

VGL NEWS

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VGL News – Provisional Measure no. 281 of February 15, 2006 - Zero-Tax Rate on Brazilian Government Securities held by Foreign Investors

Earlier than expected, President Luiz Inácio Lula da Silva has reduced to zero¹ the rate of withholding income tax (“WHT”) on federal government debt instruments (“Government Securities”) held by persons resident or domiciled outside of Brazil (“Foreign Investors”).² He has done so by issuing Provisional Measure no. 281 of February 15, 2006 (“MP 281”)³, published the next day.

Governmental officials have remarked that the purpose underlying this new policy is to induce Foreign Investors to join residents and increase the overall demand for Government Securities. It is expected that the effect will be a decline in primary interest rates while extending the average maturity of public debt.

MP 281 reduces the WHT rate from a former 15% to zero:

(1) on income⁴ from (a) Government Securities acquired on or after February 16, 2006 by Foreign Investors in accordance with the rules laid down by the National Monetary Council (“CMN”), and (b) quotas of mutual funds set up exclusively for Foreign Investors 98% or more of whose portfolio is made up of Government Securities; and

(2) on income from the quotas held by Foreign Investors in Participation Investment Funds (“FIP”)⁵, Investment in Quotas of Participation Investment Funds (“FIC-FIP”)⁶ and Emerging Company Investment Funds (“FIEE”)⁷, provided, however, that the benefit of zero-rate WHT does not extend to (a) the Foreign Investor who holds, singly or together with related persons, 40% or more of the total quotas of the relevant Fund or whose quotas, singly or together with related persons, entitle it to the receipt of income in excess of 40% of the total income realized by such Fund, and (b) Funds whose portfolio is made up at any given time of debt securities in excess of 5% of its net asset value, excluding Government Securities.

Income derived from the investments specified in foregoing (1) made on or before February 16, 2006 remains taxable at the former rates effective at the time made.

¹ Technically speaking, WHT has not been exempted but decreased to zero.

² However, Foreign Investors resident or domiciled in jurisdictions classified as tax havens are not eligible for zero-tax rate WHT at all.

³ A Provisional Measure – *Medida Provisória* – is a law-making function that the Executive branch can assume in relevant and urgent cases. While the Provisional Measure has the force of law, unless approved by the National Congress within a 120-period of its publication it will forfeit as though it never came into effect.

⁴ Income is to be understood as any amount that remunerates a cash investment, including such income items as interest, premiums and discounts.

⁵ The *Fundo de Investimento em Participações* (“FIP”) invests in equity, debentures or equity-related or equity-convertible securities. The Fund has a say in the management of the underlying security issuer, hence the name “participation funds”.

⁶ The *Fundo de Investimento em Cotas de Fundo de Investimento em Participações* invests in quotas of FIPs.

⁷ The *Fundo de Investimento em Empresas Emergentes* is a venture capital fund.

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However, if the Foreign Investor so wishes, however, it may pay WHT on income from Government Securities at such former rate on a date prior to that on which the tax would otherwise be triggered. In this way, the Foreign Investor pays WHT on income accrued up to the date of such WHT prepayment and enjoys the zero-rate reduction thereafter until maturity of the Governmental Security. This WHT prepayment option is exercisable until August 31, 2006.

Zero-rate WHT does not apply to Government Securities purchased by a buyer who has committed to resell them.

MP 281 also reduces to zero the former 0.38% Temporary Contribution on Financial Transactions (*Contribuição Provisória sobre Movimentação Financeira*) ("CPMF") levied on funds debited from bank accounts held by foreign investors in settlement of purchases of public offerings of shares registered with the Comissão de Valores Mobiliários (Brazilian equivalent of the U.S. Securities Exchange Commission) carried outside a the floor or negotiating system of a stock exchange provided the issuer is a listed company.

MP 281 includes provisions that affect the resident investor as well. As this summation is directed primarily to the Foreign Investor and fund investment manager and other Foreign Investor service providers, we will not discuss the effect of MP 281 on the resident investor at this time.

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