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# LATIN AMERICAN
## Law & Business Report

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## HIGHLIGHTS

**Effect of Brazil's Corruption Scandal on Foreign Investors—More than "Just Politics"**
A political scandal in Brazil has been gathering force, and President Lula's name, and that of his Minister of Finance, have recently been brought into the expanding congressional investigations. Lula's presidency may have already been damaged beyond repair. A special interview examines whether Brazil can maintain the economic policies that have attracted so much foreign investment. **Page 4**

**Mexico's Energy Shortage Will Force an Opening to Foreign Investments–But When?**
Mexico faces a real danger of running out of oil, but despite the challenge, no politician will propose opening the energy sector to foreign investors. Barring unforeseen good luck, an energy shortage will probably force Mexico's hand soon. **Page 3**

**Brazil Fashions Incentives for High Technology Companies**
The measures include tax breaks and other benefits, and are designed to push companies toward adoption of open source software. **Page 11**

**When Will Brazil Start to Lower Interest Rates?**
The Central Bank is expected to start lowering rates, now at 19.75 percent, in September. **Page 15**

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**Privately-Held Colombian Companies to Benefit from New Rules for Private Equity Funds**
The regulations will permit local and foreign fund managers to buy shares of Colombian private companies. **Page 19**

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**Mexico's New Tax Rules on Thin Capitalization Leaves Many Unanswered Questions**
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## Energy Sector

# Mexico's Oil, Gas, and Energy Policy Options

by Sidney Weintraub (Center for Strategic and International Studies)

The difficulties Mexico faces in making decisions on oil, gas, and energy policy are essentially political, not technical. This does not make the problems easier to resolve; indeed, it makes them harder to deal with because technical issues can be approached head on, whereas political obstacles, rooted in the structure of government and society, can be surmounted only by means of complicated strategies. Technical operations of Pemex (Petroleos Mexicanos), Mexico's government-owned oil monopoly, are entangled in political considerations foisted on the company. These contribute to Pemex's low productivity (or, phrased differently, the company's excess employment for the output generated) and its periodic corruption scandals. What follows will deal with Pemex's finances, which are unbelievably complex and chaotic because of political, or should I say extraneous, demands placed on the company.[1]

### Tapping Undersea Reserves

Pemex, for some years now, has lacked funding to engage in sufficient exploration to find new sources of oil and gas. Deepwater exploration, which is expensive but where the prospects of significant findings are promising, has not been undertaken for want of money. Pemex also lacks the technical expertise for deepwater drilling, but this could be hired if funding were available. Exploration is urgently needed because at present rates of use Mexico's proven reserves of oil will last only about 12 years. Mexico already imports a considerable amount of natural gas, and the country is in the process of converting the fuel for most of its energy generation from oil to natural gas. The domestic shortage and the high cost of imported gas is reducing the competitiveness of Mexico's high energy-using businesses. But there may well be much gas to be found in the deep waters of the Gulf of Mexico.

There are three main options for dealing with these problems: seek private, necessarily largely foreign, sources of investment for oil and gas exploration and exploitation; reduce the amount of Pemex revenue the government takes for its own budgetary needs; or continue to muddle through and hope for the best. The third option is stated pejoratively, even though the government did luck out in the 1970s when new oil output came on stream; however, running a government based on an assumption of repeated good fortune is hardly a rational choice. Carrying out the first option involves running roughshod over deeply held emotions stemming from Mexican history, which led to setting up a government-owned monopoly in the first place after foreign owners of oil companies in Mexico rejected government requests. The second option would require changing the entrenched Mexican habit of low tax collections to relieve Pemex of being the cash cow for one-third of the federal government's budgetary needs.

> ***The danger Mexico faces is running out of oil, both for domestic use and export in a relatively short period.***

### Reducing Dependency on Pemex Tax Revenues

With respect to the fiscal option, the current situation is as follows: Mexico now collects between 11 and 12 percent of gross domestic product in taxes; this amounted last year to about $80 billion. Pemex provided about 6 percent of GDP, or $40 billion, to finance the government budget. If the revenue take from Pemex were reduced by, say, one-half, this would leave Pemex with roughly an extra $20 billion for its own needs. Pemex now obtains much of its needed funds from borrowing and is not in a position to increase borrowing much more. Pemex also obtains appropriations from the central government, but

*Policy Options, Continued on page 20*

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## Special Interview

# Political Scandals Threaten Brazil's Economic Resurgence

*The Surprising Fall from Grace for Brazil's Workers' Party, and Possibly President Lula*

### An Interview with Lehman Brothers' John Welch

**For the last two years Brazil seemed on a roll. Led by surging growth in exports, the economy has grown steadily, and the growth is finally starting to show up in reduced unemployment figures. The Central Bank has maintained a relentless battle against inflation, and has endured harsh criticism from commercial associations for stifling prosperity. But the policy has vanquished Brazil's economic arch enemy—inflation—and interest rates are expected to start dropping as soon as next month. These orthodox economic accomplishments are even more remarkable when one considers that they have been performed with the support of a president from Brazil's Workers' Party, who rose from a humble background to fashion a party that symbolized, until recently, grassroots democracy and integrity. Until three months ago, President Luiz Inacio Lula da Silva, buoyed by high popularity ratings, looked like a sure bet to win reelection in October 2006.**

