LOWER TAXES WILL HELP IMPROVE THE PUBLIC DEBT PROFILE AND CORPORATE FINANCE

On August 9, 2004, the Brazilian government issued a Presidential Decree (*Medida Provisória* n° 206/2004) aimed at fostering long-term savings. At that time, it lowered the income tax on stocks as well as on fixed-income investments held for more than a year. On August 27, another Presidential Decree (MP nº 209/2004) complemented those measures, specifying the tax treatment of mutual funds and new types of pension funds and insurance policies.

MUTUAL FUNDS AND OTHER FIXED-INCOME ASSETS

MP nº 206/2004 lowered the income tax on fixed-income instruments held by individuals for more than a year. After the first year, the income tax will be limited to 17,5% of accrued gains. This rate will drop to 15% after the second year. In contrast, whenever an investor will sell a fixed-income instrument after holding it for less than six months, the new income tax rate will be of 22,5%, rather than the current 20% (which will be maintained for holding periods between 6 and 12 months). In addition, the withholding tax rate will in general drop to 15%. The withholding tax on mutual funds will become semiannual after the *Conta Investimento* becomes effective in early October 2004. The new rule will apply to mutual funds, bank CDs and other fixed-income instruments and will be effective as of January 2005.

The new 15% income tax rate will apply also for direct holdings of stocks, independent of the holding period. On the other hand, the new tax brackets will not affect firms, because all their financial revenues already are consolidated with their operational revenues for the purpose of corporate income taxes.

To boost the effect of early measures, MP 209 aligns the new tax rates also to types of saving instruments. More specifically, MP 209 incorporates the classification put forward by the *Comissão de Valores Mobiliários* (the Brazilian SEC) in recent weeks, which distinguishes “long-term fixed income funds” from other types of funds. “Long-term” funds are those for which the maturity of their portfolio is of more than one year (365 days). In order to stimulate the development of new instruments, MP 209 establishes that the lower income tax brackets will not apply to funds with portfolios of less than one year of maturity, independent to the time the asset is held by any individual. This segmentation is natural, and creates an incentive to investors to segregate the resources they intent to hold for a longer period from those for short-term purposes.

The price incentive is also important because Brazilian financial instruments seldom include withdrawing restrictions or penalties. In the wake of numerous macroeconomic shocks, investors have increasingly preferred instruments that can be made liquid in less than two days. Consequently, and because of marking to market rules, fund managers tend to hold a significant amount of cash (or repo operations). With the new instrument, fund managers have gained a tool to diversify their products, allowing investors to reap greater benefits from the outlook of increased macro-economic stability and the extensive range of fixed-income instruments issued by the government. It will also foster the development of the corporate bond market. Importantly, the government has no intention to introduce any withdrawing restrictions on savings instruments.

The new incentives will profit from the *Conta Investimento* as of next October. The contemporaneous enhancement of savings instruments and incentives for the diversification of financial products would have been hindered by the payment of the *CPMF* on portfolio adjustments, as it would consume some of the investors´ gains provided by the lower income tax. The *Conta Investimento* will exempt any transfer of savings from one instrument to another from the *CPMF*, permitting savers to migrate with minimum costs to instruments that will benefit from more favorable taxation.

PENSION FUNDS, LIFE INSURANCE AND OTHER PRE-FUNDED SCHEMES

MP 2009 also creates new pre-funded pension schemes and life insurance instruments that will benefit from lower income taxes. As of January First, 2005, the income tax paid when realizing the gains from a new type of open pension fund and from a life insurance policy with survivor payments will have the following schedule.

Tax rate	Holding Period
35%	< 2 years
30%	Between 2 and 4 years
25%	Between 4 and 6 years
20%	Between 6 and 8 years
15%	Between 8 and 10 years
10%	More than 10 years

The lower schedule is of significance, as investors can deduct from their taxable income the resources invested in these assets. Hence, by holding the new products for a long-enough time, income taxes can be reduced from the 15%-27,5% rates on normal income, to rates as low as 10%. These new rules will *not* affect existing plans, which will be allowed to continue to receive inflows from their participants, and insurers and *FAPI* managers will be able to continue offering products under either tax scheme (this grandfathering rule is important to the fast-growing segment of individual pension funds – *Fundos de Aposentadoria Programada Individual-FAPI*).

In addition, the government is freeing the *financial income* of pension funds and insurance policies from withholding taxes, thus raising the return of accrued interest. The government is also regulating the payment of taxes at the moment of the withdrawal from the instruments, and the payment of income tax by employees in collective pension plans.

The new measures will also help reduce the overall tax burden. The tax measures in MP 206 and MP 209 will help put a lid on tax revenues, limiting the scope for continue increases in taxes. The government continues, on the other hand, attentive to the need to ensure a favorable dynamics for primary expenditure as the prime instrument to guarantee fiscal stability.

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