Legal Bulletin
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Provisional Measure No 651: The Taxation on the Financial and Capital Markets

Provisional Measure ("MP") No. 651, of July 9, 2014, has brought about a number of changes to the taxation levied on investments in the financial and capital markets. We highlight some of them below.

Payment of fund with assets: market value? "Yes"

The payment of fund quotas with assets is made with some frequency in Brazil, especially by individuals. The Brazilian Revenue Service has traditionally understood that these payments should be made at market value, so that the investor is taxed on the corresponding capital gain.[1] This understanding lacks, however, legal grounds.

As per MP No. 651, as from January 1, 2015, the fund manager will be responsible for charging and collecting this tax. The most likely outcome is that the managers will be conservative and favor taxation, rather than risk a fight that is not theirs.

New taxation levied on the indexed fixed income fund

MP No. 651 creates a new tax regime for indexed fixed interest fund ("ETF Renda Fixa") investors.[2] The Provisional Measure establishes income tax regressive taxation, depending on the average term of the financial assets composing the fund portfolio. Accordingly, earnings and capital gains will be subject to the following taxation:

Average term	Rate
Up to 180 days	25%
From 181 to 720 days	20%
Above 720 days	15%

In case the fund does not comply with the minimum composition percentage of its portfolio as established by applicable regulation, the income tax will be due at a 30% rate during the noncompliance period.

The new rules may be considered an improvement in the legislation, as the current taxation levied on these funds, although regressive, takes into account the period during which the investor keeps his investment:

Term of investment	Long term fund	Short term fund
Up to 180 days	22,5%	22,5%
From 181 to 360 days	20%	20%
From 361 to 720 days	17,5%	-
Above 720 days	15%	-

[1] Interpretative Declaratory Act ("ADI") No. 7 of 2007 (effective as of January 1, 2008).
[2] Investment funds having a portfolio composed by financial assets seeking to reflect the variation and yield of fixed rate indexes and whose internal rules determine that at least 75% of their portfolio be composed by assets that are part of a reference fixed rate index.

São Paulo
Av. Brig. Faria Lima, 2601
12th floor - 01452-924
São Paulo, SP - Brazil
Phone. +55 11 3555 5000

Rio de Janeiro
Praia de Botafogo, 440
15th floor - 22250-908
Rio de Janeiro, RJ - Brazil
Phone. + 55 21 3503 2000

Brasília
SBN Q 1, Bl B, n. 14, Ed. CNC
2th floor - 70714-900
Brasília, DF - Brazil
Phone. + 55 61 2109 6070

contato@levysalomao.com.br

This new tax regime, which is only applicable to investment funds with shares traded in a secondary market administered by a stock exchange or an organized over-the-counter market entity, should result in greater liquidity for the quotas of these funds, that are today traded less frequently due to the tax incentive to hold the investment for longer terms.

The relevant articles of MP No. 651 will enter into force on January 1, 2015.

Loan of shares

MP No. 651 details the tax treatment applicable to the lender and the borrower in the loan (commonly known as "rent") of shares. These transactions are becoming more common and it is beneficial that the applicable tax regime is clear in their regard.

The Provisional Measure brought an end to the transaction known in the market as the "surrogate mother" transaction, in which investment funds borrow quotas from individuals before the payment of the interest on net equity and subsequently return them. The economic rationale of the transaction derived from the difference between the income tax rates levied on the interest on net equity: 15% for individuals and exemption for funds. MP No. 651 now determines that the 15% rate should also be applicable to funds.

Also in this case, the relevant articles will enter into force on January 1, 2015.

Exemption for shares of small and medium companies

MP No. 651 provides income tax exemption, until December 31, 2023, on the capital gains earned by individuals in the sale of shares issued by companies that have: (i) shares admitted to be traded on a market special segment ensuring differentiated corporate governance practices[3]; (ii) a market value lower than R$ 700 million; and (iii) annual gross revenue lower than R$ 500 million. In addition, the Provisional Measure requires primary distribution corresponding to, at least, 67% of the total volume of the shares issued by the company as a requirement for the granting of this tax benefit.

The Government's goal is to attract individual investors to the market. The Government also responds the call of the market to create conditions granting small and medium businesses access to financing alternatives less expensive than bank loans.

In practice, the most active investors – foreign investors[4] and investment funds – are already exempt from tax. There is however criticism in the market that Brazilian legal entities should also be included in the exemption (we believe they should), that has been granted by the Provisional Measure exclusively to individuals. Another criticism is that, at present, very few issuing companies[5] meet the requirements of the Provisional Measure so as to enjoy the tax treatment it provides.

The results of the Provisional Measure should take effect in the medium and long term, depending on economic factors. But the first step has been taken in the right direction.

These articles of the Provisional Measure have already entered into force, since July 10, 2014.

Ana Carolina Monguilod
amonguilod@levysaloma.com.br

Fernando de Azevedo Peraçoli
fperacoli@levysalomao.com.br

[3] Currently “Novo Mercado” or “Bovespa Mais”.
[4] Non-resident investors outside tax havens with investments in accordance with National Monetary Council (“CMN”) Resolution No. 2.689, of January 26, 2000.
[5] Seven entities, according to the most recent Brazilian Securities Commission (“CVM”) information.

São Paulo
Av. Brig. Faria Lima, 2601
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Brasília, DF - Brazil
Phone. + 55 61 2109 6070

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