**Suddenly however, all bets are off. In May a congressman under investigation for bribery declared he would not be a fall guy, and started naming names. Three congressional special investigatory committees soon started taking testimony, and the fully televised sessions have dominated the news coverage and created a press frenzy. What initially started out as "support payments" to secure opposition votes in Congress has gradually revealed a more insidious network of slush funds and diversion of state revenues. President Lula was able to stay above the fray until two weeks ago, when his ratings started dropping like a stone after allegations by a former adviser that Lula's presidential campaign was partially underwritten by illegally obtained funds. A few days later a former secretary of the Minister of Finance charged that Antonio Palocci took bribes when he was a city mayor. Investors began to worry that the managers guiding Brazil's economic policies could be in jeopardy. Mr. Palocci made a persuasive denial of the charges on national television, and the financial markets were calmed.**

John Welch is Senior Vice President, Sovereign Strategy at Lehman Brothers in New York.

**To find out just how sanguine investors should be about the political upheavals in Brazil, *LALBR* talked with Lehman Brothers' John Welch. John had just returned from a week of meetings with clients and managers in Brazil.**

***LALBR: Has the political crisis dampened the robust growth of the Brazilian economy?***

**Welch:** The Brazilian economy was already going to slow down this year because of the very conservative stance of the Central Bank in keeping interest rates elevated. So the question is, has the crisis affected over and above what we already had? Probably not yet. It has probably left the Central Bank a little more conservative than it would otherwise be.

> ***If Lula were impeached, we'd have some big problems.***

***LALBR: As evidenced by its failure to lower interest rates?***

**Welch:** Yes. Also, the crisis is starting to affect investment somewhat, although we have not seen the full signs of this yet.

*Special Interview, Continued on page 5*

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# Special Interview (from page 4)

### Foreign Investors Not Scared

***LALBR: How is the political crisis affecting foreign investors?***

**Welch:** Investors have generally thought that as long as Lula was safe and his Minister of the Economy was safe, that everything would be fine. Well, investigations are getting very much closer to Lula. Just a few weeks ago Brazil's Minister of Finance, Antonio Palocci, was accused of receiving kickbacks when he was mayor of the town of Ribeirão Preto in São Paulo state. This is a serious turn of events because Mr. Palocci is closely associated with current economic policies. So you can see that perhaps some foreign investors, I am talking about portfolio managers, have been focused too narrowly. In terms of long-term investment, we had a massive amount of direct foreign investment in July—over $2.2 billion. So, that part seems to be fine and certainly whatever crisis Brazil is feeling right now is nothing compared to what it has gone through in the past. Similarly, multinationals in Brazil have seen much more significant changes in the past than what they are seeing now. So the crisis is affecting on the margin, but not a huge amount.

***The things that really would affect foreign direct investment are not part of this crisis.***

***LALBR: Judging at least from the amount of foreign capital that is going into Brazil, direct foreign investors do not seem to be taking much notice of this crisis. Why isn't this crisis causing more concern among foreign investors?***

**Welch:** Foreign investors make very long term plans. Is this crisis going to affect whether someone buys a car in 10 years or drinks Coca-Cola in the next three? Probably not. Some sectors perform better during times of crises, such as tobacco and alcohol. Is the current crisis going to affect how well Vale do Rio Doce [CVRD—the largest mining company in the Americas, and world's largest exporter of iron ore] is doing on the export markets? No. Should foreign investors be worried that Brazil will hinder the transfer of funds by imposing controls on capital leaving the country? Well, the probabilities of those scenarios happening is quite low. The things that really would affect foreign direct investment are not part of this crisis. And politicians are making every effort to insure that the economy is not affected by the crisis. They are trying to make it seem like this crisis will not affect companies and investors.

***LALBR: You just returned from Brazil. Were the people you met with worried about the way this crisis is unfolding?***

**Welch:** I think most of them were concerned. They are worried that the crisis could bring market volatility, but I don't think their long term vision for Brazil being on the right track has changed.

### Problems if Scandal Reaches President

***LALBR: What is the biggest risk that this crisis poses for Brazil's economy?***

**Welch:** The biggest risk is a loss in governability. If Lula were impeached, we'd have some big problems. The vice president, José Alencar, is not well known; many do not trust him to carry on the economic policies of the current administration. To add to the uncertainty, there are different procedures for impeachment in Brazil. So it is not possible to say if the vice president would take office if President Lula were impeached. To make matters more complicated, investigations centering around violations of campaign finance rules could implicate both President Lula and the vice president. If this were the case, then Severino Calvacante, the speaker of the lower house, would take over as president for 30 days. He would call for an election by members of Congress. The winner of the congressional vote would serve out the remaining time of Lula's term [the presidential term ends on January 1, 2007]. The problem with this procedure is that it confines the election to members of Congress, and right now the reputation of Congress has been sullied by the scandals. Certainly the image of Congress is worse than the president's at this point.

***LALBR: What would be the effect on foreign investors if Lula were impeached?***

**Welch:** Foreign investors would hesitate, because they would not know who would be the next president, but a change in the presidency would not signal changes in policies for investors. Foreign investors would pay more because of the turbulence, but this would not be a massive effect.

