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MP 252/05 – Amendment to Tax Legislation

Provisory Measure no. 252, dated June 15th, 2005 (“MP 252/05”), published on the Official Gazette (“D.O.U.”) on June 16th, 2005, amended certain provisions of the tax legislation currently in force and, more important, brought innovations to certain business sectors with the objective of fostering the Brazilian market.

Based on this context, we present to you our brief comments in relation to the most important points of the aforementioned MP, so as to assist you in the understanding of the modifications.

I - REPES

MP 252/05 instated the Special Method of Taxation for the Export of Information Technology Services (Regime Especial de Tributação para a Plataforma de Exportação de Serviços de Tecnologia da Informação - REPES), with the objective of rendering greater competitiveness in the international market to companies that exclusively perform activities in the area of software development and information technology services.

In order to benefit from REPES, the legal entity, in addition to exclusively performing activities in the aforementioned areas, must commit to export more than 80% of its annual gross revenues resulting from the sales of assets and services. It is important to mention that legal entities that have their revenues partially or totally submitted to the PIS and COFINS cumulative incidence methodology, legal entities enrolled in the Integrated System of Payment of Taxes and Contributions of Microcompanies and Small-Sized Companies (Sistema Integrado de Pagamento de Impostos e Contribuições das Microempresas e Empresas de Pequeno Porte - SIMPLES) and legal entities having overdue federal taxes and contributions are not entitled to this special method of taxation.

The main point of this Method is the suspension of the incidence of PIS/PASEP-Import and COFINS-Import on the import of new assets and services, to be listed in a specific regulation, for the performance, in Brazil, of software and information technology services, when imported directly by the beneficiary, and provided that they are allotted as fixed asset. Such application is extensive to internal sales to other legal entities that are beneficiaries of REPES.

The suspension mentioned in the aforementioned paragraph shall be converted to a zero rate in 5 years, counted from the date of occurrence of the respective triggering event.

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II - RECAP

The Special Methodology for the Purchase of Capital Goods for Exporting Companies (Regime Especial de Aquisição de Bens de Capital para Empresas Exportadoras - RECAP), is aimed at eliminating of the accumulation of PIS and COFINS credits by exporting companies, complementing the provisions of Law no. 10,865/04, which suspends the incidence of such contributions on the sale of raw material, intermediary products and packaging material, when directed to "preponderantly exporting legal entities".

In this sense, RECAP was instated to benefit "preponderantly exporting legal entities". "Preponderantly exporting legal entities" are those having gross revenue arising from exports, in the calendar-year immediately prior to that of inclusion in the special methodology, equal to or higher than 80% of their total gross revenue of sale of goods and services in such period. In addition, the legal entity must also commit to maintain this percentage of exports during the period of two calendar-years.

It is important to mention that legal entities that have just begun operations, or that did not reach, in the previous year, the aforementioned percentage of export revenues, can also qualify for this methodology, provided they commit to obtain, during the period of three calendar-years, gross revenues arising from export transactions corresponding to at least 80% of their total gross revenue of sale of goods and services.

With the inclusion in the RECAP, the legal entity will benefit from the suspension of PIS/PASEP-Import and COFINS-Import levied on the import of new machines, devices, instruments and equipment, to be listed in a specific regulation, when allotted as fixed asset of the beneficiary, which will be converted into a zero rate after the aforementioned requirements are met.

The inclusion in the RECAP is conditioned to the legal entity's tax regularity, regarding federal and tax contributions.

