deferred profit: revenue and costs that will be recognized in future periods;
- Equity (amended by Law 11.638/07): capital contributions, legal reserves, profit reserves, current profit and retained/accumulated profit and losses. Equity also includes the account equity valuation adjustments reflecting the effects of asset and liability valuations to market value;
- Deferred tax assets or liabilities.

According to current Brazilian tax legislation, tax loss carryforwards can be offset with taxable income in future years, with an annual upper limit of 30% of the income for tax purposes. Carryforwards do not have expiration dates.

Also, specific expenses are either non-deductible or only deductible on a cash basis.

Considering the above, deferred tax assets have to be accounted tax loss

carryforwards or temporary differences. Temporary differences may also generate deferred tax liabilities.

Regarding publicly held companies, CVM Instruction 371/02 provides the following guidance with respect to recognizing deferred tax assets:

- The company must have been profitable in at least three of the past five years;
- It must also have taxable income expectations based on a business plan approved by management.

### ***Statements of income***

Items in the statement of income are in general classified as follows:

- Gross revenues reduced by discounts, value-added taxes and other taxes based on proceeds
- Sales, administrative and financial expenses; financial expenses or income
- Non-operating income and losses
- Income or losses before income tax and social contribution
- Income tax and social contribution
- Net income or losses
- Net income or losses per share.

### ***Statements of cash-flows***

The statement of cash-flows presents the changes in cash and cash equivalents for the period and may be prepared using the direct or indirect method. The cash flows are divided by operating, investing and financing activities.

The direct method considers inflows and outflows directly. The indirect method provides the reconciliation between the net profit or losses and total cash flow, adding or excluding non-cash expenses and revenues.

Cash equivalents include all highly liquid financial investments (securities) available to be converted into cash.

Privately held companies with equity below R\$ 2 million are not required to provide the statements of cash flows.

### ***Statements of changes in shareholders' equity***

The statement of changes in shareholders' equity provides the disclosure of changes in equity that occurred during the period and also capital increases or reductions, dividends and the net income or losses for the period.

The statement is not required by Brazilian Corporate Law but is required for publicly held companies according to CVM Instruction 59.

### *Statements of Added Value (Introduced by Law 11.638/07)*

Required for publicly held companies from 2008 onward.

This statement shows the added value created and its distribution to employees, investors, shareholders, governments, and others and also shows the non-distributed portion.

### *Footnotes*

The above financial statements must be accompanied by the following footnotes:

- Valuation criteria of assets, liabilities, inventories, depreciation, amortization, depletion, accruals and others
- Investments in subsidiaries and others
- Changes in assets value
- Pledges over assets and warranties in favor of third parties
- Interest rate, due date and warranties on long term loans
- Amount, class and type of shares
- Share options issued and exercised during the year
- Previous year adjustments
- Subsequent events after the fiscal year

Publicly held companies must provide additional information requested by CVM.

### *Valuation of assets and liabilities*

#### **Assets**

- Financial instruments, derivatives, current assets and long term assets (amended by Law 11.638/07).
  - a) by market value or equivalent when it is a negotiable asset or available to be sold;
  - b) acquisition or issuance cost, updated by legal or contract rules, and adjusted to the realizable value, if lower.
- Goods, raw materials, inventories in process, and others by the lower of cost of acquisition or market values.
- Investments in equity:
  - a) Equity method: It will be applied when the parent company has:

- significant management influence over controlled or non-controlled companies; or
  - equity participation in voting capital higher than 20%;
  - Investment in companies which take part in the same economic group or under joint control.
- b) Cost method: It will be applied when the above conditions are not achieved. This method is based on acquisition cost, less a provision for losses, if necessary.
- Other investments: acquisition cost, less a provision for losses or lower of cost or market.
  - Property, plant and equipment: at acquisition cost reduced by depreciation or depletion. Asset reevaluation has not been allowed since January 1, 2008, due to Law 11.638/07. Existing asset reevaluations may be kept until realized by means of depreciation, depletion, selling of revaluated assets, or write-off until the end of 2008. Reversal of existing reevaluations was also permitted by Law 11.638/07.
  - Deferred charges: capitalized amount deducted by the respective amortization.
  - Non-current assets have to be values based on their present value. Present value calculation demands the definition of a proper discount rate based on management judgment, market practices and eventual regulations from CVM applicable to publicly held companies.
  - The company must periodically assess whether property, plant and equipment, intangibles and deferred charges have been impaired.

### **Valuation of liabilities**

- All liabilities must be accounted for based on the accrual method of accounting and considering the contractual, legal and other updates required.
- Liabilities in foreign currency must be accounted for considering the exchange rate as of the balance sheet.
- Non-current liabilities must be accounted for based on their present value. Similar to Item VIII within the topic valuation of assets, a proper discount rate has to be defined.

### ***Consolidated Financial Statements***

If investments in other companies represent more than 30% of the parent company's equity, consolidated financial statements must be provided in addition to Parent Company's only financial statements.

CVM can issue additional rules regarding consolidation and determine whether companies have to be included in the consolidation.

CVM may also authorize the exclusion of one company for consolidation purposes, if requested by the parent company.

***Certain differences that remain between Brazilian GAAP and IFRS***

Despite the effort towards convergence with IFRS and the pending accounting standards that are being prepared by the CPC, some differences between BRGAAP and IFRS will still remain.

Notably Law 11.638/07 no longer allows reevaluations of tangible fixed assets – a possibility allowed for groups of assets by IFRS – and pre-operational expenses and costs of restructuring that will effectively contribute to increased results of more than one financial year and that not only represent a cost reduction or increase in efficiency are recognized as deferred assets within intangible fixed assets.

Further, Law 11.638/07 requires that public companies prepare a Statement of Value Added, something IFRS do not require.

Other differences may exist but the enactment of Law 11.638/07 and future pronouncements of the CPC are aimed at approximating Brazilian GAAP to IFRS.

	Adoption of IFRS <sup>(2)</sup>	Adoption of CVM Rules	Publication of Financial Statements	Independent Audit
Public companies	Yes <sup>(2)</sup>	Yes	Yes	Yes
Closely held companies - large-sized companies	No	Optional	Yes	Yes
Closely held companies - other companies	No	Optional	Yes <sup>(3)</sup>	No
Limited liability companies- large-sized companies	No	No	No	Yes
Limited liability companies- other companies	No	No	No	No

(1) The Law requires CVM to begin adopting International Financial Reporting Standards in its rulings and regulations.  
(2) For consolidated financial statements, beginning 2010.  
(3) Except for companies with less than 20 shareholders' equity less than R\$1 million.

## Summary of the impacts

The table below sets forth a summary of the impacts of the new requirements of Law No. 11.368/07, insofar as related to the adoption of IFRS, compliance with CVM requirements, publication of financial statements, and mandatory auditing of financial statements.

### Public Companies – Consolidated Financial Statements

In line with a previous Central Bank ruling, in July 2007, the CVM issued Instruction 457, which requires public companies to prepare annual consolidated financial statements, on a comparative basis, in accordance with IFRS, with effect from 2010. Companies may voluntarily early adopt this Instruction for their 2009 consolidated financial statements.

### Certain differences from Brazilian GAAP to U.S. GAAP

With the eminent conversion into IFRS, the differences from financial statements prepared in accordance with Brazilian GAAP and US GAAP tend to diminish. The discussions below, consider Brazilian GAAP currently adopted and thus have not taken into consideration the amendments and modifications brought by Law 11.638/07.

#### Capitalized Interest

Under Brazilian GAAP, interest charges and monetary and foreign exchange variation from financing linked to construction in progress are capitalized to the balance of the assets and credited to interest expense and monetary and foreign exchange variation. Under U.S. GAAP, interest incurred on borrowings is capitalized as part of the cost of certain assets to the extent that borrowings do not exceed construction in progress. The credit is recorded as a reduction of interest expense. The amount of interest capitalized excludes monetary gains on local currency borrowings and foreign exchange gains and losses on foreign currency borrowings.

#### Deferred charges

Brazilian GAAP permits deferral of pre-operating expenses incurred during the pre-operating stage, construction or expansion of a facility before the facility begins operations, research and development and certain other items. The deferred charges are amortized over a period of five to ten years. Under U.S. GAAP, these costs are generally expensed as period costs when incurred.

## Marketable Debt and Equity Securities

Under Brazilian GAAP, marketable debt and equity securities are generally stated at the lower of cost or market value and reflect realized gains and losses in income. As previously noted, the accounting treatment under Brazilian GAAP should change with the implementation of Law 11.638/07.

Under U.S. GAAP, in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," the accounting and reporting for investments in equity securities that have readily determinable fair values, and for all investments in debt securities, are as follows:

- debt securities that the enterprise has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and are reported at amortized cost;
- debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities, and reported at fair value, with unrealized gains and losses included in earnings; and
- debt and equity securities not classified as either held-to-maturity or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses reported in cumulative other comprehensive income, a separate component of shareholders' equity.

Declines in the fair value of available-for-sale and held-to-maturity securities below their cost that are deemed to be other-than-temporary are reflected in earnings.

U.S. GAAP, EITF 96-15, "Accounting for the Effects of Changes in Foreign Currency Exchange Rates on Foreign-Currency-Denominated Available-for-Sale Debt Securities," requires that the entire change in fair value of a foreign currency denominated available-for-sale debt security be recorded in shareholders' equity; including the part attributable to changes in exchange rates. Transaction gains and losses on available-for-sale equity securities are recorded in earnings.

## Business Combination, Purchase Accounting and Goodwill

Under Brazilian GAAP, business combinations are not specifically addressed by detailed accounting pronouncements. The accounting practices adopted in Brazil prescribe the application of the purchase method based on book values of the net assets acquired. Shares issued in exchange for shares of other companies in connection with a business acquisition are accounted for at their net asset value per share. Goodwill or negative goodwill recorded

on the acquisition of a company is calculated as the difference between the cost of acquisition and the net book value of assets and liabilities acquired and is attributed to one of the following reasons: step up basis of the assets due to differences in the carrying values and fair values of the assets, future profitability and other reasons. Such goodwill should be amortized as follows depending on its nature:

- *Step up basis of the assets.* Goodwill or negative goodwill should be amortized proportionally over the remaining estimated useful lives of the corresponding assets of the acquiree;
- *Future profitability.* Goodwill should be amortized during the time expected results are achieved. In this case, the amortization period should not exceed ten years;
- *Other reasons.* Goodwill should be expensed immediately. Negative goodwill should not be amortized to income until the related investment is sold or written off.

As previously noted, the accounting treatment under Brazilian GAAP should change with the implementation of Law 11.638/07.

For U.S. GAAP purposes, all business combinations, except those involving entities under common control, are accounted for using the purchase method. The combination of entities under common control is accounted for in a manner similar to a pooling of interest. Under the pooling of interest method, the recorded assets and liabilities of the separate enterprises generally become the recorded assets and liabilities of the combined enterprise. Additionally, the combined enterprise records as capital, the share capital and capital in excess of par or stated value of the outstanding stock of the separate enterprises. Similarly, retained earnings or deficits of the separate enterprises are combined and recognized as retained earnings or deficits of the combined enterprise. Any assets or liabilities exchanged to affect the transfer are accounted for as a capital dividend to, or capital contribution by, the transferor. Under the pooling of interest method, the financial statements of the combined enterprise for periods prior to the combination are restated to present the previously separate enterprises as if they had always been combined.