***LALBR: Will Lula be reelected?***

**Welch:** Well, it is increasingly looking like he will not be. Our base case, before mid August, was that he would be reelected, but now it is looking like he may choose not to run again.

***LALBR: Would Lula's defeat be good or bad for foreign investors?***

**Welch:** That would be a welcome thing. It would be a good thing.

***LALBR: What would happen if Lula announces that he does not intend to run again, and Palocci is brought down by the scandal?***

**Welch:** Well, this is probably the worst set of circumstances that could happen, because then Brazil would

*Special Interview, Continued on page 33*

## Antitrust

# Possible Modification of Argentine Competition Law Grants more Power to Ministry of Economy in Control of M&As

by Alfredo M. O'Farrell and Miguel del Pino (Marval, O'Farrell & Mairal)

### Immediate Modification of Competition Law No. 25,156

The Executive Power, through the Ministry of Economy, submitted to the National Congress on August 17, 2005 a draft bill (Amending Bill) for the modification of Argentine Competition Law No. 25,156 (Competition Law). The Amending Bill intends to modify, among other matters, certain articles of the Competition Law regarding term for approval, approval of certain economic concentrations, set up of the National Tribunal for the Defense of Competition (Antitrust Tribunal) and appointment of its members.

### Initial Comments on the Amending Bill

Although the main terms of the control for economic concentrations are not modified, the proposed changes grant more power to the Secretary of Technical Coordination of the Ministry of Economy, as it will have the right to oppose every transaction that involves the industries of mining, defense, energy or transactions with high impact on employment and/or investment.

The concept of tacit approval if no decision is issued by the Antitrust Tribunal is also modified as it will also involve a communication to the Secretary of Technical coordination and the expiration of a term for the mentioned authority to issue a decision.

Also, with the proposed changes, the National Commission for the Defense of Competition (Commission) is transformed into the Antitrust Tribunal and the former members of the Commission (four members and the president) are appointed as members of the Antitrust Tribunal (and the Ministry of Economy has to elect two additional members as it should have seven members). Creation of the Antitrust Tribunal resolves the uncertainty caused by the Province of Mendoza Courts that held in past decisions (see *LALBR*, June 30, p. 9) that the Commission does not have powers to resolve and approve M&A transactions according to the terms of the Competition Law.

### Proposed Changes

The first modification proposed reduces from 45 to 40 business days the term for approval of economic concentrations by the Antitrust Tribunal. After the

*Competition Law, Continued on page 7*

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## Competition Law (from page 6)

issuance of the resolution, the Antitrust Tribunal has two business days to notify its decision to the Secretary of Technical Coordination of the Minister of Economy, who will have three additional business days to request the entire file under certain specific reasons ("national general interest reasons" involved and if it relates to public utilities, or defense, energy or mining activities or the transaction has a high impact on employment or investment). If the file is not requested within the mentioned term, the transaction is considered approved.

On the other side, if the Secretary of Technical Coordination requests the file, it will have a term of 10 business days to analyze the Antitrust Tribunal's decision, confirm or modify it. It is not clear from the text of the Amending Bill whether the Secretary of Technical Coordination needs to ground any possible rejection of a transaction that is approved by the Antitrust Tribunal.

Therefore, the term for approval may be extended to a total term of 55 business days (or 45 if there is no intervention of the Secretary of Technical Coordination) and it also grants the Ministry of Economy the power to reject certain transactions for national general interest reasons even if they have been approved by the Antitrust Tribunal. The bill states in the "whereas" that this system is also applied in Spain, Germany and the United States.

If the Antitrust Tribunal does not issue its decision within the 40-business-day term mentioned above, the transaction will be considered as tacitly approved by the Antitrust Tribunal. However with the text suggested by the Amending Bill, at the end of the 40-business-day term without an express decision from the Antitrust Tribunal, the involved parties will have to request the Antitrust Tribunal to communicate the tacit approval to the Secretary of Technical Coordination. If the Secretary of Technical Coordination does not request the file or issue a resolution within the terms mentioned above (three days to request the file and 10 business days to issue a Resolution), the transaction shall be considered as tacitly approved and will have definitive administrative effects vis-à-vis third parties. Based on this scheme, with the new inclusions of the Amending Bill, the concept of tacit approval has also disappeared because the involved parties have to request of the Antitrust Tribunal that a specific notice be sent to the Secretary of Technical Coordination.

### *Independent Status for Tribunal*

The Amending Bill also states that the Antitrust Tribunal is created as an independent entity within the area of the Ministry of Economy. Although the Competition Law created the Antitrust Tribunal, it was never set up. The Amending Bill resolves this issue.

The Amending Bill establishes that once it becomes operative, the first composition of the Antitrust Tribunal will be formed by the current members of the National Commission for the Defense of Competition and two additional members (one lawyer and one economist) to be appointed directly by the Executive Power. After completion, the members will decide in a random election which appointments will be renewed after two and four years and which will be in office for the entire term (six years).

Members of the Antitrust Tribunal will be appointed by the Executive Power after a public contest of general backgrounds and opposition before a special jury. Their renewal will be done partially every two years and they could be reelected by the proceedings established in the previous paragraph. Members of the Tribunal can only be removed after a decision by a special jury.

#### Enactment of the Amending Bill

In order to be enacted, the Amending Bill must be approved by simple majority of the Senate and House Chambers and it has to be signed by the Executive Power and published in the Official Gazette. If no specific term is contemplated by the law, it could become operative as soon as eight days after publication.