III – TECHNOLOGICAL INNOVATION INCENTIVES

In line with the legal provision that establishes that the Federal Government will foster the innovation in companies through the granting of tax incentives to scientific and technological innovation and research in the production line (article 28 of Law no. 10,973/04), legal entities are allowed to carry out:

(i) The deduction, for the purpose of ascertaining net profit, of an amount corresponding to the sum of expenses incurred within the ascertainment period with technological research and development of technological innovation for products, classifiable as operational expenses under the Corporate Income Tax ("IRPJ") legislation;

(ii) 50% reduction of the Tax on Industrialized Products ("IPI") levied on fixed assets used in technological research and development of technological innovation of products;

(iii) Accelerated depreciation of such fixed assets through the multiplication, by two, of the depreciation rate usually permitted, notwithstanding the normal depreciation, and also amortize, on an accelerated basis, through the deduction as cost or operational expense, in the period in which they are carried out, of the expenses relating to the acquisition of intangible assets, provided that they

are used in technological research and development of technological innovation of products, classifiable under the beneficiary's deferred assets, for the purpose of ascertaining IRPJ; and

(iv) The use of Withholding Tax ("IRF") credit levied on the amounts paid, remitted or credited to non-resident beneficiaries, as royalties, scientific and technical assistance and specialized services, established in agreements for the transfer of technology registered in accordance with the provisions of Law no. 9,279/96, in the following percentages: a) 20%, regarding ascertainment periods ended from 01.01.05 to 12.31.08; and b) 10%, regarding ascertainment periods ended from 01.01.09 up to 12.31.13.

In this sense, technological innovation is understood as the conception of a new product or manufacturing process, as well as the aggregation of new functionalities or characteristics to a product or manufacturing process, that ensue incremental improvements and effective quality or productivity gain, resulting in a greater competitiveness in the market.

Notwithstanding the provisions of items “i” through “iv” above, the legal entity, as of the 2006 calendar-year, may exclude from the net profit, in the ascertainment of the taxable profit and of the Social Contribution on Net Profit (“CSLL”), the amount corresponding to up to 60% of the sum of the expenses made within the ascertainment period with technological research and development of technological innovation, classifiable as expense under IRPJ legislation. Furthermore, this exclusion may reach up to 80% of the expenses, based on the number of researchers that are employed by the legal entity.

It is important to highlight that the aforementioned exclusion will be limited to the amount of taxable profit and of the CSLL calculation basis before the exclusion itself. The use of any possible excesses in the subsequent ascertainment period is expressly prohibited.

Finally, in accordance with legislation in force, expenses with fixed installations, devices, machines and equipment used in technological research and development projects, metrology, technical rulings and conformity assessment, applicable to products, processes, systems and personnel, procedures for the authorization of registrations, licenses, approvals and related forms, as well as procedures for the protection of intellectual property, are allowed to be depreciated.

IV – MICRO-REGION INCENTIVES

In order to incentive the regional development of poorly developed micro-regions located within the area of activities of the Northeast Development Agency (Agência de Desenvolvimento do Nordeste - ADENE) and the Amazon Development Agency (Agência de Desenvolvimento da Amazônia - ADA), the Brazilian government created certain incentives for legal entities having projects for the installation, increase, modernization or diversification of activities, provided such projects have been approved, inserted in economic areas considered to have priority in the regional development, as follows:

(i) Incentive accelerated depreciation, for the calculation of the IRPJ; and

(ii) Discount of PIS/PASEP and COFINS amounts levied on the acquisition of new machines, devices, instruments and equipment, to be listed in a specific

regulation, allotted as fixed assets, within the term of twelve months from the purchase, from the amount due for the contributions levied on the gross revenue.

V - CSLL

The term for legal entities taxed by the actual profit methodology to purchase new machines, devices, instruments and equipment, allotted as fixed assets and used in the industrial process of the purchaser, including the tax benefit of accelerated depreciation for the calculation of the CSLL, was extended to 12.31.06.

VI - IRPF

The modifications to the Individuals' Income Tax (Imposto sobre a Renda das Pessoas Físicas – IR) provisions basically regard the taxation of capital gains received on the sale of assets.

In accordance with the new wording given to article 22 of Law no. 9.250/95, the exemption limit of the IR levied on capital gains received in turn for the sale of assets and rights having a small value was increased to R$35,000.00. The previous limit (R$20,000.00) is now only applicable to the cases of sale of stocks traded in the stock-exchange market or over-the-counter market.