The purchase method is applicable for a business combination in which one company acquires an unrelated company. Under the purchase method, the acquiring company records identifiable assets and liabilities acquired based on their fair values. If the purchase price exceeds the amount of such fair value, the excess is recorded as goodwill in the books of the acquiring company.

Under SFAS No. 141, more detailed guidelines have been provided for the recognition of “intangible assets.” Goodwill and other intangible assets with indefinite lives are no longer amortized. Under Statement of Financial Accounting Standard No. 142, or SFAS No. 142, the amount of goodwill will be evaluated for impairment at least annually, and, if an impairment exists, its recorded value will be adjusted accordingly. Purchase price includes direct costs of acquisition. If assets other than cash are distributed as part of the purchase price, such assets should be valued at fair value. When securities traded in the market are issued as part of the purchase price by the acquiring entity, the market price for a reasonable period before and after the date the terms of the acquisition are agreed to and announced should be considered in the determination of the purchase price. Under SFAS No. 141, any excess of net assets of the purchase price is first allocated to reduce the allocated amount of long-term assets, and any unallocated amount is recognized as an extraordinary gain in the statement of operations.

### **Consolidation**

Under Brazilian GAAP, as per CVM Instruction no. 247 of March 27, 1996, as amended by CVM Instructions Nos. 269/97 and 285/98 for fiscal years ending after December 1, 1996, inclusive, financial statements should consolidate the following entities: (a) entities on which the company has voting rights that provides it with the ability to have the majority on the social decisions and to elect the majority of the members of the board of directors, (b) overseas branches, and (c) companies under common control or controlled by shareholders’ agreements irrespective of the participation in voting stock. Joint ventures, (including investees in which the company exerts significant influence through its participation in a shareholders’ agreement in which such group controls the investee) are to be accounted for under the proportional consolidation method. In October 2004 the CVM issued Instruction 408 which requires companies subject to the regulation of CVM to consolidate special-purpose entities, or SPE, when the nature of its relationship with the reporting company indicates that the activities of the SPE are controlled or joint-controlled, directly or indirectly, by the reporting company. Consolidation is required in annual consolidated financial statements for financial years ending after January 1, 2005, with earlier application permitted. Instruction 408 provides guidelines as to when it should be considered that the reporting company controls or joint-controls the activities of the SPE. The guideline is not as detailed as the regulations included in FIN 46. The minority shareholders’ share of the subsidiaries’ earnings is deducted from (or losses added to) the results of operations.

Under U.S. GAAP, the basic rule is that when a company has a controlling interest in another entity (either through a majority voting interest or through the existence of other control mechanisms), such entity's financial statements should be consolidated with those of the parent. The minority shareholders' share of the subsidiaries' earnings is deducted from (or losses added to) the results of operations. Losses applicable to minority interests, that exceed their interests in shareholders' equity, should be applied to the majority interest. Proportional consolidation generally is not allowed under U.S. GAAP.

### **Consolidation of Variable Interest Entities**

Under U.S. GAAP, the Financial Accounting Standards Board has issued Interpretation No. 46R, "Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51," or FIN 46R. FIN 46R requires the consolidation of entities that meet the definition of a variable interest entity in which an enterprise absorbs the majority of the entity's expected losses, receives a majority of the entity's expected residual returns, or both, as a result of ownership, contractual or other financial interests in the entity.

Brazilian GAAP guidance does not specifically address Variable Interest Entities, however, as previously mentioned, the CVM issued in 2004 a rule that determines that Special Purposes Entities (SPEs) must be consolidated when the essence of its relationship with the company indicates that activities of the SPE are directly or indirectly controlled by the company.

### **Equity Method of Accounting**

Under Brazilian GAAP, the equity method of accounting results in recording an investment in the equity of another entity at cost; which is thereafter periodically adjusted to recognize the investor's share of the investee's earnings, losses and dividend payments. A company is required to use the equity method of accounting to record investments in subsidiaries (companies that are controlled by the parent company) in its parent-only financial statements, and in its affiliates (companies in which the parent company owns at least 10.0% of the issued share capital without controlling it) over whose management it exerts influence or in which it owns 20.0% or more of the voting capital, if the aggregate book value of all such investments is equal to or greater than 15.0% of the net worth of the parent company, or if the book value of an investment in any single subsidiary or affiliate is equal to or greater than 10.0% of the net worth of the parent company. The foreign exchange variation resulting from investments in subsidiaries abroad is

required to be recorded as a gain or loss on equity investments in the income statement. Brazilian GAAP establishes certain factors that are indicative of the fact that a company exerts significant influence.

Under U.S. GAAP, the equity method of accounting is used for investments in which the company has significant influence over the operations of the investee, generally as evidenced by a 20.0% to 50.0% ownership interest, and for joint ventures in which neither party has control. Investments under which significant influence is not exerted (generally ownership levels below 20%), are carried at cost and evaluated for impairment, unless the investment is in the form of a debt or marketable equity security that would otherwise be accounted for as a trading security or available-for-sale security at fair value pursuant to SFAS No. 115.

### **Dividends and Interest Attributable to Stockholders' Equity**

Under Brazilian GAAP, at each balance sheet date, management is required to propose a dividend distribution from earnings, subject to ratification by the shareholders' meeting, and accrue for this in the financial statements. Ordinarily, this dividend should not be less than the compulsory minimum. Companies are permitted to distribute or capitalize an amount of interest on stockholders' equity, subject to certain limitations, and whose calculations are based on a government interest rate. Such amounts are deductible for tax purposes recorded initially as a financial expense and reversed afterwards in the statements of income to be presented as a deduction from stockholders' equity.

Under U.S. GAAP, since proposed dividends in excess of the compulsory minimum may be ratified or modified at the annual shareholders' meeting, such dividends would not be considered as declared at the balance sheet date and would therefore not be accrued. However, the higher of the compulsory minimum dividend or the interest credited to shareholders as capital remuneration under Brazilian legislation would be considered as declared for U.S. GAAP purposes.

### **Income Taxes**

Under Brazilian GAAP, the methods for the recording of income taxes are similar to U.S. GAAP, but their practical application may lead to different results in certain circumstances. The recognition of tax benefits derived from temporary differences and tax losses is an area that requires, under Brazilian GAAP, a reasonable amount judgment. In general, tax benefits are recognized when there is evidence of future realization under a going-concern assumption.

Tax benefit rules prohibit the recognition of tax benefits whenever there has been a tax loss for the last three-year period (including the current year) or available evidence indicates that realization is unlikely.

Under U.S. GAAP, the asset and liability method is used to calculate the income tax provision, as specified in SFAS No. 109, "Accounting for Income Taxes." Under the asset and liability method, deferred tax assets or liabilities are recognized with a corresponding charge or credit to income (or in certain cases to shareholders' equity) for differences between the financial and tax basis of assets and liabilities at each year/period end. The deferred tax assets and liabilities are measured using rates enacted by law. Entities operating in highly inflationary environments do not record deferred taxes for differences relating to certain assets and liabilities that are remeasured into U.S. dollars at historical exchange rates, and that result from changes in exchange rates, or indexing to inflation in local currency for tax purposes. Net operating loss carry forwards arising from tax losses are recognized as assets, and valuation allowances are established to the extent it is not more likely than not that such assets will be recovered. There may be differences in timing with respect to the recognition of the effects of changes in tax rates. In addition, under SFAS No. 109, provisional measures, which are temporary differences used by the Government to determine changes in tax rates, are not considered to be enacted law.

In July 2006, the FASB issued FASB Interpretation No. 48 "Accounting for Uncertainty in Income Taxes," an interpretation of FASB Statement 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a threshold of more-likely-than-not for recognition of tax benefits of uncertain tax positions taken or expected to be taken in a tax return. FIN 48 also provides related guidance on measurement, derecognition, classification, interest and penalties, and disclosure. The provisions of FIN 48 became effective on January 1, 2007, with any cumulative effect of the change in accounting principles to be recorded as an adjustment to opening retained earnings.

### Segment Information

Under Brazilian GAAP, there is no requirement for disclosing information about operating segments.

U.S. GAAP, SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information," requires public companies to report both financial and

descriptive information about its reportable operating segments. Reportable operating segments are defined as those about which separate financial information is available and is regularly evaluated by the chief operating decision maker. Generally, financial information to be reported will be on the basis used internally for evaluating segment performance. Financial information to be disclosed includes segment profit or loss, certain specific revenue and expense items and segment assets as well as a reconciliation of total segment revenues, profit or loss and assets to the corresponding amounts in the financial statements.

### Earnings Per Share

Under Brazilian GAAP, disclosure of earnings per share is computed based on the number of shares outstanding at the end of the year, although a weighted-average basis is acceptable.

Under U.S. GAAP, SFAS No. 128 "Earnings per Share", public companies are required to present earnings per share, including earnings per share from continuing operations and net income per share on the face of the income statement, and the per share effect of changes in accounting principles, discontinued operations and extraordinary items either on the face of the income statement or in a footnote.

SFAS No. 128 also requires dual presentation of earnings per share; basic and diluted. Companies should base computations of basic and diluted earnings per share on the weighted average number of common shares outstanding during each period presented. Diluted earnings per share is calculated on the same basis, except that effect is given to all outstanding potentially dilutive common shares.

In accordance with SFAS No. 128, earnings per share data has to be adjusted for all periods presented in the financial statements to reflect the new number of shares that result from a stock split or a reverse stock split.

On March 31, 2004, the EITF issued EITF Issue 03-6, "Participating Securities and the Two-Class Method". Typically, a participating security is entitled to share in a company's earnings, often via a formula tied to dividends on the company's common stock. The issue clarifies what is meant by the term "participating security", as used in SFAS 128. When an instrument is deemed to be a participating security, it has the potential to significantly reduce basic earnings per common share because the two-class method must be used to compute

the instrument's effect on earnings per share. This EITF issue also covers other instruments whose terms include a participating feature and addresses the allocation of losses. If undistributed earnings must be allocated to participating securities under the two-class method, losses should also be allocated. However, EITF 03-6 limits this allocation only to situations when the security has (1) the right to participate in the earnings of the company, and (2) an objectively determinable contractual obligation to share in net losses of the company.

### **Comprehensive Income**

Brazilian GAAP does not contemplate the concept of comprehensive income.

U.S. GAAP, SFAS No. 130, "Reporting Comprehensive Income," effective for years beginning after December 15, 1997, requires the disclosure of comprehensive income. Comprehensive income is comprised of net income and "other comprehensive income" that include charges or credits made directly to equity, and which are not the result of transactions with owners.

Examples of other comprehensive income items are cumulative translation adjustments under SFAS No. 52 and unrealized gains and losses under SFAS No. 115.

### **Share Issuance Costs**

Under accounting practices adopted in Brazil, costs related to the offering of shares are charged to expenses as incurred.

Under U.S. GAAP, costs related to the offering of shares are deducted from the proceeds received from such offering as a charge to capital.

### **Share-based Compensation**

Under Brazilian GAAP, no expense for stock-based compensation, such as stock options and warrants, is usually recognized in the financial statements. The purchase of the stock by employees is recorded as an increase in capital stock for the amount of the purchase price. Footnote disclosure of details of stock-options and other stock based incentives is necessary.

SFAS No. 123R (Accounting for Stock Based Compensation) defines a fair value-based method of accounting for an employee stock option or similar equity instrument and encourages all entities to adopt that method of accounting for all of their employee stock compensation plans. Under the fair value-based method, compensation cost is measured at the date of the grant based on the value of the award and is recognized over the service period,

which is usually the vesting period. For periods beginning after June 15, 2005, U.S. GAAP requires a public entity that is not a small business issuer to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions) under the provisions of SFAS No. 123R (which was issued in December 2004 and amends SFAS No. 123).