#### Status of Current Transactions under Review of the Commission

It is expected that, once the Amending Bill becomes operative and the Competition Law is modified, its terms will be applicable to transactions under review. Therefore, transactions currently being reviewed by the Commission will continue to be analyzed by the Antitrust Tribunal and the Secretary of Technical Coordination may also intervene, as detailed above. This modification will affect important transactions such as Ahold/Cencosud (acquisition of Disco and Vea Supermarkets) and Camargo Correa/Lacroze de Fortabat (acquisition of Loma Negra Group). The new rules will surely be applied to them. Also, the new rules could impact on certain transactions that are pending to be approved as their approvals were subordinated to the compliance of conditions (divestments). This last group includes transactions such as Telefónica/Bell-South (acquisition of Movicom cellular company), AmBev/Bemberg Group (acquisition of a stock participation of Quilmes brewery) and the acquisition of Fargo by the Mexican Bimbo.

#### Final Words

Although it is not possible to assess when this Amending Bill will be considered by both Chambers of the National Congress, it is expected that approval may come soon, probably before the end of the year. The Amending Bill modifies material aspects of the Competition Law. The changes make it easier for the government to intervene in material transactions for political reasons. ❏

# Argentina further Tightens Foreign Capital Controls

by Carlos E. Alfaro (Alfaro Abogados)

The Executive Power has recently issued a series of decrees and resolutions adopting further capital controls to the ones already in force.

### *30 Percent Reserve Withholding*

Decree No. 616/2005 and Minister of Economy's Resolution 365/2005 establishes restrictions and a reserve requirement of 30 percent on inflows of foreign capital for investments. The decree imposes the obligation of establishing a cash reserve in dollars during one year to the funds of non-residents entering the country for the acquisition of pesos, active or passive financial transactions, and investments in the secondary market.

### *365-day Term to Refund Abroad*

Decree 616/2005 also ratifies the 365-day term (set forth by a former Resolution) during which funds that entered the Argentine exchange market need to remain in the country. All funds that entered into the Argentine exchange market may only be transferred abroad after 365 days. Furthermore, inflows and outflows of currencies from said market must be registered before the Argentine Central Bank.

## Main Points of the Decree

### *Bonds and Shares*

The restrictions will be applied when a foreign investor wishes to purchase public bonds issued by the Argentine Central Bank for the monetary regulation either in the primary or secondary market. To the contrary, if the foreign investor wishes to purchase public bonds—others than those issued by the Central Bank—in the primary market or company shares it will be exempted from these restrictions.

### *Foreign Direct Investments*

Foreign Direct Investments are exempt of restrictions when a foreign investor contributes to a direct investment.

### *Financial Loan*

If the loan is related to *(i)* foreign trade, or *(ii)* direct investment, or *(iii)* investments in non-financial assets obtained and canceled within a term over 24 months, including the payment of principal and interest, is exempt of restrictions.

### *Other Financial Loans*

The following are operations subject to the 365-day term restriction to transfer abroad, but not to the 30 percent reserve retention: *(i)* loans granted by bilateral or multilateral financial entities; or *(ii)* other foreign loans applied to the acquisition of foreign currency within the same bank that receives the inflows, for the cancellation of the principal of a foreign debt and/or to create external assets of long-term periods.

### *Repatriation of Funds*

The inflows of foreign currency to the country by Argentine residents (foreigners nationals or not) are not restricted by the decree as long as the original outflow from the country had been declared, and in the case of sales of foreign assets the amount resulting is less than $2 million. Anytime the amount is over $50,000, the resident shall inform the Federal Tax Bureau of the operation.

### *New Information Regime*

Argentine residents have to inform the Central Bank of direct and real estate investments if their value (calculated on the basis of the net worth of the relevant foreign companies and/or the fiscal value of real estate abroad) equals or exceeds $1 million. If the relevant investment does not reach this threshold, filing of the report is optional. When the value of the direct and/or real estate

*Controls, Continued on page 9*

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## Mandatory Corporate Capital Reduction and Dissolution Provisions, Once Again Suspended

Due to the 2001-2002 economic crisis in Argentina, the Executive Power suspended the application of two provisions of the Companies Act No. 19,550, among other measures.

One of the provisions suspended Section 94, subsection 5, which includes as one of the causes for company's dissolution: when a company losses its capital.

The other provision suspended Section 206, which established a compulsory capital reduction: every time that losses are superior to the reserves plus 50 percent of the capital.

The term of the suspension began on July 18, 2002 up to December 10, 2003. Afterwards, the Executive Power extended the term up to December 10, 2004.

Now, through Decree 540/2005, dated June 1, 2005, the Executive Power extended once again the term of suspension up to December 10, 2005. — *by Carlos E. Alfaro, Alfaro Abogados, Buenos Aires*

## Controls (from page 8)

investment is between $1 million and $5 million, the report may be filed annually at the end of each calendar year. Information relating to direct and/or real estate investments shall be provided by the entity or person required to report through an electronic form developed by the Central Bank and to be provided by financial entities. Once the form is completed, it shall be filed with a financial entity, which will then process and deliver the form to the Central Bank. ❑



# Recent Antitrust Developments

by Marta Garcia, Priscila Castello Branco and Marcelo Maciel (Trench, Rossi e Watanabe Advogados)

### Gravel Cartel is Fined by CADE

On July 13, 2005, the Brazilian Competition Commission (CADE) fined companies operating in the gravel market in the São Paulo region for illegal cartel activity. Fines ranging between 15 percent and 20 percent of the companies' gross revenues in the year prior to the investigation were imposed, depending on whether or not the company had participated in the "Management Committee" of the cartel. The Sindipedras labor union which was responsible for organizing the cartel and arranging the location of cartel meetings was fined R$300,000.