In addition, a new benefit was created, regarding the exemption of IR levied on the capital gains received in turn for the sale of residential real estate properties, as long as the seller uses the amount obtained in the sale to purchase another residential real estate property, within the term of 180 days, as of the date of execution of the sale agreement, subject to penalty and interest in case of failure to comply with the aforementioned provisions. In case the new purchase is made with only a part of the amount received at the time of the sale of the residential real estate property, the IR due in relation to the capital gain of the part that was not used in the new purchase will have to be ascertained.

However, this new benefit may only be used by individual taxpayers once every five years and is restricted to individual taxpayers resident and domiciled in Brazil for tax purposes.

In addition, a capital gain reduction factor, to be applied to gains ascertained in the sale of any kind of real estate properties, irrespective of the destination for residential or commercial purposes, was created. Such reduction factor corresponds to the following formula (please refer to Exhibit I):

FR = 1/1,0035m

Where:
FR = Reduction factor; and
m = number of months elapsed from the date of purchase of the real estate property

until its sale.

Please note that this new possibility of capital gain reduction ascertained by individual taxpayers does not exclude the application of capital gain reduction percentages already established in article 18 of Law no. 7,7713/88 (applicable to real estate properties purchased before 12.31.88).

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VII - PIS/PASEP and COFINS

Among the several modifications made to PIS/PASEP and COFINS legislation, we highlight the following:

(i) Expenses incurred for the raising of funds for securitization of agricultural credits, pursuant to the National Monetary Council (Conselho Monetário Nacional) ruling that levels the aforementioned activities to the activities of securitization of financial and real estate credits, may be deducted from the calculation basis of the aforementioned contributions;

(ii) Revenues relating to activities of resale of real estate properties, subdivision and parceling of land, real estate development and construction of buildings for sale, when resulting from long-term agreements executed before October 30, 2003, remain subject to the cumulative methodology of PIS/PASEP and COFINS;

(iii) For the calculation of PIS/PASEP-Import and COFINS-Import, any taxes, contributions, fees and customs expenses levied on import operations, except for the Tax on the Circulation of Merchandise and certain Services (“ICMS”), will be disregarded;

(iv) The definition of “preponderantly exporting legal entity”, with the suspension of the incidence of PIS/PASEP and COFINS, in the case of purchase of industrial input (insumos), is conditioned to the export of 80% of the amount of its sales of assets and services;

(v) The term for the use of PIS/PASEP and COFINS credits, resulting from the purchase of new machines, devices, instruments and equipment, to be listed in a specific regulation, allotted as fixed assets and used in the industrial process of the purchaser, to be used within the term of two years, was extended for an indefinite basis; and

(vi) In the case of industrialization upon order, PIS/PASEP and COFINS will be levied on the gross revenue received by the legal entity placing the order, at the rates of 1,65% and 7,6%, respectively. In this sense, it has been established that the

definition of industrialization upon order is that given in the IPI legislation.

VIII – COMPLEMENTARY PENSION FUNDS AND INSURANCE

Since the legislation that governs the operation of complementary pension entities and insurance companies needed to be adjusted so as to give greater assurance to participants and insured parties, MP 252/05 brought certain modifications, specifically in relation to the separation of the funds that are being set up, as explained below.

As of 01.01.06, Open-Ended Complementary Pension Entities (Entidades Abertas de Previdência Complementar - EAPC) or insurance companies may set up investment funds, with separate assets, exclusively related to complementary pension plans or life insurance plans with survival coverage, structured in a variable-contribution methodology, not being liable, even on a subsidiary basis, for their debts. Plans or insurance commercialized up to 12.31.05 may be adapted to this new structure.

Contributions or premiums to PGBL and VGBL plans and similar products, invested by the EAPC or insurance company in quotas of an exclusive investment fund (“FIE”), may, in accordance with this new structure, be invested on behalf of the individual himself/herself.