### Financial instruments and derivatives

Under Brazilian GAAP, aside from Central Bank rules applicable only to banks, financial instruments are not marked to market and a certain amount of disclosures is required under pronouncements of CVM. As previously noted, the accounting treatment under Brazilian GAAP should change with the implementation of Law 11.638/07.

Under U.S. GAAP, SFAS No. 133, as amended and interpreted, "Accounting for Derivative Instruments and Hedging Activities," is effective for all fiscal quarters of fiscal years beginning after June 15, 2000. Such Statement requires that a company recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. If certain conditions are met, a derivative may be specifically designated as:

- a hedge of the exposure to changes in the fair value of a recognized asset or liability or an unrecognized firm commitment;
- a hedge of the exposure to variable cash flows of a forecasted transaction; or
- a hedge of the foreign currency exposure of a net investment in a foreign operation.

The accounting for changes in the fair value of a derivative (that is, gains and losses) depends on the intended use of the derivative and the resulting designation. Derivatives that are not designated as part of a hedging relationship must be adjusted to fair value through income. Certain robust conditions must be met in order to designate a derivative as a hedge. If the derivative is a hedge, depending on the nature of the hedge, the effective portion of the hedge's change in fair value is either (1) offset against the change in fair value of the hedged asset, liability or firm commitment through income or (2) held in equity until the hedged item is recognized in income. The ineffective portion of a hedge's change in fair value is immediately recognized in income. If the hedge criteria are no longer met, the derivative instrument would then be accounted for as a trading instrument.

Specific disclosures required by SFAS No. 133 include:

- objectives for holding derivative instruments and the strategy to reach the objectives including description for each type of hedging category and for those not classified as hedges;
- risk management policy for each type of hedge;
- specific quantitative disclosures for derivative financial instruments designated as hedges.

### **Accounting for Guarantees by a Guarantor**

Under accounting practices adopted in Brazil, guarantees granted to third parties are recorded in memorandum accounts. When fees are charged for issuing guarantees, the fee is recognized in income over the period of the guarantee. When the guaranteed party has not honored its commitments and the guarantor should assume a liability, a credit is recognized against the guaranteed party representing the right to seek reimbursement for such party with recognition of the related allowance for losses when considered appropriate.

Under U.S. GAAP, FIN No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" is effective for guarantees issued or modified after December 31, 2003. FIN No. 45 requires that a guarantor recognize, at the inception of a guarantee, a liability for the fair value of the obligation undertaken in issuing the guarantee. Specific disclosures of guarantees granted are also required under FIN No. 45.

### **Financial Statement Note Disclosure**

Brazilian GAAP, in general, requires less information be disclosed in financial statements than U.S. GAAP. Disclosures required under U.S. GAAP, not typically found in Brazilian GAAP financial statements, include, but are not limited to, the following:

- general business, political and economic risks
- off-balance sheet risks and commitments, concentration of credit risk and major customers
- details of guarantees provided to third parties
- irrevocable commitments such as take-or-pay or minimum sales contracts
- advertising expenses and assets
- research and development costs
- environmental related costs, liabilities and proceedings
- analysis of sales by geographical area and by operating segment

- financing facilities and terms
- footnote disclosure of summarized financial statements of affiliated companies which meet certain significance levels.

Brazilian GAAP generally requires more disclosure than U.S. GAAP with respect to insurance coverage and details of investments in affiliated and subsidiary companies.

### **Record requirements**

All companies and individuals engaged in commercial activities must record and maintain proper accounting books in Brazilian Portuguese, apply Brazilian GAAP on a consistent basis and include appropriate disclosures. Additionally, there is a list of legally required official records 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 recorded. Financial statements must be transcribed in the journal book at least once a year.

The other auxiliary books are subsidiary to 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.

Corporations and limited companies which have been operating under Law 6.404, and changed by Law 11.638, are obligated to provide specific financial statements following special legislation or specific tax procedures and are also obligated to provide financial statements according to Brazilian GAAP.

Financial institutions are required to use a general chart (COSIF) with specific codes for reporting and financial statement preparation purposes required by the Brazilian Central Bank.

Some other formalities must be observed when keeping the official records, including:

- The official records must be stated in Brazilian Portuguese and values must be recorded in Brazilian currency. There are no restrictions to show equivalents in foreign currency, although such figures are considered merely for illustrative purposes, except for transactions that originated 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;
- Inventory registration must be recorded at the end of each year in order to record accurate information related to inventories of final products, raw materials, and intermediary products;
- Use of codes (i.e., the use of numbers instead of headings) for accounting entries in the journal book is permitted as long as 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.

## SPED

SPED is an instrument unifying the activities of receipt, validation, storage and authentication of the books and documents that are part of a companies' commercial and fiscal bookkeeping and allows them to do so electronically. Due to the implementation of SPED, certain accounting/fiscal books in paper format are substituted by an electronic format. The digital bookkeeping will include certain accessory obligations that taxpayers will have to comply with, such as DIPJ, DACON, GIA, etc., as this data will have to be in electronic format.

The principal objectives of SPED are:

- To promote the integrated audit activities by tax authorities through sharing information;
- To allow the delivery of various accessory obligations to different government agencies at once;
- To ease the identification of illegal activities from a tax perspective by sharing accounting and tax information;
- To reduce the costs of having the information in paper format;
- To increase the productivity of the auditor to the extent that certain steps in the process of collecting documents are eliminated.

SPED regarding digital accounting bookkeeping will have to be delivered before June 30, 2009, with respect to transactions that occurred in 2008 for those entities that were notified. Other companies will deliver SPED in 2010 with regards to transactions having occurred in 2009.

SPED regarding digital fiscal bookkeeping will be delivered from 2009 considering the transactions occurred in 2008. Each State will determine the date of delivery.

### **NF-e**

The Electronic Invoice (NF-e) is the national standard of an exclusively digital document, issued and stored electronically, with the purpose of documenting an operation of transfer of goods or rendering of services, which legal validity is guaranteed by the electronic signature of the issuer and its reception by the state and federal tax authorities.

The implementation of a national standard with legal authority, which substitutes the actual issue on paper format, is aimed at simplifying the taxpayer's obligations. It also allows tax authorities to follow commercial transactions in real time. It is an initiative to modernize and integrate the national tax system, facilitating the analysis of federal, state and municipal taxes, and improving the tax audit process by allowing for the sharing of information.

Certain benefits with the implementation of NF-e include:

**For companies:** simplification of the accessory obligations (elimination of the use of forms, print and storage of documents on paper for five years); reduction of waiting time at Fiscal Posts at the border; reduction of costs regarding printing, acquisition of paper, sending and storing fiscal documents and encouraging doing business with clients and suppliers electronically; and

**For Tax Authorities:** (State and Federal Inland Revenue Services): more reliable invoices; access to information (in real time) with regards to commercial operations, allowing for a more effective audit of the obligations for tax on the transfer of goods and services purposes (Imposto sobre a Circulação de Mercadorias e Serviços, ICMS); sharing of information between tax authorities; reduction of tax evasion; increase in tax revenues; and more control by the Federal Inland Revenue over the tax on industrialized products (Imposto sobre Produtos Industrializados, IPI).

NFe is already a reality for some companies, e.g. tobacco and beverage companies. Other companies are undertaking pilot programs to start issuing these documents from 2008, while the remaining companies will do so beginning in 2009.

## Chapter 11

# Banking & Finance

### Regulatory environment

The National Monetary Council (*CMM*) is responsible for issuing regulations applicable to financial institutions in Brazil while the Central Bank of Brazil (*BACEN*) has the primary responsibility of supervising these financial institutions to ensure their compliance with these regulations. The Brazilian Securities Exchange Commission (*CVM*) and Federal Revenue Service (*SRF*) also have limited regulatory and supervisory influence over financial institutions. For example, *CVM* is responsible for the supervision of public traded financial institutions and the mutual funds industry. These regulatory authorities are under the same political leadership and cooperate in matters of common interest.

The regulation of the financial sector is a key element in Brazil's economic policy. Accordingly, Brazil's banking industry has become accustomed to a high level of government supervision. The extent of such regulation often comes as a surprise to foreigners. The regulatory environment is complex with various specific rules applicable to each type of financial institution. For example, not only are Brazilian banks subject to the usual type of controls on banking operations (e.g. limits on capital, lending, foreign currency and fixed assets) but they are also, on occasion, bound by government directives on both operational and accounting matters. These matters include the maximum interest rates for certain types of loans, requirements to extend a minimum percentage of their loans to small and medium sized companies and limits on the maximum percentage that can be extended to foreign owned entities, fixed price policies for some specific services and fees and prescribed methods of revenue recognition on specific types of transactions. Seldom is any major or minor economic policy introduced without extensive directives and circulars to the banks from the monetary and banking authorities.

*BACEN's* supervision is performed through both indirect monitoring of the financial and accounting data and direct “*in loco*” inspections that can focus on specific areas within a financial institution or the financial institution as a whole. To facilitate this monitoring, financial institutions are obliged to provide various types of information to *BACEN* on a weekly, monthly and annual basis depending on the type, nature and complexity of the institution. In addition to this, *BACEN* may at any time demand that financial institutions provide specific information relating to its current area of regulatory focus.

From the perspective of accounting records, financial institutions are required to file general ledgers on a monthly basis, financial statements subject to auditors review on a quarterly basis and audited financial statements on a semi-annual basis.

Currently, financial institutions should follow Brazilian Generally Accepted Accounting Practices (BR GAAP) and, in certain specific aspects, rules defined by the *CMN*. Key legislation issued by the *CMN* includes:

2682	Credit provisions
3068	Classification of securities
3059 & 3355	Deferred tax assets
3535	Contingent assets and liabilities
2099	Capital limits
3380 & 3464	Operational and market risk management – Basel II

Resolution 3380 was the first step on the path to Basel II compliance for Brazilian financial institutions. Refer to the section “Significant Milestones” below for more details.

In 2006, *BACEN* issued *Comunicado* 14.259 which established that financial conglomerates should prepare and publish Consolidated Financial Statements in accordance with IFRS starting December 31, 2010. This initiative, among many others, is part of *BACEN's* strategy to bring the Brazilian regulatory environment in line with international standards.

### **Market participation**

While the composition of the three largest banks in Brazil (the federally owned bank *Banco do Brasil* and national private banks Banco Itaú and Banco Bradesco) has not altered in recent years, there has been considerable movement in the rankings of the banks below these institutions as a result of different growth strategies and a relatively high number of mergers and acquisitions.

Of particular relevance was the acquisition of ABN AMRO Real by Banco Santander which created a combined entity with a strong presence in Brazil that could challenge the dominance of these largest national banks.

In recent years, there has been a significant expansion in the participation of foreign owned banks in Brazil as the perceived political and economic risks decreased and their national markets stagnated causing them to search for higher yields overseas. By assets held, foreign owned banks now represent approximately 27% of the industry. The dominant foreign owned banks in terms of asset size include: ABN AMRO / Santander, HSBC, Citibank, and UBS (who acquired Banco Pactual in 2006). The focus on growth in Brazil by foreign owned banks is evidenced by the profits earned in 2007. Foreign owned banks registered an increase of 160% in profits on the prior year. This compares to an increase of 22% registered by the nationally owned banks (source: Brazilian Central Bank).