The Secretariat of Economic Law (SDE) received, in April 2002, information that 17 companies operating in the gravel market had formed a cartel. It was in this investigation that the SDE, together with the Federal Police and a Federal Attorney, for the first time ever in an antitrust investigation, conducted a dawn raid in order to collect sufficient evidence to convict the companies of cartel activity.

Among the material that was seized, the authorities found computer software programs which gathered data relating to clients, quotations, prices, etc. One of the programs found collected information on clients and daily quotations for prices, which allowed the monitoring of quotas allocated to each participant of the cartel. Another program controlled the quotas by registering information on clients, prices charged and distribution regions, which served to verify if the agreed price was being observed. In addition, the Federal Police, which had investigated the headquarters of Sindipedras as requested by SDE, reported that several meetings were held frequently in a closed room with security cameras that could only be entered by using magnetic entry cards. According to the documents that were seized, the companies would agree on matters in the interests of the cartel in such meetings.

The Reporting Commissioner, Mr. Prado, notwithstanding adverse opinions, stated that cartels in Brazil are per se illegal. According to the Commissioner, if the classic conditions of a cartel are present—as was the case in the gravel cartel—conviction of the companies involved in the cartel is almost a certainty. For this same reason, Mr. Prado and the remaining CADE members disregarded econometric studies presented by the SDE in this case. The gravel companies and the labor union cannot appeal CADE's decision in the administrative sphere, but they may still appeal CADE's decisions in the Federal Courts.

### CADE Decides Proceedings Relating to Medical Price Guides

On July 13, 2005, the Brazilian competition authorities decided to terminate administrative proceedings concerning an investigation into the pharmaceuticals industry by the Parliamentary Commission of Inquiry (CPI), which commenced in 2000. The object of the proceedings was to evaluate the influence of prices set out in pharmaceutical guides produced by BRASINDICE and ABCFARMA on the prices of medicine in the market.

According to the CPI's findings, the guides published by the defendants led to higher prices of medicines in the market, whereas, the defendants claimed that the objective of the guides was only to inform customers of prices of medicines. The guides played no role in setting prices of medicines in the market and there were various Orders and Laws, which required the publication of prices of medicines to the public.

Commissioner Cueva, the reporting commissioner in this case, agreed with the arguments of the defendants. The Orders and Laws supported the defendant's statements that the only function of the guides was to reveal prices to consumers and not to interfere with the setting of prices or any increases in prices of medicines in the market. In addition, the Commissioner explained that the pharmaceutical sector had special characteristics

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## Antitrust (from page 9)

requiring intervention by the State—in particular, given that asymmetry of information prejudiced the consumer. To this end, therefore, the price guides represented a benefit to consumers, reducing search costs for the prices of medicines and ensuring prices of medicines were made publicly available to consumers.

In accordance with the information provided during the proceedings, the guides only set down the maximum prices that could be charged for each medicine. Hence, one other concern raised was the possibility that pharmacies might end up charging the maximum price for medicines, facilitating tacit collusion prejudicial to the consumer. In Commissioner Cueva's opinion, a response by the Brazilian competition authorities to an inquiry in 2002 demonstrated that the publication of maximum resale prices in the guides was unlikely to lead to tacit collusion between the pharmacies, given that there was a possibility of negotiating discounts from these maximum resale prices between consumers and pharmacies.

In the final decision, which resulted in termination of these proceedings, the Brazilian Authorities recommended that the defendants include on each page of the guides a statement explaining that all prices contained in the guides were maximum resale prices and that consumers would have the right to negotiate discounts from these maximum resale prices with pharmacies.

### CADE Approves with Restriction Transaction between Koch and Dupont

The Brazilian Competition Commission approved a transaction between Invista (Dupont's textile division) and the Koch Group subject to one restriction. The restriction imposed by CADE concerns an exclusivity clause contained in the acquisition agreement that was entered into by the parties.

The main antitrust concern that this transaction raised related to the exclusivity agreement. Invista is a manufacturer of polyamide (nylon), which is used in the production of textile fibers, engineering plastics and tires. The companies decided to enter into an exclusivity arrangement because Dupont decided not to sell its engineering plastic's business. Under the agreement, Koch would be able to sell its excess production of polyamide only to Dupont.

The Italian group Radici participated in the proceedings, arguing that the exclusivity arrangement between the merging parties would give rise to anticompetitive concerns in the Brazilian market. Radici is active in the engineering plastics business and, therefore, uses polyamide as an input.