In group plans, contributions or premiums made by the legal entity may also be invested in quotas on its name. However, the agreement or policy must contain the periodicity in which the quotas purchased by the legal entity will be transferred to the participants or insured parties. This is because, for the participants or insured parties to be able to withdraw their proceeds, the quotas must be in their name.

In the case of granting of continuous benefits, the quotas shall be transferred to the EAPC or insurance company, while in the case of bankruptcy of the legal entity that is the holder of the quotas, the property of such quotas shall be transferred to the participants or insured parties.

The EAPC or insurance company will be liable for the withholding and collection of taxes and contributions levied on investments made in the funds. It is important to highlight that, due to an express legal provision, there will be no incidence of income tax on the transfer of quotas from the legal entity to the individual, or from the latter to the former.

Finally, quotas held by individuals in these kinds of funds and quotas of the Individual Programmed Retirement Fund (Fundo de Aposentadoria Programada Individual - FAPI) may be given as guarantee to financial institutions in real estate financing agreements. EAPC and insurance companies are prohibited from placing any restrictions regarding this issue. This guarantee must be established in a specific agreement and will integrate the plan or policy.

IX – FUTURE SETTLEMENT MARKETS

Financial institutions and other institutions authorized to operate by the Central Bank of Brazil (Banco Central do Brasil - BACEN), when ascertaining the calculation basis of PIS/PASEP, COFINS, CSLL and IRPJ, must compute as revenues or expenses incurred in the operations carried out in the future settlement market:

a) The difference ascertained in the last business day of the month, among the variation of the rates, prices or indexes. The balance will be ascertained at the time of the settlement of the agreement, assignment or termination of the holding, in the cases of:

(i) Swap and futures; and

(ii) Futures and other derivatives with daily or periodic financial adjustments of holdings, which underlying assets are spot interest rates or fixed-yield instruments for which the ascertainment through the use of the formula established in item “a” is possible;

b)
The result of the addition of the adjustments ascertained on a monthly basis, in the case of the markets described in item “ii” above, which underlying assets are goods, currency, fixed-yield assets, future interest rates or any other asset or economic variable for which it is not possible to use the formula established in item “a”; and

c) The result obtained in the settlement of the agreement, assignment or termination of the holding, in the case of options and other derivatives.

Furthermore, the Brazilian IRS (Secretaria da Receita Federal) will regulate the aforementioned issue and may also determine that the amount to be recognized on a monthly basis, mentioned in item “ii”, be calculated:

a) By the exchange market in which the agreements were traded or registered; or

b) In accordance with the formula established by BACEN, while the information mentioned in the previous item is not yet available.

In relation to over-the-counter market operations, the recognition of expenses or losses will only be allowed if the operation has been registered in a system that is able to assess if the prices, in the beginning or end of the holding, are consistent with market prices.

For the purposes of hedge operations carried out in future settlement markets within foreign exchange markets, the revenues and expenses shall be computed by the result:

(i) Of the sum of the adjustments ascertained on a monthly basis, in the case of agreements subject to adjustments of holding; and

(ii) Obtained on the settlement of the agreement, for the other derivatives.

It is important to mention that the recognition of expenses or losses ascertained in operations performed out of foreign exchanges markets, for the purposes of ascertainment of the calculation basis of PIS/PASEP and COFINS, is prohibited.

X – TAX REFUND/OFFSET

In accordance with the new wording of article 7 of Decree-Law no. 2,287/86, the Brazilian IRS (Secretaria da Receita Federal - SRF), after the recognition of the taxpayer's right to a certain credit (the taxpayer is responsible for requesting the credit), and before refunding or reimbursing such taxes, must verify if the taxpayer is a debtor of the SRF or Brazilian Treasury General Office (Procuradoria-Geral da Fazenda Nacional - PGFN).