Public banks still have a large influence in the Brazilian banking system. The most visible participants are the Banco do Brasil and Caixa Econômica Federal which have retail branches in all of the major cities and towns in Brazil. There are also State government owned, national financial institutions without retail operations such as development banks and development agencies. The largest of these is *Banco Nacional de Desenvolvimento Econômico e Social (BNDES)*, the role of which is to provide funding for projects and areas of national interest such as infrastructure and agribusiness. Beyond these there are a multitude of state owned banks which participate to different extents within and sometimes outside of their home states. Some of these state banks have full retail operations and others are focused on helping specific segments, considered vital to the local economy, gain access to funding.

Government owned banks are generally perceived as being slow to adapt and extremely cautious when compared to their dynamic private counterparts. However, the relative confidence and complexity of public banks in Brazil is demonstrated by the plans of Banco do Brasil to issue American Depositary Receipts in the second half of 2008 (source: Valor Econômico – April 25, 2008) and the fact that the growth of public banks has matched that of private banks with a market share by assets of 35% in 2007, which compares with the 33% that they held in 1996 (source: Central Bank of Brazil). This number only includes the large public banks with retail operations. When the assets of the development banks are included as well, the participation increases further. Privately owned banks have various levels of involvement in the financial market.

The larger banks usually offer full retail and investment bank services with branches in cities across Brazil and investment banking activities centralized in São Paulo. Other institutions, including some of the international banks, have chosen to focus on particular market segments (e.g. agriculture) or particular products (e.g. equity and debt underwriting or car loans) as opposed to offering a full range of banking services. In some of these markets, the financial institutions face competition from companies that primarily operate in other industries, such as large vehicle manufacturers who have set up banks in order to provide car loans to their clients. Outside of the international institutions there has also been a proliferation in the number of niche, nationally owned institutions specializing only in certain areas of the market. Among these there has been a significant growth in the number and influence of Private Equity, Real Estate and Hedge Fund companies.

### **Significant Milestones**

#### **Credit Risk Central Database (*Central de Risco de Crédito*)**

In 1997, *BACEN* created the Credit Risk Database with the objectives of enhancing the supervision of the financial system and improving fraud detection and prevention processes. This database has become an important tool for *BACEN* in the supervision and monitoring of credit risk.

All financial institutions are responsible for uploading all consolidated credit exposures above R\$5,000.00 (five thousand *Reais*), broken-down by client, credit-rating, amounts, maturities, and status, among others, to this database. More recently, various enhancements and upgrades were made to the Database, improving the quality and accuracy of the information that is available and can be accessed by the regulators and the financial institutions.

#### **Brazilian payment system (*Sistema de Pagamentos Brasileiro*)**

In 2002, *BACEN* implemented the Brazilian Payment System (*SPB*), a set of integrated operational systems, clearing houses and agents responsible for the administration of payments and money transfers in Brazil. It is one of the most important changes to the Brazilian financial market and significantly altered the way in which payments and money transfers in Brazil are conducted.

The introduction of the *SPB* enhanced the security, agility, trustworthiness and efficiency of the Brazilian payment system. It also significantly reduced its operational, credit and liquidity risks.

All financial institutions had to revise their products, processes and systems in order to adapt to changes that affected their relationships with other financial institutions, their clients and suppliers, and *BACEN*.

### Record number of initial public offers (IPOs)

Starting in 2004, the Brazilian capital market experienced significant changes as a result of the economic situation of the country. In 2005, a significant increase in the number of publicly traded companies listed in the Bolsa de Valores de São Paulo (BOVESPA) was noted and this growth in the number and value of IPOs continued in the following years. The increased liquidity and interest that this generated in the market provides companies with improved fund raising abilities and investors with a further exit option.

This has had a profound impact on the banking industry which has been directly involved as both the issuer and buyer in IPOs and in the roles of coordinator and/or underwriter.

### Introduction of basel II

Resolution 3,380 issued by the *CMN* in June 2006 was the first in a series of steps to improve the operational risk management of financial institutions in Brazil and, eventually, require them to be Basel II compliant. Its implementation was required to be performed in steps until the end of 2007. It requires that financial institutions create effective programs of operational risk management that encompass their processes, activities and internal controls and allow management to identify, evaluate, monitor, control and mitigate the specific and generic risks of the financial institution. It also requires the creation of a database of operational losses as a contingency plan for continued operations in an emergency.

Resolution 3,464 was issued in June 2007 and sets out the requirements for Brazilian financial institutions in relation to market risk management. The last of the requirements is to be put in place by June 30, 2008, and includes the selection of a director responsible for the program, definition of the institution's policies, the implementation of the systems required to monitor these risks and the validation of internal models of market risk. Further requirements are set to come in to force on the path to Basel II compliance, including the validation of internal models of credit and market risk, and are scheduled to occur at various dates between 2008 and 2011.

## IFRS conversion

As mentioned above, *BACEN* issued Comunicado 14.259 in 2006 establishing that financial conglomerates should prepare and publish Consolidated Financial Statements in accordance with IFRS starting from December 31, 2010.

The IFRS initiative also has some specific objectives such as to reduce funding costs, enable financial institutions to access international capital markets, improve comparability and trustworthiness of the local banking system and encourage transparency. This initiative, combined with specific risk management rules and continuous monitoring activities, demonstrates *BACEN*'s commitment to the development of the Brazilian financial system.

## Investment grade

Brazil received an upgrade to 'investment grade' status by two of the major rating agencies – Standard & Poors (in April, 2008) and Fitch Rating (in May, 2008). This is expected to generate further significant inflows of foreign investment capital from sources restricted to investing only in 'investment grade' countries (e.g. US pension funds).

## Operations within the industry

### Retail banking

A focus for growth for many Brazilian banks in the past few years has been retail banking as both interest rates and unemployment figures have fallen while the average wage has increased as a result of improving salaries and falling import costs due to the strengthening of the Brazilian Real. In these growth conditions and with improving credit analysis processes, financial institutions have been lending ever larger amounts. In addition to this, to date, lenders have been able to avoid passing on all the cuts made in the base interest rate to their clients making this area even more lucrative.

As these retail products have become more common, the population has become more sophisticated and accustomed to making use of them and, as a result, both demand and supply of consumer credit have increased rapidly. A growing middle class and an extremely wealthy upper class also means there is a high demand for innovative investment products.

The retail market continues to expand at a frantic pace and new products are constantly being developed, but the staple products are still those usually offered by international banks in developed markets including:

- Bank accounts
- Credit cards

- Personal loans
- Mortgages
- Savings accounts.

Recently there has been a focus by *BACEN* on the protection of consumer rights including the requirement for each financial institution to provide an ombudsman service, limits on the charges that can be applied for certain banking services and a requirement to disclose the total percentage cost of each loan facility.

### Bank accounts

Banks are permitted to charge a basic fee for the provision of bank account services and additional fees for services beyond the basic package. It is not permitted to pay interest on money held in these accounts.

While access to banking facilities has improved vastly for the lower income segment of society, a large part of the Brazilian population does not have access to banks accounts (the "unbanked"). In 2006 there were a total of 143 million bank accounts held in the country compared to a population of 186 million (source: Central Bank of Brazil). The number of unbanked is much greater than 143 million bank accounts, as many people hold more than one bank account.

### Credit cards

The leading worldwide credit card networks are represented in Brazil with a multitude of issuers. The use of credit cards has increased significantly in recent years and there is a large range of cards, reward schemes and payment options aimed at further growing this business. One popular payment method that is uncommon outside of Brazil and provides interest free credit to the consumer is 'compras parceladas' which allows the consumer to split the purchase into a number of installments only one of which is debited to the card on each month following the purchase. This method is rapidly replacing the previously popular system of post-dated bank checks which is an informal loan provided by the seller. The purchase is split into a number of banking checks with a future date written on each check. It is supposed that the seller will present each check on the date written.

### Personal loans

Another example of the increase in credit volume has been personal loans. Improving credit conditions and a demand by the growing middle class for large ticket items, particularly cars, has caused an expansion in personal loans.

Some car manufacturers and larger department store chains, as well as financial institutions, are providing loans for financing the acquisition of these products. Many financial institutions are also launching products which provide credit to unbanked people, with no formal income as the interest spreads that can be charged for these services and the recent history of re-payment rates make this an attractive market segment.

### **Mortgages**

In the 1980s, personal home loans brought large losses to financial institutions in Brazil due to high levels of default and caps on loan repayments stated by the Federal Government. This measure was taken in order to keep control over inflation and reduce the demand for salary increases by these borrowers as they were middle class people. As a result, the majority of private financial institutions stopped offering mortgages. The current benign credit conditions and increasing property prices have seen many of the banks re-enter the market with products of increasing sophistication.

### **Saving products**

Savings deposits are the traditional means of saving for working classes. Additionally, most banks offer access to retail mutual funds with varying strategies including cash investments, fixed and floating rate bond investments, index trackers and industry specific equity investments. While interest rates on traditional savings deposits are decreasing, the attractiveness of alternative savings products is increasing. This is a good opportunity for financial institutions to increase management and performance fees for these funds.

### **Commercial and investment banking**

The standard products offered by commercial and investment banks in Brazil are: corporate finance (advisory and underwriting), structured finance, project finance, trade finance, cash management services, treasury (including investments and derivatives), brokerage and custody services, loans and credit guarantees.

Generally, the main players in the retail market are also the main players in commercial/investment bank activities, especially in investment bank services. Some foreign banks with little or no retail operations occupy leading positions as a result of their global presence and international expertise.

As a result of the recent Brazilian economic scenario, significant gains have occurred on the investment bank side due to the large increase in IPOs, debt underwritings, mergers and acquisitions.

## Mutual funds (Asset Management)

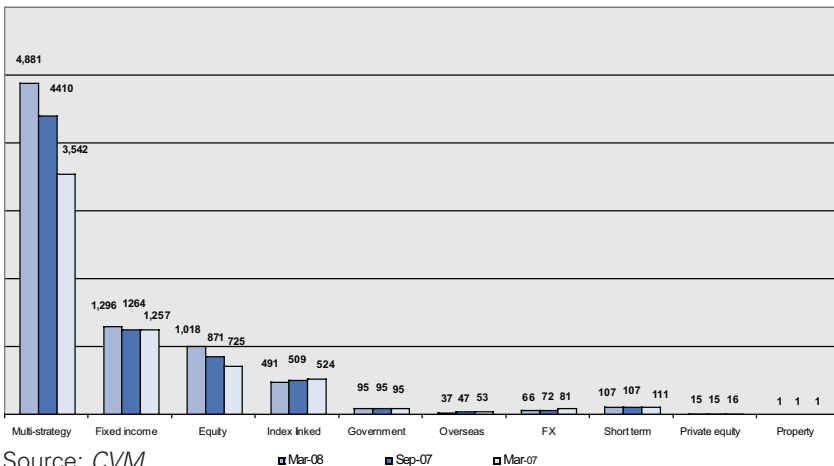
Recently, the mutual funds industry has experienced a huge increase. The continuous reduction of basic interest rates, economic growth and modifications in rules of other types of investment, such as savings accounts, motivates investors to invest in mutual funds.

The Brazilian mutual funds industry is one of the largest in the world with more than R\$1,000,000,000,000 (one trillion Reais) under management as of June 2007 (source: *Associação Nacional dos Bancos de Investimento - ANBID*). Mutual fund activity is under the regulation and supervision of the *CVM*. *Instrução CVM 409/04* establishes rules related to set up, management issues and disclosure of information that should be provided by the management of these mutual funds. *CVM* issued *Plano Contábil dos Fundos de Investimento (COFI)*, a specific accounting framework to be used by the industry.

