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# Brazil

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# BRAZIL

*The following is a review of recent legal and economic developments in Brazil.*

## I. Presidential Decisions

### *Corporate Income Tax*

The President approved Decree-law No. 2.354 on August 24, 1987, eliminating the requirement for companies to file bi-yearly income tax returns. Furthermore, companies with profits of more than 40,000 National Treasury Bonds (OTN) in the last fiscal year shall, from September on, make pre-payments for income tax owed for the 1988 fiscal year.

### *Reduction of IPI Tax Rate for Automobiles*

Decree No. 94.746 of August 7, 1987, executed by the President, reduced the tax on manufactured products (IPI) on passenger and utility automobiles and trucks. The IPI rate for passenger cars with gasoline engines of up to one-hundred horsepower was reduced from eighty percent to forty-five percent, and the IPI rate for alcohol-powered automobiles with the same horsepower was reduced from seventy-three percent to forty percent.

### *New Rates of Withholding Tax*

The President signed Decree-law No. 2.356 of August 28, 1987, altering the table for the calculation of withholding tax. The main changes introduced by the new table are: (a) an increase in the discount per dependent from Cz 750,00 to Cz 2,000,00; (b) the creation of a new rate of fifty percent for net monthly income above Cz 165,850,00; and (c) the elimination of the former eight percent rate for net income of Cz 8,201,00 to Cz 16,613,00.

### *Agreement on Scientific and Technological Cooperation Between Brazil and West Germany*

The President signed Executive Decree No. 94.513, bringing

into effect the Agreement on Scientific and Technological Cooperation between Brazil and the Federal Republic of Germany, signed in Brasilia on November 22, 1984. The Agreement was ratified by Congress through Legislative Decree No. 21, and went into effect between the parties through an exchange of notes executed in Berlin on April 3, 1986. The Agreement provides for cooperation between both countries through the exchange of scientists and representatives of industrial and commercial organizations, scientific information and documentation, the organization of seminars and the joint investigation of scientific and technical issues.

*Civil Aviation*

Executive Decree No. 94.711, signed on July 31, 1987, assigns to the Civil Aviation Coordination Commission (CCTAC) the following functions:

(a) to propose measures to assure the harmonious development of the airline industry;

(b) to review the technical, financial and economic aspects of applications to import and export civil aircraft; and

(c) to provide compensation in the form of services and products manufactured in Brazil for the acquisition of aircraft for airline companies.

CCTAC, which is composed of officers from the Civil Aviation Department (DAC) and from Banco do Brasil S.A. (the commercial bank controlled by the federal government), will review all applications for importation of aircrafts and parts. The decision on any such application will be submitted to the Minister of Aeronautics for final approval. Executive Decree No. 94.711 also lists the criteria to be applied by CCTAC when reviewing aircraft import applications by airlines.

*Federal Administration Contracts*

The President executed Decree-Law No. 2.348 on July 24, 1987, which governs the bidding procedures for administrative contracts related to works, services, purchases, dispositions, concessions and leases within the federal administration.

### *Federal Contracts - Price Adjustment*

Executive Decree No. 94.684 regulates price adjustments in contracts to be executed by the federal administration. Under the new decree, the National Treasury Bond (OTN) index will be used in the adjustment of contract prices. Contracts for works or services, or for the production or supply of goods for future delivery are not subject to application of the OTN index. Such contracts may contain adjustment clauses based on indices reflecting the variation of the production costs or prices of the inputs used, or sectorial or regional cost or price indices.

### *Brazilian Fund*

On July 23, 1986, the Executive Branch enacted Decree-Law No. 2.385, granting tax benefits to foreign portfolio investments. This Decree-Law was subsequently regulated by Central Bank of Brazil Resolution No. 1.224, which specified the ways in which foreign portfolio investments could be made in Brazilian capital markets. Resolution No. 1.224 was replaced by Resolution No. 1.289 of March 20, 1987, which consolidated all rules applicable to the three structures through which foreign portfolio investments can be channeled into Brazil.