According to the Reporting-Commissioner's decision, the exclusivity clause was indeed anticompetitive and could not generate any efficiency gains. The Commissioner found that competitors' prices would increase as a result of the exclusivity clause. According to his decision, several market conditions led to the anticompetitive effects of this exclusivity agreement, such as high barriers to entry of new polyamide producers, high cost of importation and the difficulty that small and medium-sized producers would have to manufacture by themselves this input (since production facilities must be very large in order to be cost-effective).

CADE, by majority vote of its members, decided not to intervene in respect of another clause that was under discussion. The non-competition agreement between Dupont and Koch had a seven-year term, which is longer than the five-year term that CADE's case law establishes as being reasonable. The Commissioners, however, agreed that this longer term was reasonable, given that the transaction involved several brands that had strong consumer appeal (e.g., Lycra). ❑

### Will Brazil Seek Another Victory over the U.S. at the WTO?

For many years Brazil has complained that some of its major exports have been constrained by high tariffs and threats of dumping and countervailing duties at ports of the U.S. and Europe. In the last three years Brazil has changed its trade dispute strategy from bilateral negotiations to dispute resolution at the WTO. The strategy has paid off, with the WTO recently siding with Brazil on cotton exports to the U.S., and sugar exports to the EU.

A long simmering dispute between Brazil and the U.S. over orange juice might be the latest issue to be sent to a WTO panel. Brazilian officials have long complained over the high tariffs on Brazilian orange juice charged by the U.S.: $418 a ton. Now the duties will rise even more.

On August 17 the U.S. Department of Commerce announced dumping duties on Brazilian orange juice of 25 to 60 percent. The duties will vary for different Brazilian producers. The decision by the U.S. cited the plight of the Florida orange juice industry after successive hurricanes.

Officials at Brazil's Foreign Ministry said they could demonstrate that no dumping had occurred. They said that they would first focus on bilateral talks with the U.S. to reverse the decision. — *by Scott P. Studebaker*

# New Law Provides Incentives for Technology, R&D

by Ricardo Barretto Ferreira da Silva (Barretto Ferreira, Kujawski, Brancher e Gonçalves Sociedade de Advogados)

Important measures recently have been adopted to boost and foster the information and communication technology sector.

The Innovation Law, which was approved at the end of 2004, brought incentives for innovation, scientific and technological research. The concept of creation contemplated by law includes inventions, utility models, industrial drawings, computer programs, integrated circuit topographies, new essentially derived varieties and any other technological development that leads to or could lead to the emergence of a new product, process or incremental upgrade, obtained by one or more than one creator.

The Innovation Law determines that the federal government, ICTs[1] and related agencies will promote and stimulate development of innovative products and processes at national companies and at not-for-profit private national entities focusing on research activities, through the granting of financial, human, material or infrastructure resources, to be agreed on in specific arrangements or contracts, designed to support research and development activities, to address the priorities of the national industrial and technological policy.

## Designed to Increase Exports

Although the law determines that such priorities should be established in a regulation, it should be emphasized that among the Guidelines of the Industrial, Technological and Foreign Trade Policy (PITCE) launched by the government in March 2004, the drive for technological innovation and education become the focus of the country's agenda. The measures announced in the governmental guidelines aim to fulfill the needs of national companies to keep track of new demands of the global market, seeking to move and expand the flow of exports, to enable the country to have greater participation and competitiveness in international trade.

## Software Sector

One of the priorities of the government is the software sector. Discussions involving fiscal and political issues of exclusive financing for the area have become more intense.

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With the signing of "MP do Bem," which was the name by which Provisional Measure 252, signed on June 15th of this year by President Luiz Inácio Lula da Silva became known, some benefits, especially of a fiscal nature, were granted, including the areas of software and TI, digital inclusion projects and technological innovation.

## Tax Benefits

A "Special Taxation Regime for the Information Technology Service Export Platform" (REPES), was created, whereby the beneficiaries will be companies that: *(i)* are in a regular situation with their federal tax obligations (the adhesion of companies electing for SIMPLES is prohibited); *(ii)* execute software development and information technology service rendering on an exclusive basis; *(iii)* assume an export commitment over 80 percent of their annual gross revenue from the sale of goods and services. Companies that adhere to REPES will be able to suspend the imposition of certain taxes, the Import PIS/PASEP and of Import COFINS levied on imports of new goods earmarked for the development of software and information technology services.

## Open Source Software

The REPES beneficiary company should utilize a computer program in open code, through which the Internal Revenue Service will have access to information for auditing purposes (control of production and of the proof that the contracting party of the rendered service resides or is domiciled abroad). Other important aspects include the Special Capital Goods Acquisition Regime for Exporting Companies—RECAP and the Digital Inclusion Program.

Special benefits were also granted to micro and small companies under the MP do Bem, such as elimination of the retroactivity of the exclusion of Simples, when resulting from the entry of debits in the Outstanding Debt with the federal government or of INSS, in addition to tax incentives for technological innovation.

The MP do Bem still has to be voted on in the National Congress.

It is also important to observe the existence of specific legislation for the tax benefits for information technology and automation goods (Information Technology Law); also at the end of 2004, the aforesaid Information Technology Law was amended, guaranteeing the reduction of IPI (Excise Tax) until the year 2014.

Generally speaking, the measures currently in force are expected to be effectively implemented, pushing the country toward escalating development.