The main investment fund families in Brazil are:

- Short term
- Fixed income
- Equity
- Foreign exchange
- Multi-strategy
- Index linked
- Receivables
- Private equity
- Overseas
- Government related funds.

Number of funds



Source: *CVM*

## Other operations / alternative investments

In addition to the main business lines highlighted above, there has been a recent significant increase in the number of smaller and specialized companies providing services in private equity, hedge funds and real estate.

### Private equity

Managing and investing in private equity funds are activities that have become more common for financial institutions in recent years. While the expansion of the capital markets provides competition for these funds, it also gives an alternative exit route, reducing the risk of having to hold assets beyond their expected realization period.

Increasing consumer spending power, existence of underdeveloped industries and high export demand for main products provides a large number of investment opportunities for investors. Large amounts of capital have been raised from investors looking for gains from the high yields being earned.

### Hedge funds

The popularity of this alternative investment type has increased in Brazil as a result of the demand for access to high yields on offerings through diversified investment strategies. While the funds do not have the same significance that they have in UK and US markets, further growth is expected. Active minority shareholders are likely to become more common in Brazil, even though it is a market that is used to relatively passive investors.

### Real estate

Real estate has become an increasingly popular investment option as several construction companies, real estate management companies and real estate funds went public (IPO) in 2006 and 2007. Commercial, industrial, retail and residential projects have all become attractive as company profits and personal wealth have increased. Currently, investment in real estate funds is restricted to qualified investors (with a minimum of R\$ 300,000.00 in available financial instruments, such as cash, stocks, and other securities) as regulatory restrictions have prevented their sale on a retail basis (to all types of investors). However, expected adjustments to the laws governing real estate funds should allow managers to open them to private investors and increase their fund raising opportunities.

## **Custody agents and other significant service organizations**

### **SELIC**

*Sistema Especial de Liquidação e Custódia (SELIC)* is the name given to the electronic system of liquidation and custody services for all federal government bonds. After trading federal government bonds, financial institutions should register the transaction in *SELIC* in order to transfer the custody of the bonds traded. Seller and buyer register the terms of this operation in *SELIC*'s electronic system. The transaction is accepted and the custody is transferred only if information provided by both traders is the same.

### **CETIP**

*CETIP* is an electronic system used for the registration and liquidation of government and private fixed income bonds, an over-the-counter exchange market for traded instruments although it also has a trading platform that allows participants to submit quotes and receive offers for the products handled by the system. The products registered include inter-bank deposits, swaps, options and repos. It provides a low risk settlement environment and a registration system that effectively acts as a 'custodian.' *CETIP* provides systems and technological support for Camara Interbancária de Pagamentos (CIP - interbank payments clearing house) and the clearing house of *Federação Brasileira de Bancos (FEBRABAN - Brazilian banks federation)* at *SPB*.

### **ANDIMA**

*Associação Nacional das Instituições do Mercado Financeiro (ANDIMA)* is a Brazilian non-profit civil entity that brings together several financial institutions and offers technical and operating support to these institutions, opening up new markets and working towards the integration of Brazil's financial system. These support services include daily monitoring of market behavior with the dissemination of statistical data; monitoring legislation; preparing analyses, studies and reports on key economic issues; and running one of the most complete databases in Brazil. It is open to society at large through publications and electronic media.

## **Treasury and proprietary investment opportunities**

### **Fund raising**

The fund raising options for Brazilian companies are comparable to those found in other developed financial systems; however, there are some local peculiarities. Government owned banks and private banks provide the majority of funding.

Main funding sources for Brazilian companies are:

Loans and promissory notes

- Trade finance
- Debentures
- Offshore notes
- Leasing
- Securitization of receivables
- Equity (including DRs).

Additionally, financial institutions often use:

- Retail and commercial deposits
- Reverse repos
- Inter-bank deposits.

Some of the particularities of these forms of funding in Brazil are discussed below.

### Loans and promissory notes

Government owned banks and private banks can provide loans for companies. Generally, these financial institutions require guarantees in the form of liquid financial instruments, trade bills, fixed assets or support guarantees from credit-worthy financial institutions. Development bank loans preferentially provide long term loans to Brazilian owned companies, but, under certain circumstances, foreign capital companies are eligible for these loans.

In the past, the Brazilian government has placed restrictions on the lending operations of financial institutions in order to keep control on inflation, as its main objective is to reduce currency circulation velocity in the economy. Furthermore, development banks/agencies provide direct loans for exportation, agriculture, small and medium sized businesses, and other sectors that it is seeking to develop. This two-pronged intervention in the market means that, at times, the pricing of loans in the promoted markets does not necessarily reflect the perceived credit risk in that market, and restrictions on lending amounts to other markets can inflate their cost even in the absence of negative credit factors.

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times, the pricing of loans in the promoted markets does not necessarily reflect the perceived credit risk in that market, and restrictions on lending amounts to other markets can inflate their cost even in the absence of negative credit factors.

Foreign currency loans are also offered by most large financial institutions either directly from international banks (Law 4,131 loans) or via pass-through arrangements with Brazilian banks (Resolution 2770 loans). Foreign loans must be registered in the Brazilian Central Bank declaratory electronic system *Registro Declaratório Eletrônico (RDE)*. Through this system, the company and/or bank registers this transaction, and it is subject to the review of terms and interest rate set by the Brazilian Central Bank.

Promissory notes are written by companies requiring funding. They are, effectively, loans in a more regulated legal form. Each issuance must have prior approval from the *CVM* and a formal Offering Document should be provided if the intention of the company is to offer these securities to the public. They have a maximum term of one year.

### Trade finance

Short-term borrowing for exports use contract advances (where exporters anticipate the amount of sale in foreign currency from exportation transactions with the bank) instead of a more traditional exchange. More recently, the volume traded of export notes (securities issued by exporters, based on future exportation contracts) for a discount at banks has increased.

### Debentures

Debentures can be convertible or non-convertible to the stock of the company that issues these securities. Usually, interest rates paid on these securities are based on inflation indexes plus a floating interest rate. Investors have a put option for these securities every three to six months, according to the terms of issuance of these securities. The rate is geared 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 is concerned.

Debentures are usually preferred because they are less costly and provide longer term loans than bank borrowings. Various discussions have been held regarding the creation of a secondary market for commercial debt instruments such as debentures but, to date, this secondary market is still under development.

## Offshore notes

Brazilian companies may issue short-term commercial paper or long-term bonds or notes to foreign investors which may be undertaken through off-shore subsidiaries. The Brazilian 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 main advantage of using commercial paper instead of an ordinary foreign loan is the fact that it does not normally reflect the country risk, thus reducing the cost of borrowing.

## Leasing

Leasing as an alternative form of financing for acquiring large ticket assets. This instrument is widely accepted and Brazilian private and government owned retail banks may offer this product through their widespread branch networks. Assets financed range from buildings and industrial turnkey projects to the financing of high technology equipment, computers, machine tools and vehicles. The vast majority of leases in Brazil are financing leasing whereas the operational leasing market is still being developed.

Special factors encouraging 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 withholding tax;
- All lease contracts are recorded by the lessee as operational lease expenses. Therefore, the cost of lease installments are deductible for corporate taxes purposes. This scenario could be changed as a recent change in corporate law (*Lei das S.As.*) stated that assets from financing lease operations should be booked as operational assets. Tax authorities have not issued their position with respect to this issue;
- 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.

## Securitizations of receivables

In recent years, Brazilian companies have become much more aggressive in the securitization of their receivables. Recent regulatory changes have allowed new vehicles to be developed in which large receivable portfolios can be moved, thus freeing up funds for the company to use.

## Equity (including depository receipts)

The number and size of IPOs in the *Bovespa* (Brazilian stock exchange market)

in recent years reflects the growing popularity of raising funds through the equity markets. Record levels of foreign income flows, increasing participation of individuals and the search for higher yields in a falling interest environment have increased the total amount traded and the enhanced liquidity of the equity market.

Alternative funding can also be sought directly in foreign exchange markets through Depository Receipts (“DRs”). The most common is the American DR (“ADR”). Through these instruments, investors may acquire stocks issued by a Brazilian company with the advantage of liquidity, additional regulation and familiar processes of the foreign exchange market. DRs are an important instrument for Brazilian corporations that wish to access other funding sources and increase the liquidity of their shares. To issue a DR, underlying shares of the company must be deposited in a Brazilian financial institution that provides custody services. The acquisition of DRs is subject to registration with the Brazilian Central Bank. This registration allows the remittance of dividends and income from the sale of shares abroad. Investors have the option to convert DRs into direct investments in the Brazilian company.

Non-resident companies may issue DRs in the Brazilian exchange market, called Brazilian DRs (“BDRs”), as ruled by Resolution 2763/00.

### **Proprietary investments**

Large financial institutions in Brazil usually provide a varied portfolio of all the instruments mentioned above. Smaller financial institutions are usually specialized to provide only one or two types of funding. The majority of Brazilian financial institutions also keep some of their resources invested in government issued bonds. Hedging the majority of risks is relatively simple with an actively traded derivative exchange. The following are some of the significant features of the Brazilian markets:

### **Government issued bonds**

Over the years, the Brazilian government has issued a variety of bonds with denominations such as LTN, NTN and LFT. Each type of security has specific characteristics such as fixed rate, floating rate, USD indexed and inflation indexed bonds. While some of the types are less common, those traded regularly have a number of advantages including:

- High liquidity
- Relatively low credit risk
- Commonly accepted as collateral in reverse repo transactions
- Can serve as deposits for legal disputes
- Low capital cost.

## Over-the-counter (OTC) derivatives

OTC products are available in Brazil although they remain less sophisticated than those used in more developed markets such as the US. Options and swaps are commonly traded by financial institutions with their clients and between financial institutions. In the latter case, the majority of these are registered with *CETIP*. Swaps and some types of option contracts may be registered with the *Bolsa de Mercadorias e de Futuros (BM&F* – Brazilian commodities and futures exchange market).

## Exchange traded instruments

Brazil had two major exchanges until 2008 – *BOVESPA*, which is the equity exchange, and *BM&F*, a derivatives exchange. The equity exchange is the largest by volume traded and total market capitalization in Latin America and contains mainly Brazilian companies with a small number of overseas companies listed via BDRs. The derivatives exchange is one of the largest future exchanges in the world and offers a range of derivative products for risk management and speculative purposes. These products include FX forwards, Forward Rate Agreements, equity index linked futures and options on commodities.

These two exchanges undertook successful IPOs in 2007 and, as a result of their potential synergies, announced a merger in the first half of 2008. The combined company will continue to offer the same products and services.

## Capital markets

Historically, the Brazilian economy has been subject to high levels of inflation. However, after the introduction of the “Plano Real” (the new Brazilian monetary unit) in 1994, the inflation matter was alleviated. Once this first obstacle was removed, it was expected that the capital market could finally be consolidated and developed. However, this was not observed during the first eight years of the *Plano Real* and, instead, there was a decrease in the amount of investment in the market. Many companies exited the stock market by closing their capital and returning to the private sector. Moreover, high interest rates, a complex tax system and a lack of protection to those willing to invest in Brazil were other problems faced at that time.

It was because of this scenario that in 2000, aiming to boost the market, the stock market (*BOVESPA*) created the *Novo Mercado*, a special segment for the listing of stocks of companies complying with corporate governance rules in Brazil.