On June 25, 1987, the Securities Commission (CVM), also in charge of regulating foreign portfolio investments in Brazil, issued Instruction No. 67 and Resolution No. 51, further regulating the formation and management of managed portfolios, a structure for portfolio investment in the Brazil Fund. Instruction No. 67 establishes the conditions precedent for the granting of authorization for the incorporation and management of a managed portfolio. Accordingly, any foreign entity interested in establishing and managing a managed portfolio in Brazil must incorporate a publicly-held investment company whose sole purpose is to invest in the Brazilian capital markets. Funds for the formation of the portfolio must be raised through a public order of shares or units outside of Brazil. Instruction No. 67 also details the necessary steps a foreign institution must take to obtain authorization from the Commission.

Resolution No. 51 provides that authorization for the formation of a managed portfolio is valid only for one year, and also stipulates the requirements that the investment company formed to invest in Brazil, must fufill. Two such requirements are a mini-

mum initial capital of one hundred million U.S. dollars, and a listing on a foreign stock exchange. A few days after the release of Instruction No. 67 and Resolution No. 51, the Securities Commission announced that The First Boston Corporation had been granted authorization to incorporate the Brazilian Fund and manage the public offer of its shares.

### *Monetary Correction of Financial Statements*

The President signed Decree-Law No. 2.341 on June 29, 1987, introducing new rules for the monetary correction of financial statements for base periods ending in 1987, for purposes of determining the taxable profits of legal entities.

### *Leasing Transactions*

Through Decree-Law No. 1.960, of September 24, 1982, the President authorized the Executive Branch to contract for or guarantee rental payments under leasing transactions by state companies. Now, by means of Decree-Law No. 2.353, of August 11, 1987, the President has added a paragraph to article 1 of Decree-Law No. 1.960 to provide that, in exceptional cases, such transactions or guarantees may be executed for legal entities established in Brazil, including in the event of sale, a clause providing for compulsory leasing of the item sold to its original owner.

### *SEI Controlled Imports*

On August 3, 1987, the President approved Justification Statement No. 7 of the Economic Development Council, proposing that the limit established by Justification Statement No. 241/87 of the Planning Office, exclude imports authorized by the Special Informatics Office (SEI) for the current year if the imports are intended to be fixed assets of the company and made without exchange coverage as a foreign capital investment.

### *Incentives for Steel Production*

The President signed Decree-Law No. 2.350 of July 31, 1987, which deals with the tax incentives granted to companies controlled by Siderurgia Brasileira S.A.-SIDERBRAS (SIDERBRAS Group) under law No. 7.554/86. This law determines that as an

incentive to increase production, those steel companies that satisfy certain conditions may credit the equivalent of ninety-five percent of the difference between the amount of Tax on Manufactured Products (IPI) owed on the products that leave their plants, and the credit for such tax on entries of raw materials, intermediary products and packaging materials acquired for use in the manufacture and conditioning of such products in each assessment period. The amount of the incentive will be credited exclusively to units of companies controlled by SIDERBRAS.

### *Minimum National Wage*

Decree-Law No. 2.351 of August 7, 1987, creates the minimum compensation payable directly by employers to all workers for a normal workday. The initial minimum wage is Cz 2,400,00 per month. The Decree-Law also changed the name of the minimum wage to Minimum Reference Wage to serve as an index for social security, contractual, and legal obligations. The minimum reference wage was established at Cz 2,062,31.

## II. Central Bank Resolutions

### *Debt-to-Equity Conversion*

*1. Introduction.* The Central Bank of Brazil has not yet established precise rules for debt to equity conversion; however, the Central Bank has decided that applications submitted before July 20, 1987, will be processed according to the rules then applicable, as set forth in Circular Letter No. 1125, of November 9, 1984. Applications submitted subsequently will be processed in conformity with rules yet to be established. Great interest centers around these new rules because they may facilitate new investments and permit the creation of new jobs. The new rules may also open the path for privatization. The political debate on the matter is intense, however, and this debate is delaying the establishment of the new rules. On August 7, 1987, the newspaper, O Globo, published proposed regulations submitted to the Minister of Finance. The regulations published in O Globo are not necessarily those that will be issued by the monetary authorities, but they do provide a good indication of what path Brazil eventually will adopt. The regulations deal separately with capitalization of interest and capitalization of principal. Also, specific rules are established for relending. The following are the main points of such proposed

regulation.