In case of debt, even if the debt is being paid in installments or enrolled (or not) in the Overdue Federal Tax Registry (Dívida Ativa) of the Federal Government (irrespective of such debt having a tax nature), the amount of the reimbursement or refund shall be used to totally or partially pay the debt, via an automatic procedure for the offsetting of the amounts.

After such procedure, and in case there is credit, the reimbursement or refund of the credit will be conditioned to the evidencing, by the taxpayer, of his/her/its tax regularity regarding the contributions mentioned by articles 1 and 3 of Law no. 11,098/05, including those registered in the Overdue Federal Tax Registry of the Brazilian Social Security Institute (Instituto Nacional de Seguro Social – INSS).

In case of debt regarding any of the aforementioned contributions, the remaining value

of the credit to be reimbursed to the taxpayer, after the offset carried out by the SRF, will be used for total or partial payment of the debt.

Notwithstanding the foregoing, it is important to highlight that the procedures mentioned above for the extinction of debts shall be preceded by the summoning of the taxpayer, for him/her/it to express consent, or not, within the term of fifteen days. Taxpayers' failure to reply shall be construed as consent.

It is important to highlight that the same procedure will be used in relation to INSS contributions.

Regarding this issue, in accordance with the modifications made to the specific legislation, a penalty shall be applied, calculated on the total amount of the offset amount, in case a debt is unduly offset, in the events in which the credit (i) belongs to third parties; (ii) refers to the IPI premium-credit; (iii) refers to government bonds; (iv) results from a judicial decision that is not final and unappealable; or (v) does not refer to taxes and contributions controlled by SRF. In such cases, the following percentages will be applied:

(i) 75%, in the cases of lack of payment or collection, payment or collection after the due date (without late-payment penalty), failure to submit a statement or incorrect statement; or

(ii) 150%, in the cases of evident fraudulent intent, defined in articles 71, 72 and 73 of Law no. 4,502/64, notwithstanding other administrative or criminal penalties applicable to the case.

Furthermore, if the taxpayer does not respond to the summoning, within the established term, in order to present clarifications, the aforementioned penalties will be increased to 112,5% and 225%, respectively.

XI – FORCE AND EFFECT OF MP 252/05

Pursuant to the provisions of article 73, MP 252/05 came into force on the date of its publication (06.16.05) and will produce effects as of:

a) The first day of the month subsequent to its publication, regarding the maintenance in the cumulative methodology of PIS/PASEP and COFINS of revenues pertaining activities of resale of real estate properties, real estate development, subdivision or parceling of land and construction of buildings for sale, when resulting from long-
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term agreements executed before October 30
, 2003;

b) The first day of the fourth month subsequent to its publication, regarding the extension of the term for use of PIS/PASEP and COFINS credits resulting from the purchase of new machines, devices, instruments and equipment, to be listed in a specific regulation, allotted as fixed asset and used in the industrial process of the purchaser, to be used in two years;

c) 10.01.05, regarding item "X", except for the application of penalties for undue offsetting, which effects are immediate and, in relation to the conditioning of the refund/reimbursement to the tax regularity in relation to the taxpayers mentioned in Law no. 11,098/05, as well as the use of the remaining credits to settle such debts, which will come into force as of the enactment of the act that regulates this issue;

d) 01.01.06, regarding technological innovation incentives; and

e) The enactment of the act that regulates the issue, regarding the aspects related to the future settlement market (item "IX"), where the minimum terms shall be:

(i) The first day of the fourth month subsequent to that of the publication of the MP, for PIS/PASEP and COFINS; and

(ii) The first day of the month of January of 2006, for IRPJ and CSLL.

THIS IS MERELY AN INFORMATIVE NEWSLETTER, RESTRICTED TO VGL CLIENTS. QUESTIONS AND CLARIFICATIONS ON THE MATTERS CONTAINED HEREIN SHOULD BE ADDRESSED TO OUR OFFICE.

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