Along with the creation of the *Novo Mercado*, two new intermediary segments were created: *Níveis I* and *II*. All together, the three new segments established different levels of commitment related to the corporate rules in Brazil.

In this context, the *IBovespa* index has been improving since 2003 and at the same time, the interest rates of government bonds pegged to *SELIC* (DI funds) were reduced. As a result, the *BOVESPA* became an option for those Brazilian citizens looking for alternative ways to invest their money.

In 2007, *BOVESPA* registered 64 Initial Public Offers, which was a record number. In 2008, *BOVESPA* and the Brazilian Mercantile and Futures Exchange (*BM&F*) announced the integration of their operations and established an important agreement in order to strengthen Brazilian capital markets.

The Brazilian stock market is regulated by the Brazilian Securities and Exchange Commission (*CVM*).

Active financial futures and options on commodities such as metals, grains, meat, and currencies are also traded in the market.

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. They 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 Mobiliários* and *Distribuidoras de Títulos e Valores Mobiliários* undertake virtually the same activities, namely, securities brokerage. The two types of entities are distinguishable because *corretoras* have a seat on a stock exchange, whereas *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*, other financial institutions in the group sell their financial papers (certificates of deposit and acceptances) to the market. Similarly, when such paper matures, the *distribuidora* purchases it from the market.

The *distribuidora* places group papers in the market for a fee received from the issuing company, engages in trading such papers for its own account, and may also hold papers of the issuing company for its own portfolio yield purposes.

Funding usually comes from the *distribuidora*'s own capital or from deposits made by 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.

## Investment funds

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 with 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 the publishing of their semiannual 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 the 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 and invest in a different fund.

Quotaholders of the funds 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.

## 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 Brazilian GDP. When compared with other countries that reach from 6% to 7%, it has been confirmed that the difference is related mainly to the large volume of personal insurance.

Insurance companies in Brazil work mainly 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.

- Insurance companies: They may sell general, life and health insurance.
- Open complementary pension entities: They provide complimentary pension related benefit plans and may also offer/combine life insurance plans in the same product.
- 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. During the period 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 health insurance companies are supervised and regulated by the National Agency for Supplementary Health (ANS), a Federal Government Agency related to the Ministry of Health.

There are approximately 180 insurance companies currently in Brazil, including capitalization companies and open pension entities. There are more than 67 thousand insurance brokers, and more than two thousand operator companies registered with *ANS*, represented by approximately 15 insurance companies specialized in health.

## **Regulatory agencies of the insurance market**

### **CNSP**

The National Council of Private Insurance (*CNSP*) is responsible for defining the rules and guidelines of 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* also resolves loose ends in the field of insurance related to rules and guidelines, regulates the compulsory insurances and establishes the limits for insurance operations in Brazil.

### **SUSEP**

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

## **Reinsurance regulatory operations in Brazil – important changes**

In 1939, Instituto de Resseguros do Brasil (*IRB*), at that time a Brazilian Federal Government Agency, was created and established that all reinsurance operations originating from Brazilian insurance companies must be contracted with the *IRB*, making it a monopoly. Reinsurance operations are mandatory when responsibilities of insurance companies exceed their own retention capacity, according to *CNSP* and *SUSEP* rules. In January 2007, a very important regulatory change occurred in Brazilian insurance business, as Complimentary Law 126 was issued. It established the end of *IRB*'s monopoly on reinsurance operations and opened the reinsurance market to other Brazilian and foreign reinsurance companies.

In December 2007, *CNSP* and *SUSEP* issued a number of rules in order to discipline reinsurance, retrocession and reinsurance brokerage activities. Other rules were also included related to capital requirements and developing and presenting a business plan for pre-approval by *SUSEP*.

Complimentary Law 126 states that reinsurance and retrocession operations must be operated, after the previous authorization of *SUSEP*, through one of the following types of reinsurance companies:

- I – Local Reinsurance Company: Company is incorporated in Brazil with the exclusive purpose of operating reinsurance and retrocession operations.
- II – Admitted Reinsurance Company: Foreign reinsurance company operating through a representative office incorporated and domiciled in Brazil.
- III – Eventual Reinsurance Company: Foreign reinsurance company operating without a representative office incorporated and domiciled in Brazil.

The minimum required capital for local reinsurance companies is R\$ 60 million, if the objective of this company is to operate exclusively with reinsurance operations. For admitted reinsurance companies, the minimum required capital is US\$100 million. For eventual reinsurance companies, the minimum required capital is US\$150 million.

For admitted and eventual reinsurance companies, the recognition of investment grade is required, issued by a recognized credit ratings agency.

Complimentary Law 126 states that 60% of reinsurance contracts must be contracted with local reinsurance companies by January 16, 2010. After that, the rate is reduced to 40%.

Nine international reinsurance brokerage companies have obtained the pre-approval from *SUSEP* to operate in this market in Brazil.

### **Health insurance market**

Companies specialized in health insurance and their 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, regulate the operators, including their relationships with providers and consumers, and carry out activities related to health insurance 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 but will not be subject to composition with creditors nor bankruptcy unless, in the latter case, 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 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 and product as well as presentation of the business plan, provided that there is no incompatibility or inconsistency in the information.

In the event the registration is cancelled, 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.
- 0.33 times the annual average of all retained claims in the last 36 months.

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

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 cannot be less than R\$ 15 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 cannot 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 benefits, income and life plans in all regions of Brazil cannot 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.

**Companies specialized in health insurance** – The minimum capital for an insurance company in all regions of Brazil cannot 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

Corporate governance is currently one of the most debated issues in many capital markets around the world.

The general concern is how to obtain a consensus among investors, regulators, board of directors, executives, government and other stakeholders, of which are the best practices in corporate governance.

Initiatives have been developed by regulators, such as the Brazilian Securities Exchange Commission (*CVM*) and the Brazilian Central Bank, the São Paulo Stock Exchange (*BOVESPA*) and by groups specialized in the subject, including the Brazilian Institute of Corporate Governance (*IBGC*) and the Audit Committee Institute – ACI of KPMG in Brazil.

According to *IBGC*, corporate governance is a system by which companies are directed and monitored, and includes the shareholders, the board of directors, the independent auditors and the fiscal council (*conselho fiscal*). These components, together with practices such as equal treatment of shareholders, full disclosure, accountability and corporate responsibility, are considered to be the best practices in corporate governance, with the intention of increasing the value of a company, facilitate its access to capital and contribute to its sustainability.

Additionally, in order to create more effective and updated corporate governance practices in Brazil, *CVM* and *BOVESPA* have been thoroughly studying and discussing corporate governance practices for public companies in order to improve its regulations and applicability. As a result, *CVM* has issued the

“CVM Recommendations on Corporate Governance” which contains the main directives associated with the best practices in corporate governance. Its main goal is to provide guidance on questions that can significantly influence relationships between the company and its stakeholders.

On the other hand, the provisions stated in the CVM Recommendations publication are not mandatory. They are only guidelines for Brazilian public companies wanting to comply with best practices in corporate governance. Noncompliance with such practices is not subject to penalties, and in fact, the adoption of these practices is considered to be at a higher standard than those required by Brazilian corporate law.

For illustrative purposes, the main items of the CVM Recommendations are as follows:

- General shareholders’ meetings must be set on dates that do not prevent shareholders’ attendance. In case complex issues need to be discussed, the meeting must be set at least 30 days in advance.
- Shareholders agreements must be available to all shareholders.
- The company should adopt and release standard procedures that enable shareholders to easily obtain the list of current shareholders and their interest in the corporate stock.
- The company’s articles of incorporation should clearly regulate shareholders’ voting and representation procedures.
- The board of directors should have five to ten technically qualified members, with at least two members considered as financial experts (experience in finance and accounting practices). The number of members should be sufficient in order to ensure a wide representation although not so large as to impair efficiency.
- The board of directors should establish its own regulations, 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 of directors and the chief executive officer shall not be the same person.
- The majority of share capital, regardless of types or classes, should be the criteria for voting decisions, with each share representing one vote.
- The board of directors should ensure that transactions with related parties are clearly reflected and fully disclosed in the financial statements of the company, completely documented and under market conditions (arm’s length).

- 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 an arbitration panel (câmara de arbitragem).
- The company should release management reports for every quarter 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 (conselho fiscal) 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 be responsible for hiring the independent auditor.
- The company should adopt international standards for its financial statements, reviewed by an independent auditor.

### **São Paulo stock exchange – BOVESPA**

The São Paulo Stock Exchange has been very innovative by creating differentiated levels of corporate governance practices, which are a set of rules of conduct for companies, their management and their controlling shareholders that *BOVESPA* considers important for increasing the value of shares and other securities issued by publicly held companies.

Currently, there are three different listing levels in *BOVESPA* for securities issued by publicly held companies. The listing level depends on the issuing company's adherence to the "Differentiated Levels of Corporate Governance": (i) *BOVESPA's* New Market - *Novo Mercado*, (ii) Level 1 Corporate Governance - *Nível 1* and (iii) Level 2 Corporate Governance - *Nível 2*.

The *Novo Mercado* is a listing segment of the stock exchange specifically established to negotiate shares issued by companies that voluntarily adopt corporate governance and disclosure practices, aside from minimum standards required under Brazilian legislation. *Novo Mercado* adopts higher standards of Corporate Governance than *Nível 1* and *Nível 2*.

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

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

In summary, 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;
- Free float of a minimum portion of shares representing 25% (twenty five percent) of corporate capital;
- Provision of same sale conditions to transfer shareholding control (“tag along” rights);
- Establishment of a one year mandate for all members of the board of directors;
- Annual financial statements in Brazilian accounting standards (BR GAAP) and other international accounting standards such as US GAAP or international accounting standards (IFRS);
- Improvement in the accuracy of information provided quarterly by the companies, including consolidation of financial statements and independent auditor reviews;
- 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 the negotiation of assets or derivatives issued by the company on behalf of controlling shareholders;
- Adoption of an arbitration panel (*camara de arbitragem*) for resolving conflicts (*Novo Mercado* adopts The Market Arbitration Panel to provide an independent, confidential, swift and cost-effective environment for dispute settlements in line with the directives of the Arbitration Law).

The adoption of the *Novo Mercado* regulation demonstrates a company’s efforts towards improving its relationship with investors, and potentially increasing assets’ valuation.

### **The Brazilian institute of corporate governance – IBGC**

The *IBGC* ([www.ibgc.org.br](http://www.ibgc.org.br)) is a non-profit cultural entity of national scope and is one of the parties responsible for the introduction and dissemination of the corporate governance concept in Brazil.

It issues, periodically, the “Best Practices of Corporate Governance.” The main objective of this study is to provide guidelines for all types of companies which are interested in increasing their value, improving corporate performance, facilitating access to capital at lower costs, and contributing to the long-term operation of a company.

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

With over one thousand associates, *IBGC* keeps a staff of researchers and specialists constantly aware of the changes in corporate practices. It has, therefore, affirmed itself as an international reference in corporate governance.

### **The KPMG'S audit committee institute – ACI Brazil**

Recognizing the importance of audit committees, board of directors and fiscal councils, the Audit Committee Institute (ACI) Brazil has been created to serve audit committees, board of directors and fiscal council members and help them adapt to their changing roles. Historically, these groups have largely been left on their own to keep pace with rapidly changing information related to governance, audit issues, accounting, and financial reporting. Sponsored by KPMG, the ACI provides knowledge and experience and is a resource to which these groups can turn to for information and to share knowledge.