2. *Capitalization of Interest.* When Brazil declared a moratorium on payments of interest to foreign creditors, the Central Bank issued Resolution No. 1263, of February 20, 1987, determining that the interest due to foreign financial institutions on transactions continuing in excess of 360 days be deposited with the Central Bank, in foreign currency, in the name of the respective creditors. The proposed regulation provides that such interest may be paid by means of *Bonus da Republica* (Bonds of the Republic). These bonds are freely negotiable abroad and qualify for the debt-equity conversion program.

The conversion will be made pursuant to an auction system, and the winners will be those proposals that combine debt conversion with the largest supply of fresh funds to the country. In order to participate in the auction, the proposals must first be submitted to the Central Bank for prior approval. The Central Bank will scrutinize the proposals to ensure compliance with the legislation and rules concerning foreign investments.

Additional rules applicable to the system for capitalization of interest are as follows:

(a) the amount resulting from conversion of interest must remain in the country for a minimum period of eight years. Additional fresh funds will not be subject to this restriction;

(b) converted funds cannot be invested in the acquisition of foreign investments already existing in the country, unless there is re-utilization of such funds in other projects, which shall remain subject to the same rules;

(c) remittance of profits and dividends is not permitted for a period of three years, during which time the profits must be reinvested, except in the case of export projects which have been approved by the Comissao para Concessao de Beneficios Fiscais a Programas de Exportacao (BEFIEX - Commision for the Granting of Tax Incentives to Export Programs). This restriction does not apply to profits attributed to additional investments with fresh funds;

(d) registration of the investment will be at par;

(e) there will be no ceiling for monthly auctions;

(f) the negotiation of future interest, prior to maturity, will be free, and conversion into investments will be made independently

of any auction. This conversion remains subject to the minimum period of permanency in the country, but is not subject to restrictions on remittances of profits.

*3. Capitalization of Principal.* The proposed regulation provides for rules similar to those established by Circular Letter No. 1125/84, in force until July 20, 1987. Basically, the program is valid only for original creditors, and there is no fresh-funds requirement on the debt to equity conversion. On the other hand, negotiation abroad is not permitted. Additional rules applicable to the system of capitalization of principal are as follows:

(a) the minimum period of permanency in the country must be fourteen years;

(b) the funds cannot be invested in the acquisition of foreign investments already existing in the country, unless other funds are used in other projects which remain subject to the same restrictions applicable to the conversion of the principal;

(c) remittance of profits and dividends shall not be permitted for a period of six years during which the results must be reinvested; furthermore, investors shall be permitted to switch the currency only once on conversion;

(d) a monthly ceiling will be established.

*4. Additional Rules.* The purpose of the entire debt-equity program is to avoid denationalization of the economy. To achieve this end, as previously stated above, the resources of conversion cannot be invested in the acquisition of foreign investments already existing in the country, unless such funds are reinvested in other projects. Further, the utilization of funds derived from the debt-equity conversion program shall be limited to fifty percent of the value of the transaction with respect to purchases of already existing Brazilian companies. For the purpose of diversifying the investments resulting from the debt-equity conversion program, investments are limited to a minimum of five percent and a maximum of twenty percent of the capital of each invested company. On the other hand, to promote exports, 100% of funds may be applied, as long as the project has been approved by BEFIEX, even in cases of subsidiaries of foreign companies already established in Brazil.

*5. Relending.* O Globo also discusses the relending system. The relending program must be compatible with the debt-equity con-

version program. The important points of the relending program are as follows:

(a) a monthly ceiling will be established which shall take into account the requirements of the public sector;

(b) relending may only be made by the original holders of the Central Bank deposits, and the assignment of credits abroad shall not be permitted either for interest payment deposits or principal payment deposits;

(c) a debt-equity ratio will be adopted for companies with foreign capital, to avoid the use of relending to circumvent restrictions imposed by the debt-equity conversion program. The ratio will be fifteen percent to eighty-five percent. In computing the ratio, indebtedness resulting from new funds will not be considered;

(d) the minimum period for relending of principal is fourteen years, and eight years in the case of relending of interest;

(e) interest on the relending of principal will not qualify for remittance abroad for six years, and three years in the case of relending of interest. During these periods interest must be capitalized.

In addition to the rules set forth in the preceding paragraphs, funds from relending cannot be utilized for the acquisition of foreign investment already in the country, following criteria similar to those imposed on conversion of principal and interest. Furthermore, companies that have repatriated capital within the last two years will not qualify for relending.

