

## Provisional Measure 517 and Markets for Long-Term Private Financing

Published on December 31, 2010, Provisional Measure 517 ("MP 517") seeks to create a market for long-term private financing. This goal is admirable, especially considering the amount of resources needed to sustain economic growth in Brazil and the fact that the Brazilian government and public banks are, at present, nearly the only sources of long-term financing. The following is a brief analysis of some of the more important provisions found in MP 517.

### Tax Provisions

*(i) Withholding income tax ("WHT") exemption for nonresidents earning income derived from private long-term securities:*

Non-residents not located in tax havens (i.e., countries that do not impose income tax or where the maximum income tax rate is lower than 20% - "Tax Haven") will be exempt from WHT on income deriving from long-term bonds and securities (bonds and securities whose weighted average term is more than four years) ("Securities") issued and offered publicly by companies that are not deemed to be financial institutions.

In order to qualify for such treatment, among other requirements, Securities must: (a) pay a previously determined interest rate tied to a price index or a reference rate (taxa referencial - "TR"); (b) pay interest periodically at intervals of no less than 180 days; and (c) be subject to a simplified procedure which demonstrates that any such funds raised will be allocated to investment projects.

Resolution No. 3,947 of the National Monetary Council ("CMN") of January 27, 2011, establishes the formula to be used to determine the weighted average term of the Securities and the simplified procedure to demonstrate allocation to investment projects. This resolution does not, however, define the "investment projects" that would be acceptable for purposes of the tax benefit.

This tax benefit is applicable to all Securities acquired on or after January 1, 2011. With regard to Securities acquired prior to that date, foreign holders will have the option, until June 30, 2011, to prepay the WHT accrued to that date so that income earned thereafter may be exempt.

*(ii) Reduction of individual and corporate income taxes levied on income arising from long-term infrastructure debentures:*

MP 517 has reduced to 0% and 15% the tax rates payable, respectively, by resident individuals and legal entities on income arising from long-term debentures whose weighted average term is superior to four years and that comply with certain requirements equivalent to those described in item (i) above, provided that such debentures have been issued by special purpose entities ("SPEs") that seek to finance priority infrastructure projects.

This tax treatment shall only be applicable to debentures that are issued between January 31, 2011 (when the above referenced Resolution CMN No. 3,947/2011 was published), and December 31, 2015.

*(iii) Reduction of income tax owed by investors in investment funds ("FI") or investment funds of funds ("FIC") that invest in debentures described in item (ii) above:*

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Income earned by investors holding interest in FIs which invest more than 85% of their portfolios in debentures described in item (ii) above ("Qualified FIs"), as well as the income earned by investors in FICs with more than 95% of their resources invested in Qualified FIs, shall not be taxed if earned by individuals or if paid to non-residents not located in Tax Havens, and shall be taxed at a 15% rate if earned by resident legal entities.

Such FIs and FICs shall have 180 days after their incorporation to comply with the requirements for such tax treatment, and ninety days to correct any noncompliance with such requirements.

*(iv) Flexible rules and rate reduction for investors in infrastructure investment funds ("FIP-IEs"):*

In addition to relaxing the legal regime applicable to FIP-IEs<sup>1</sup>, MP 517 has benefited individuals by, first, eliminating the five-year holding period that they must observe in order to benefit from the exemption, and second, by exempting from taxation any gains derived from the sale of interests in such funds.

*(v) Reformulation of income tax on periodic income from fixed-income securities:*

So as to correct distortions found in current tax laws affecting the taxation of periodic income derived from fixed-income securities, MP 517 provides that taxation must be levied, proportionally to the period of time, on the portion of income produced from the acquisition date, or the previous periodic payment date, to the date that it is earned; the income that corresponds to the period of time between the previous periodic payment and the securities acquisition date may be deducted from the taxable base. It is important to note, however, that the new provision is subject to further regulation by Brazil's Federal Revenue Office.

#### Other Provisions

MP 517 has also impacted rulings that regulate debentures more generally and by amending Law No. 6.404 of December 15, 1976, so as to simplify the debenture issuance process. In this regard, publicly-held companies now have the following rights: (i) boards of directors may authorize the issuance of non-convertible debentures, regardless of whether company by-laws expressly establish such authority; (ii) boards of directors have such authority to the extent that such debentures are non-convertible, it no longer being required that such debentures not feature in rem guarantees, and (iii) company by-laws may still permit the board to authorize the issuance of convertible debentures, provided that provisions which govern the company's authorized capital are complied with.

Additionally, MP 517 has eliminated restrictions that prevent companies from issuing new debentures before the placement of all debentures from previous issuances or from negotiating a new series of the same issuance prior to the placement of the previous series. By allowing several simultaneous issuances, MP 517 has ensured that debentures may be sold with differing characteristics, which gives the issuer more flexibility to manage this form of financing in accordance with market conditions.

MP 517 has also made it easier for companies to repurchase debentures, thus amending the law even further. In this regard, it is no longer necessary for debentures to be repurchased at face value by the company.

Another important change that will function to stimulate new issuances of debentures is the elimination of the requirement that issuances not exceed the issuing company's corporate capital. Besides the fact that corporate capital is not the best indication of an issuer's creditworthiness, the restriction itself no longer makes sense in view of the development of local capital markets in which issuers are responsible for managing their levels of indebtedness and supplying the market with full disclosure regarding their activities, leaving investors to evaluate investment risk for themselves.

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So as to address the shortage of fiduciary trustees servicing the bond market, Law No. 6.404/76 has been amended to permit the retention of the same trustee to administer different issuances of the same company, provided that such trustee is duly authorized to undertake such activities by the Brazilian securities and exchange commission (“CVM”). In this respect, the CVM should amend CVM Directive No. 28 of November 23, 1983, which governs the trustee’s duties. We note, however, that any conflict of interest which may negatively affect the duties of the trustee shall remain impermissible.

Finally, in compliance with further requests from market participants, MP 517 provides that debentures and bank bonds (“letras financeiras”) may be adjusted for monetary correction (“correção monetária”) for time periods of less than one year, provided, however, that such terms are equal to the time periods for periodic payments of interest.

The CVM has put forward MP 517 for public comment with the intention of gathering comments and suggestions from the market prior to the conversion of MP 517 into law.

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<sup>1</sup> MP 517 brings about a number of notable changes in an attempt to promote FIP-IEs: (i) a grant of authority to the federal government to expand the list of infrastructure areas/sectors deemed to be priorities; (ii) the reduction, from 95% to 90%, of the FIP-IE portfolio percentage to be applied to shares, subscription bonuses, and debentures or other bonds issued by SPEs that develop certain infrastructure projects; (iii) the reduction, from ten to five, of the minimum number of investors in individual FIP-IEs; and (iv) the increase, from 20% to 40%, of the maximum ownership interest to be held and maximum income to be earned by each investor. Such measures were taken in order to facilitate the characterization of funds as FIP-IEs, thus simplifying taxpayer access to the tax benefits enjoyed by such funds.

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