[1] Scientific and Technological Institution, a public administration agency or entity whose institutional mission includes, in addition to other aspects, execution of basic or applied research activities of a scientific or technological nature. ❑

# Private Pension Funds in Brazil: New Taxation Regime

by Vinicius Branco and Luca Priolli Salvoni (Levy & Salomão Advogados)

Law No. 11,053, of December 29, 2004, and Normative Instruction No. 497, of January 24, 2005, brought several changes to the taxation rules applicable to private pension funds in Brazil, especially with regard to the so-called individual programmed retirement fund (Fundo de Aposentadoria Programada Individual—FAPI), the supplementary social security plan (Plano Gerador de Benefícios Livres—PGBL) and life insurance plans featuring a survival coverage clause (Vida Gerador de Benefícios Livres—VGBL). FAPI and PGBL are the most frequently recommended options for employees and executive officers whose income is subject to Brazilian withholding tax (WHT), while VGBL is recommended for individuals who do not have taxable income.

## Rules Applicable to Legal Entities

Expenses incurred by Brazilian legal entities making contributions to FAPI and PGBL are deductible for purposes of Brazil's corporate taxes on profits (IRPJ and CSLL taxes), provided that the contributions assessed in each base period do not exceed 20 percent of the compensation (employee wages and executive remuneration) linked to the FAPI and PGBL plans. Beginning in 2005, VGBL contributions paid by Brazilian legal entities will also be deductible for purposes of the IRPJ and CSLL taxes, subject to the same conditions applicable to FAPI and PGBL. This is the most important change introduced by the new legislation from the perspective of Brazilian companies.

## Rules Applicable to Individuals

For Brazilian individuals, no changes have been made to deductibility rules. Contributions made/paid by participants to PGBL and FAPI plans may be deducted from their Individual Income Tax (IRPF) up to the limit of 12 percent of their gross income. Contributions to VGBL plans may not be deducted.

For taxation of redemptions and payments of benefits, beginning January 1, 2005, participants of FAPI, PGBL, and VGBL plans may choose a withholding taxation regime featuring regressive rates and set with reference to the accumulation/accrual term of the subject proceeds. In such cases, the WHT is levied equally on redemptions and payments of benefits, on a definitive basis, at rates that vary from 35 percent to 10 percent. Such rates decrease as the accumulation/accrual term increases. Individuals who do not opt for regressive rates will be subject, starting in 2005, to WHT levied at *(i)* 15 percent on advance redemptions of amounts accrued on the funds; and *(ii)* progressive rates of up to 27.5 percent on benefits received. In both cases, WHT paid is only an estimate or advance collection of the IRPF (individual income tax) due on the annual tax return, which is levied at progressive rates of up to 27.5 percent. Thus, at the end of each year, amounts received will be subject to IRPF assessed in the annual tax return in accordance with said progressive rates.

***Expenses incurred by Brazilian legal entities making contributions to FAPI and PGBL can be deductible for purposes of Brazil's corporate taxes on profits.***

## Rules Applicable to Private Pension Funds and Insurance Companies

Since January 1, 2005, earnings that derive from investments made by private pension funds and by insurance companies, during the plans' accumulation/accrual period, are not subject to WHT or to income tax payable separately. ❑

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# Brazil's Super Federal Revenue Office

by Luiz Roberto Peroba Barbosa, Maria Teresa Leis Di Ciero and Tércio Chiavassa (Pinheiro Neto Advogados)

Provisional Measure 258 (MP 258) was published in the Official Gazette of the Federal Executive on July 22, 2005. MP 258 is primarily designed to unify into a single body the administration, inspection, collection, assessment and regulation of federal taxes, formerly under the authority of the Federal Revenue Office and the National Social Security Institute (INSS). As a result, the beefed-up Brazilian Federal Revenue Office (Receita Federal do Brasil) will encroach upon social contributions until then administered by INSS, namely: (a) contributions owed by companies on the payroll; (b) contributions payable by domestic employers; (c) contributions payable by workers on their contribution salary, as well as contributions payable by third parties that are similar to such contributions.

Once again the federal government has adopted a questionable practice by issuing a Provisional Measure to carry out significant changes in powers, duties and positions, without justifying their urgency and importance as required under the Brazilian Constitution. A better alternative would have been to include such changes in a bill sponsored by the Brazilian president.

The Brazilian Federal Revenue Office will be headed by the Secretary General (Secretário-Geral), a new office created by MP 258. The Brazilian Federal Revenue Office is a body of the direct administration reporting to the Ministry of Finance. It may also, by means of a convention and upon remuneration, collect contributions payable to another body that has the same assessment base as the contributions assessed on the amounts paid those qualifying for the General Social Security System, as set out in MP 258.

The proceeds from collection of these "social security contributions," which are now under the authority of this recently-instituted Brazilian Federal Revenue Office, will be exclusively earmarked for payment of benefits under the General Social Security System.

One of the innovations is the transfer of tax administrative proceedings to the Brazilian Federal Revenue Office, including those formalized or being formalized, as well as of payment forms and statements submitted to the Ministry of Social Security and the INSS. Effective August 2006, the rules set out in Decree 70235/72 will also apply to such "social security" contributions that were incorporated into the authority of the Brazilian Federal Revenue Office. Such deadline may be changed by the Executive Branch for tax proceedings and first-instance authority for judgment of those disputes.