6. *Investment Funds*. The Central Bank issued Resolution No. 1.365, dated July 30, 1987, amending article 77 of the regulations attached to Resolution No. 1.280 of March 20, 1987, which governed the organization, management and operation of mutual stock funds. Now, at least ten percent of the portfolio of mutual stock funds must be represented by shares issued by publicly-held companies. The remaining funds may be invested in federal debt instruments, debentures or other securities. The new Resolution alters the percentages on the disposability of funds.

On August 13, 1987, the Central Bank then issued Circular No. 1.217, establishing that short-term investment funds must be represented as follows:

(a) at least eighty percent of the fund must be put into Central Bank Bonds;

(b) the remaining funds may be invested separately or cumulatively in federal and state government debt instruments; certificates of deposit, and bills of exchange issued by credit companies; and securities of institutions qualified to carry out committed transactions, linked to repurchase commitments assumed by the institutions for payment within a maximum period of twenty-eight days.

## III. Ordinances of the Ministry of Finance

### *Financial and Economic Relations with Japan*

On June 25, 1987, the Minister of Finance issued Ordinance No. 196, establishing a task force within the Ministry of Finance to review and study the financial and economic relations between Brazil and Japan. According to the ordinance, this group shall be responsible for the following:

(a) assisting the Ministry with domestic and international agencies regarding plans, programs and projects related to Japan, and organizing a system to process economic, financial and technological information, with the support of data banks in Brazil and abroad;

(b) planning, coordinating and promoting initiatives related to the identification of exchange opportunities with Japan, as well as attracting direct Japanese investments in association with Brazilian companies;

(c) following up on the execution of plans, projects and programs financed with Japanese funds and providing the Minister of Finance and the Special Secretary for Economic Matters with progress reports;

(d) reviewing such economic, commercial, industrial, technological and financial Japanese policies as are of interest to the Brazilian government and economy; and

(e) preparing a master plan for economic, financial and technological exchange between Brazil and Japan.

The formation of the task force followed the Japanese government's announcement that it is forming a thirty billion dollar fund to help Third World debtor nations.

*Price Freeze Adjustments*

Ordinance No. 200 on July 2, 1987, provides that supplies, work, or services under contracts listed in article 14 of Decree-Law No. 2.335 may have their prices adjusted by applying the contractual adjustment indices up to the month of June 1987, if they are linked to a monthly adjustment clause or subject to correction up to the date of a contractual event, when carried out during the price freeze. After the price freeze, the normal adjustments provided for in the contract will be fully applied again. Contracts providing for adjustments every two, three, four, six or twelve months remain frozen at the price level prevailing on June 12, 1987. After the price freeze, these contracts will be subject to an extraordinary adjustment on the bases established in the contract, and will be adjusted normally at the previously established intervals.

*Price Adjustments*

The Minister of Finance issued Ordinance No. 297/87, determining that, when the phase of flexible prices begins as established in Decree-Law No. 2.335/87, the adjustment of the prices of goods and services will be subject to the provisions of the Ordinance. The main purpose of the Ordinance is to classify prices according to the respective producers and merchants. For manufacturers, prices will be classified as strictly controlled by CIP, subject to a maximum percentage adjustment equal to the percentage variation in the URP (Price Reference Unit) and free. For merchants, prices will be classified as subject to price lists, subject to limitation of the sales margin, subject to a maximum percentage adjustment equal to the percentage variation in the URP and free.

*Incentive for Exports of Manufactured Products*

The Minister of Finance also issued Ordinance No. 290/87, determining that a company showing that it increased exports of its own manufactured products will enjoy tax exemption on certain imports. This exemption shall apply to import duties and to the Tax on Manufactured Products on imports of goods worth up to ten percent of the increase in FOB exports. The exemption will be effective from the 1987 fiscal year to December 31, 1991, on the conditions described in the Ordinance.