## Chapter 14

# Other Considerations

### **Consumer rights**

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

The Consumer Protection Code defines a 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 victim 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” and “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 regarding any dangers related to its products. Even if the manufacturer discovers 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, along 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 advertisements 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.

Furthermore, if 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 are prohibited.

## Class actions

These actions are restricted to consumer protection cases.

Of particular interest to foreigners are recent cases where Brazilian courts have ruled 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 of 1988 was the first in the country's history to address environmental protection. It assigned federal, state and municipal authorities with the duties of protecting the environment, taking action against pollution and safeguarding local plants and animals.

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 interaction other than scientific, cultural and leisure activities.

A third level of conservation areas includes national forests, indigenous reserves, animal reserves and hunting reserves. They receive partial protection and allow for 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 as world heritage sites.

The federal government agency responsible for 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's movement, which has been increasingly channeled through nongovernmental organizations that, at present, number over 1,400. The movement focuses on educating private sector polluters about the benefits of environmental protection and the costs of noncompliance to the applicable rulings.

There are some reports that must be submitted to the environmental authorities whenever a Brazilian company establishes or expands an industrial installation. The analysis of these reports is recommended in case of the acquisition of businesses that may generate pollution, as Brazilian law contains a strict liability for damages of this nature.

Brazilian 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 monetary 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).

Criminal liability is not only applicable 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 governed by Law 9,279/96 (Industrial Property Law). The main innovations of this law include patents for medicines, chemical, pharmaceutical and food products.

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.

The federal government established the Federal Intellectual Property Agency (*INPI*) in 1970, to regulate and enforce industrial property rights, including patents, trademarks and other such registrations of intangibles.

## 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.

Brazilian and foreign individuals as well as entities may apply for a trademark, 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 as of the filing of the documents with the *INPI*. However, only upon the issuance of the registration certificate, will the applicant be entitled to full exclusive trademark rights and the use of the registration symbol.

Unless the lack of use can be justified, the nonuse of a registered trademark for an uninterrupted five year period will invalidate the registration.

Owners may negotiate the rights to trademarks or license them to others, subject to the registration of the respective agreement with the *INPI*.

Well-known trademarks are protected by the Industrial Property Law, regardless of registration with the *INPI*.

The Paris Convention established an exclusive priority period of six months, as of the date of the application in the country of origin, for the owner to apply for registration 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 objectives of the entity.

## Patents

In order to establish legal protection for inventions, utility models and industrial designs according to the Industrial Property Law, they must be patented in Brazil. The essential elements required for the granting of a patent in Brazil are: absolute novelty, industrial application and inventive activity.

Since Brazil is a signatory of 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 time period (as of 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.

A foreign patent is considered to be in the public domain and cannot be registered in Brazil once it has been published.

A patent is valid for the following periods starting from the filing date of the request for protection: 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 expiration of the patent.

The following cannot be patented (i) products which violate morals, good customs, security, as well as public order or health; (ii) products which result from the transformation of an atomic nucleus; (iii) living beings, except microorganisms; (iv) scientific theories and surgical techniques; and (v) computer software (see “Software” section below), among others.

A patent is terminated, 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 use 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. The Law provides that the manufacturing 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 the transfer of technology, such as patent license agreements, trademark license agreements, technology transfer agreements and contracts for the 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 with the Central Bank of Brazil.

The *INPI* registration is also required, for the tax deductibility of 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 registration of a 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 for 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 of foreign software prior to marketing is no longer required. However, registration with the *INPI* is usually recommended to facilitate the protection of the underlying copyright against third parties.

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 this term, the owner or licensee will be required to provide technical assistance.

## Franchising

Franchising activities are governed in Brazil by Law 8,955/94. Franchising agreements must 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 antitrust 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 that may limit or harm competition and any other form of corporate arrangement, in which any of the participants has annual gross revenue greater than R\$ 400 million, must be submitted to *CADE* for examination within 15 days after the occurrence.

Private parties may seek redress in court, concurrently with the administrative proceeding.

The Antitrust Law has adopted the “consent decree” concept from U.S. antitrust law and also allows preliminary injunctions. Sanctions include substantial fines which may be imposed on companies and managers who are directly or indirectly responsible for their company’s violation.

## Arbitration

Individuals and entities capable of entering into contracts can have disputes related to negotiable rights resolved through arbitration, according to the terms of Law 9,307/96 (Brazilian Arbitration Law).

This Law states that arbitration can be initiated by the parties through: (i) an arbitration clause (*cláusula compromissória*) in a contract; or (ii) an arbitration commitment (*compromisso arbitral*).

The arbitration clause provides that the parties agree to submit to the arbitration of eventual disputes that may arise from their contractual relationship. The arbitration commitment is an agreement prepared after a specific dispute has arisen whereby the parties agree to take an issue to an arbitration court.

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 be based on the general principles of law, equity, customs and uses, and the rules of international trade.

Furthermore, the arbitration clause or commitment must elect the procedural rules to be applied and the arbitration court responsible for the arbitration.

Arbitrators may be appointed by the parties or selected by the arbitration court at the request of the parties and may rule on matters of fact or law. The decision issued by the arbitrators cannot be subject to judicial review, appeal or ratification.

## Foreign arbitral decisions

Brazil is a signatory of the Convention of New York of June 10, 1958, on the recognition and enforcement of foreign arbitration decisions. In order for a foreign arbitration court decision to be enforced in Brazil, it must be ratified by the Brazilian Supreme Court (*STF*).

The ratification may be denied in exceptional cases such as when the dispute matter may not be decided by arbitration according to Brazilian law, and when the arbitration decision violates Brazilian public policy.

## Bankruptcy

### Introduction

Law 11,101/05 is the new Brazilian Bankruptcy Law, also known as the Corporate Recovery Law. Enforceable since June 9, 2005, it governs judicial and extrajudicial recovery, as well as the bankruptcy of legal entities and individuals engaged in business activities.

The new preference order for credits is: (i) labor credits, limited to 150 minimum wages per creditor; (ii) secured guarantee credits (up to the value 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 companies, 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 preserve jobs and to protect the social function of the companies.

In general, the purchaser of assets which formerly belonged to a bankrupt business will not be responsible for the tax, labor and civil obligations of a debtor in bankruptcy or judicial recovery.

### Judicial recovery

Judicial recovery substitutes *concordata* and its adoption is conditioned upon compliance with certain requirements of the law.

When judicial recovery is granted, the debtor is entitled to a period of 180 days whereby almost all lawsuits and collection procedures against it are suspended (except for tax collections that may grant more flexible payment conditions).

Within 60 days of the decision's publication approving the debtor's judicial recovery request, the debtor must submit a judicial recovery plan to the court detailing the proposed recovery process.

After the presentation of the judicial recovery plan by the debtor, the judge may approve the judicial recovery after verifying that all legal requirements have been met. 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 rejection of the plan.

A judicial recovery proceeding will be converted into bankruptcy when: (i) the debtor fails to submit a recovery plan within the deadline set forth 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 two-year period from the judicial recovery approval date set by the judge.

### **Extrajudicial recovery**

In the extrajudicial recovery proceeding, 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 involvement of the judge is limited to the legality verification of the procedures adopted by the parties.

The judge's ratification of the extrajudicial recovery plan does not avoid eventual lawsuits or collection procedures against the debtor, or bar the filing of a bankruptcy petition 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. The comparable uncontrolled price method (*PIC* and *PVEx*) is the only method available to test both import and export transactions. The other methods do not consider comparability factors or reflect the objective of reaching an arm's length result.

Although the names of the methods coincide with those 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 are as follows:

- The rules are applicable to transactions between a Brazilian entity and its exclusive distributor regardless of the shareholding relationship between the parties.
- The rules are also applicable to transactions between an entity or individual taxpayer resident or domiciled in Brazil and any corporate or individual taxpayer, 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.
- Brazilian provisions do not foresee the "best method rule." 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 or 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\$ 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 on the annual income tax return. The detailed calculations should be kept by the taxpayer to have available for the tax auditor when required during an audit.

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 occurrence of one of the following hypotheses, the taxpayer may benefit from the safe harbors provided by law:

- 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.
- When the net income from exports during the calendar year does not exceed 5% of total net income during the same period.
- When a corporate entity demonstrates that it has calculated net pretax profits from export income to related companies equivalent to a minimum of 5% of its total income. 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 revenue value recognized based on the price practiced, which may be contested, if listed as 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 (PVE<sub>x</sub>):** Comparison of the sales price with the average sales price on exports to non-related parties for equivalent or similar 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.

### **Special rule for export transactions undertaken in 2005**

With respect to the export transactions undertaken during fiscal years 2005, 2006 and 2007, 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 permits the adjustment of export revenues by the multiplication factor of 1.35, 1.29 and 1.28, respectively. This adjustment has no impact other than for transfer pricing purposes.

## Chapter 16

# Corporate Sustainability

The evolution of the concepts of Corporate Social Responsibility (CSR) and Corporate Citizenship have given rise to the new broader term, Corporate Sustainability, which has superseded the former concepts when referring to ethical corporate practice.

The main characteristic differentiating Corporate Sustainability from the aforementioned concepts is the fact that Corporate Sustainability describes business practices considering economic, social and environmental issues. Consequently, a company that complies with the main principles of corporate sustainability will take all of its stakeholders into account, i.e. investors, employees, suppliers, customers, etc. In this regard, corporate responsibility may be defined as the commitment of businesses to practice sustainable economic development by working with the employees, their families, the local community and society at large to improve their quality of life.

Corporate Sustainability is easier to talk about than it is to implement. From a practical point of view, the main difficulty is associated with integrating Corporate Sustainability into the company's strategy and operations, which are becoming increasingly complex, especially in the context of the current economy.

Corporate Sustainability is becoming more common in Brazilian companies due to the negative perception of social and environmental practices in Brazil. The root of Corporate Sustainability traces back to the start of Corporate Responsibility in Brazil, which dates back to the 1980s during Brazil's re-democratization. The main activities related to Corporate Responsibility focused on social issues, driven by domestic concerns and domestic players.

In this sense, Corporate Sustainability activities have been largely philanthropic and associated particularly with investment in the community.

Recently, a rise in public pressure on Brazilian companies has led them to follow a more strategic approach to Corporate Sustainability. For instance, in December 2005, the São Paulo Stock Exchange (*BOVESPA*) launched a Corporate Sustainability Index, or 'ISE', similar to other international indices, which are linked to the US Dow Jones or the UK FTSE. ISE is an index designed to measure the Corporate Sustainability performance and disclosure of a portfolio composed of shares of companies highly committed to social responsibility and corporate sustainability, and to promote good practices in the Brazilian corporate environment. Currently, ISE includes 40 companies and has grown approximately 105% since it was launched.

Similarly, the *BOVESPA* launched the Corporate Governance Stock Market Index (*Índice de Ações com Governança Corporativa Diferenciada or IGC*), which tracks the performance of a portfolio made up of companies that demonstrate high levels of corporate governance. This portfolio includes all companies listed in *BOVESPA's* New Market, Level 1 and Level 2.

Corporate Sustainability has become a necessary practice for companies, independent of their industry and/or business practice, as they are faced with more complex issues at a social and environmental level. This has also been the case in Brazil, as companies are faced with increasing pressure from stakeholders to integrate their business strategies with social and environmental concerns. However, due to the increasing complexity of the current globalized economy, and the practical issues that arise when implementing Corporate Sustainability, this still remains a matter to be addressed by many Brazilian companies.

## Chapter 17

# KPMG in Brazil

KPMG is a global network of professional firms providing audit, tax, and advisory services. We operate in 145 countries and have more than 123,000 professionals working in member firms around the world.

### Our history

The name KPMG was created in 1987 after the merger of Peat Marwick International (PMI) and Klynveld Goerdeler (KMG), and the individual member firms. Our history has been marked by the names of our main founders, whose initials form the name “KPMG.”

**K** stands for Klynveld. Piet Klynveld founded the accounting firm Klynveld Kraayenhof & Co. in Amsterdam, in 1917.

**P** is for Peat. William Barclay Peat founded the accounting firm William Barclay Peat & Co. in London, in 1870.

**M** stands for Marwick. James Marwick founded the accounting firm Marwick, Mitchell & Co. with Roger Mitchell, in New York City, in 1897.

**G** is for Goerdeler. Dr. Reinhard Goerdeler was the first President of the International Federation of Accountants, and was the Chairman of KMG for several years. He is credited with laying many of the foundations for the Klynveld Main Goerdeler merger.

## **Our values**

Our values create a sense of shared identity within the KPMG organization. They define what we stand for and how we do things. They help us to work together in the most effective and fulfilling way, and they bring us closer as a global organization.

**We lead by example** — at all levels acting in a way that exemplifies what we expect of each other and our clients.

**We work together** — bringing out the best in each other and creating strong and successful working relationships.

**We respect the individual** — respecting people for who they are and for their knowledge, skills, and experience as individuals and team members.

**We seek the facts and provide insight** — challenging assumptions, pursuing facts, and strengthening our reputation as trusted and objective business advisors.

**We are open and honest in our communication** — sharing information, insight, and advice frequently and constructively and managing tough situations with courage and candor.

**We are committed to our communities** — acting as responsible corporate citizens and broadening our skills, experience, and perspectives through work in our communities.

**Above all, we act with integrity** — constantly striving to uphold the highest professional standards, provide sound advice, and rigorously maintain our independence.

## **Today**

Accounting standards worldwide are undergoing profound changes, and the regulatory area is being transformed. KPMG, the clients we serve, 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 2007: our income reached US\$ 19.81 billion, representing an increase of 17.4% compared to the previous year.

This overall performance is due, in part, to significant growth in all of our functional service areas – audit, tax and advisory, and our five business lines in our three geographic regions.

Our regional strategy combines the practices of countries from three distinct geographical regions. This has enabled us to accumulate resources and share best practices in the most effective manner to the benefit of our clients, as well as achieving greater efficiency in our infrastructure and support services.

The 2007 financial results reflect significant growth in all three of KPMG’s geographic regions worldwide. Recorded revenues in KPMG’s Americas region were US\$ 6.59 billion and KPMG’s Asia Pacific revenues were US\$ 2.55 billion, representing annual growth of 33% and 13%, respectively. The largest growth was in KPMG’s European, Middle Eastern and African regions (includes India), which recorded revenues of US\$ 10.67 billion, an increase of 54%.

## **What we do**

We help national and international organizations to meet their challenges.

These organizations are under constant pressure to deliver quality results while contending with a wide range of risks that can threaten their survival. Multinational companies must also address the additional demands of operating within different legal, financial, political and social systems, and managing complex cross-border issues.

We provide audit, tax, and advisory services, delivering a globally consistent set of multidisciplinary financial and accounting skills and capabilities based on deep industry knowledge.

Our focus on global industries helps us to develop a rich understanding of our clients’ businesses and the insight, skills and resources required to address industry-specific issues and opportunities.

Global capability and consistency are central to the way we work. By providing international organizations with the same quality of service and behavior around the world, we can work with them wherever they choose to operate.

**Note:** Throughout this overview of what we do, “KPMG” refers to KPMG International, a Swiss cooperative and/or its member firms, including subsidiaries

and sub-licensees, as applicable. KPMG International does not provide services to clients; its member firms are responsible for providing services.

### **Brazil - continual growth**

In 2007, we grew by 32%, reaching revenues of US\$ 178 million.

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 providing our people with the 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 located in:

- Belo Horizonte (MG)
- Brasília (DF)
- Campinas (SP)
- Curitiba (PR)
- Fortaleza (CE)
- Goiânia (GO)
- Jaraguá do Sul (SC)
- Manaus (AM)
- Porto Alegre (RS)
- Recife (PE)
- Rio de Janeiro (RJ)
- São Carlos (SP) Global Services

KPMG is one of the leading providers of audit, tax and advisory services. KPMG member firms respond to clients' complex business challenges with a global approach to services that spans industry sectors and national boundaries.

An independent audit is one of the foundations for establishing trust in the capital markets. KPMG is dedicated to providing the resources and technological tools necessary to support KPMG firms' engagement teams as they deliver audit services to a wide range of clients.

KPMG's Tax services are designed to reflect the unique needs and objectives of each client, whether dealing with the tax aspects of a cross-border acquisition

or developing and helping implement a global transfer pricing strategy. KPMG firms work with their clients to assist them in achieving effective tax compliance and managing tax risks, while helping to control costs.

KPMG Advisory professionals provide advice and assistance to enable companies, intermediaries and public sector bodies to mitigate risk, improve performance, and create value. KPMG firms provide a wide range of Risk Advisory and Financial Advisory Services that help clients respond to immediate needs as well as put long term strategies in place.

## **AUDIT**

An independent audit of financial statements is crucial for effective operation in the capital markets. Audit quality is vital for maintaining trust in the financial reporting process and the integrity of financial information. Audit teams equipped with a high level of technical skills and empowered with professional skepticism provide the heart and soul of a good audit. In addition, we believe:

- Audit methodologies must focus on fundamentals and guide good audit judgments.
- Technology can provide for effective information gathering, allow for critical data comparisons, and enhance contextual analysis.
- Compliance tools help the auditor meet professional and regulatory requirements.
- Cultural values should encourage sound judgment and objectivity.

KPMG's approach to audit services addresses each of these areas.

A multidisciplinary approach means audit engagement teams include experienced professionals in such areas as forensics, tax, information risk management and valuation. This gives the team a broad understanding of an organization and enables them to focus on the key areas of risk, adequacy of internal controls, and potential fraud.

Using KPMG's global training platform, our professionals have access to industry training, technical skill building, and instruction in KPMG's audit methodology.

Recognizing the importance of audit committees, KPMG established the Audit Committee Institute (ACI) to help provide a resource to audit committee members in order to keep pace with evolving business issues related to governance, audit issues, accounting, and financial reporting.

KPMG understands the increased regulatory pressures that companies are facing. In 2004, KPMG launched the 404 Institute to provide a forum where organizations could learn more about the requirements of section 404 of the Sarbanes-Oxley Act, share leading practices, and discuss ways to address the evolution of effective internal controls.

We believe organizational culture has a significant impact on audit quality. Central to our culture are our values and code of conduct, which are fundamental to how business is done. KPMG member firms understand and value their roles in the capital markets and will continually seek to enhance the perception of our profession by supporting our people, strengthening quality, and affirming the importance of trust and integrity.

## **TAX**

Taxation is a fundamental part of how every country and company operates. Tax policy needs to be shaped and actively managed by governments and corporations alike.

From a corporate viewpoint, tax governance is a rising priority as legislation becomes more complex. We work with our member firms' clients to establish tax policies and processes, which determine that compliance responsibilities are met, planning opportunities are realized, and there is appropriate communication with the markets and regulators. Management can then communicate that taxation is under control and get on with running the business.

We use our in-depth technical tax knowledge and our broader understanding of how tax fits into the wider business picture to help clients meet their compliance responsibilities and act on planning opportunities. Whether you are a business or an individual, we work as a team to help achieve your objectives.

This mentality is reinforced by our ability to assemble multi-disciplinary teams of professionals, drawing on KPMG's dedicated resources and global network not only in tax, but also in audit and advisory work. Our people operate within industry groups, giving you access to advisors who understand your specific tax issues and skillfully use technology to assist data extraction and management. We also maintain regular and constructive dialogues with the tax authorities.

We strive to build and maintain the trust, respect and confidence not only of our clients and tax authorities, but also of the communities in which we

operate. We believe this commitment plays a major role in KPMG's regular endorsement as a trusted and valued advisor, as well as a respected, responsible employer of choice.

The KPMG 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**

These days, for a company to be successful it has to make the most of the opportunities that are continually offered by the market. At the same time, it is fundamental that they manage the possible risks that may arise from these operations.

Our organization, in an integrated manner, can help companies manage their risks and thus help them assume greater challenges related to their finances and implement strategies that may enhance their results.

### **Financial Advisory Services (FAS)**

The KPMG in Brazil FAS practice offers solid, independent advisory services, and is aimed at providing the tools and information necessary for decision making capable of defining the success of a transaction. Our work is based on our extensive portfolio of services including advisory services for mergers and acquisitions, structured financial operations, business valuations, company restructuring, fraud risk management and due diligence.

### **Corporate Finance**

Its work is focused on the merger and acquisition of companies (M&A).

## Structured Finance

Offers advisory services to public and private clients for infrastructure projects and public services through the following services: (i) structuring of *PPP* projects or concessions for governments; (ii) manifestations of interest by private entities in *PPP* projects; (iii) participation in public bids and financing for *PPP* projects and concessions; (iv) structuring of project finance; and (v) other related services, such as structuring of *PPP* units and *PPP* guarantor funds, economic and financial viability analysis, value-for-money analysis, and renegotiations of contracts.

## Restructuring

Offers solutions that enable underperforming companies to stabilize their situation and implement strategic, operating and financial change processes.

## Forensic

Advises companies with respect to assessing their vulnerability to risks and investigating fraud. It also provides risk prevention services related to disputes, class actions, expert testimony and support in verifying insurance claims.

## Transaction Services

Provides advisory services in the areas of due diligence, vendor due diligence and other strategic questions (Strategic Commercial Intelligence) for companies involved in mergers and acquisitions, sales and restructuring. The focus is on creating value, reducing risks and carrying out successful transactions with both Brazilian and international companies.

## Information Risk Management (*IRM*)

Work focuses on the risks inherent to information systems used to support the business objectives of our clients. We stress information technology risk management benchmarking (ITRMB), assessment of external and internal vulnerabilities, analysis of business processes and review of information technology controls.

## Internal Audit Services (*IAS*)

- Risk assessment – Identification, assessment and management of the business risks that affect a company's objectives and strategies;
- Internal Audit – Assessment and monitoring of regulatory and strategic risks, with the aim of adding value to companies and identifying opportunities for improvement;

- Corporate Governance – assistance to management in maintaining sustainable companies, worthy of market trust and capable of returning the value of the investment to their shareholders. It also includes compliance with the rules of the Sarbanes-Oxley Act, *BOVESPA*, *SEC*, etc.

### **Business performance services (BPS)**

Focuses on improving a company's performance by helping align its business dealings with market regulations.

### **Human Resources Advisory Services (HRAS)**

The Human Resources Advisory Services practice offers customized services, not only for contracting executives (Executive Search) and professionals (Recruitment and selection of specialists) but also for assessing talent (Assessment).

We provide advisory services for our clients on training and holding onto their leaders (Human Development) and on improving performance and adapting to the organizational environment (Executive Coaching).

We offer support for our clients on planning and communicating changes that might have an impact on their professional staff (Downsizing and Rightsizing). We also offer support for professionals who have left the company during this transition (Career Counseling/Outplacement) to ensure that the employees who remain with the company continue to be motivated.

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