### *Taxation of Foreign Investment*

Ordinance No. 217 on July 7, 1987, amends the rules applicable to the calculation of capital gains in the repatriation of foreign investment registered with the Central Bank. Prior thereto, the repatriation of foreign investment with capital gains was not subject to taxation if the total amount repatriated was less than the total amount of foreign investment registered with the Central Bank. According to the rules now specified in Ordinance No. 217, capital gains are calculated and then subject to taxation whenever the amount of capital repatriated, and the total number of shares disposed of, are not proportional to the total number of shares held by the foreign investor and to the total foreign investment registered with the Central Bank. Repatriation of foreign capital without capital gains, however, remains tax-exempt as provided for in Law No. 4.131 of September 2, 1962, as amended. The ordinance attempts to avoid the remittance of dividends abroad disguised as repatriation of capital.

## IV. Judicial Decisions

### *Income Tax on Remittances Abroad*

A branch of a foreign company authorized to operate in Brazil is equivalent to a legal entity with its own legal personality for many aspects of tax law. The branch may acquire shares of another foreign company that invests in Brazil and remit payments to a seller abroad as a repatriation of foreign capital. The registration of the investment at the Central Bank will then be cancelled. The transaction is classified as a repatriation of capital and not as a remittance of profits (Decision No. 103-07.723 of the 3rd Chamber of the 1st Taxpayers Council, 1987).

### *Telephone Conversation Admissible as Evidence*

The reproduction of a sound recording of a telephone conversation is admissible as evidence whether or not the opposing party is aware of the recording (Decision of the 2nd Chamber of the 2nd Higher Civil Court on Interlocutory Appeal No. 209.028-2).

### *Service Companies: Are Their Activities Lawful?*

Brazilian labor law distinguishes service companies from temporary employment companies. Service companies, such as security and cleaning services, provide third companies with services not directly related to their businesses. On the other hand, temporary employment companies provide temporary employees to other companies. Labor courts held that a temporary employment company and the company to whom a temporary worker is provided are jointly and severally responsible for the labor obligations due to the temporary worker.

In April 1987, the Labor Court for the Tenth Circuit held that the activities of service companies are legal and are different from temporary employment companies. The court also held that the activities of service companies are not subject to the provisions of article 9 of Convention No. 95 of the International Labor Organization. Article 9 of Convention No. 95 tries to ensure that no direct or indirect payment by a worker to an employer or his representative, agent or intermediary is made for the purpose of obtaining or keeping employment. Although the purpose of service companies is to serve third parties in general, these companies contract with employees, pay salaries and manage services rendered, thus assuming the economic risks of the enterprise. The employment relationship between service companies and their employees does not involve the third parties to whom the services are rendered. The third parties merely enter into a contract with the respective service company under applicable contract law. Thus, the court confirmed the existence of an employment relationship between the service company and its employees. *Manoel Martins Espindola v. Confederal S.A. e Ind.* (slip op., Higher Labor Court, 10th Cir. June 6, 1987).

## V. Miscellaneous Decisions

### *Foreign Exchange Variations in the Financial Statements of Publicly-Held Companies*

The Securities Commission released Opinion No. 13 providing that the rules of Resolution No. 8 of January 8, 1987, on the deferment, by publicly-held companies, of the effects of foreign exchange rate variations on their financial statements, were only applicable for that specific year. The Commission further explained

that publicly-held companies must observe the following rules concerning foreign exchange variations on their financial statements:

(a) variations arising from adjustments in credits and obligations in foreign currencies are to be treated as income or expenses and shall be considered in the calculations for the respective fiscal year in which they occurred; and

(b) when foreign exchange rate variations refer to obligations arising from the financing of setting-up or pre-operating assets, the expenses defined as net financial charges will be added to the amount deferred for amortization as specified in the Corporation Law.

*Withholding Income Tax*

The Federal Revenue Service issued Normative Instruction No. 111 on August 19, 1987, providing that withholding income tax on earnings produced by securities or investments which have a term of twenty-eight days or less between purchase and transfer or redemption, cannot be offset against the tax due under the income tax return. This provision also applies in the case of withholding income tax on earnings produced during the period in which the securities are subject to an open market transaction, pursuant to Resolution No. 1.088 (which regulates transactions and commitments involving fixed-income securities). In such an event, the prohibition applies to tax on income produced as of September 1, 1987, even if the open market transaction started on a previous date.

*Re-enrollment of Foreigners*

By means of Ordinance No. 431 of June 30, 1987, the Minister of Justice extended until September 30, 1987 the period established in article 2 of Ordinance No. 559 of June 30, 1987, for the re-enrollment of foreigners that hold identity cards for foreigners.

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