An important aspect is that MP 258 maintained the rules dealing with offsetting, refund, reimbursement, immunity and exemption, which continue to be regulated by the rules in effect at the time MP 258 was published. Article 74 of Law 9430/96, however, does not apply to the contributions formerly under the authority of the INSS, which are now entrusted to the Brazilian Federal Revenue Office.

### Advance Tax Rulings

Requests for advance tax ruling will observe a single system, in accordance with the rules set forth in Decree 70235/72 and articles 48 and 49 of Law 9430/96. Requests pending review and determination by the Social Security Revenue Office of the Ministry of Social Security will be voided and must be resubmitted. Taxpayers should check carefully whether this case applies to them.

***Tax hearings and other tax administrative proceedings are transferred to the Brazilian Federal Revenue Office.***

On the other hand, MP 258 does not change the INSS authority, which is established in specific legislation, particularly in connection with *(i)* granting and payment of benefits and rendering of social security services; *(ii)* services provided to those qualified for such benefits; *(iii)* review of administrative proceedings involving entitlement to social security benefits and services linked or related to the social contributions addressed above; and *(iv)* issuance of a certificate for length of contribution.

MP 258 transfers the authority to rule on appeals filed in relation to contributions, which are now under the authority of the Brazilian Federal Revenue Office, from the Social Security Appeals Board to the 2nd Taxpayers' Council of the Ministry of Finance. Cases currently underway at the Social Security Appeals Board will be sent over to the 2nd Taxpayers' Council within 30 days from creation of the new chambers. Until then, the Social Security Appeals Board will continue with authority to rule on existing appeals.

*Revenue Office, Continued on page 14*

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# Revenue Office (from page 13)

### Office of Tax Auditor

MP 258 created the office of Tax Auditor of the Brazilian Federal Revenue Office to exercise the authority of the Brazilian Federal Revenue Office. The Tax Auditor will *(i)* exclusively, formalize, by assessment, the tax liability arising from taxes that fall under the authority of the Brazilian Federal Revenue Office; *(ii)* make and render decisions on and take part in tax administrative proceedings, and in requests for advance ruling involving refund, offsetting and acknowledgment of tax benefits; *(iii)* conduct inspection procedures, including customs inspection procedures; *(iv)* examine the accounting records of business companies, bodies, entities, funds and taxpayers in general, without applying the restrictions set out in articles 1190 and 1192, but with due regard for article 1193, all of the Civil Code; and *(v)* audit the collecting network in connection with receipt and transfer of taxes collected by the Brazilian Federal Revenue Office.

The National Treasury Attorney's Office will act as advisor, represent the federal government in and out of court, and determine the liquidated nature and certainty of the debts posted in the federal overdue tax liability roster in connection with the "social security" contributions transferred to the Brazilian Federal Revenue Office. Such powers were previously entrusted to the INSS Attorney General's Office. Until July 31, 2006, INSS will be represented by the federal government Attorney's Office in issues involving tax liabilities predating the effectiveness of MP 258. A Transition Committee was created, and will report to the Attorney-General of the federal government and to the Minister of Finance.

***MP 258 created the office of Tax Auditor of the Brazilian Federal Revenue Office to exercise the authority of the Brazilian Federal Revenue Office.***

In order to accommodate the recently-created duties and obligations, MP 258 has instituted 120 National Treasury Regional Attorney's Offices to be set up by a ruling of the State Ministry of Finance in cities where there are federal lower courts, as well as 1200 new National Treasury Attorney positions. Likewise, the Brazilian Federal Revenue Office will have five Judgment Boards and 60 Judgment Panels to take joint internal resolutions, with authority to render a first-instance decision on proceedings claiming taxes administered by the Brazilian Federal Revenue Office. Such measures will be implemented in accordance with the need for the services and availability of budgetary resources.

MP 258 has modified article 44 of the Social Security Organic Law (Law No. 8212 of July 24, 1991), providing that the Brazilian Federal Revenue Office, through the National Treasury Attorney's Office (charged with representation in court), will also be responsible for collecting social security contributions levied on payments made in labor claims. The other provisions of Law 8212/91 remain in full force and effect.

MP 258 will come into force on the date of its publication in relation to articles 32 and 37, which state, respectively, that DATAPREV will be authorized to provide services to the Ministry of Finance for the purposes of MP 258, and that the Federal Revenue Office and the Social Security Revenue Office will issue up to August 14, 2005 the joint rules required for operation of the Brazilian Federal Revenue Office as from August 15, 2005. The other articles of MP 258 become effective as from August 15, 2005.

The notion of consolidating the INSS and the Federal Revenue Office duties is not new, having been heard of since the former administration, particularly due to the Federal Revenue Office's constantly-improved and dynamic procedures, which increased considerably tax revenues and improved the efficiency and automation of such office. Inspection activities have been divided by specific matters (Department of International Affairs, Special Financial Institutions Office, etc.). Such efficiency will be very useful to manage social security liabilities and reduce costs, since only one body will be in charge of tax revenues.

### Confusion Caused by Recent Changes

However, one can't be careful enough! Automation and development of the Federal Revenue Office have greatly helped to increase tax revenues in recent years. Several hurdles were created for taxpayers, especially a good number of new tax statements, which hinder the issuance of debt clearance certificates as a result of errors in the information filled out or absence of correlation in the information obtained by the Federal Revenue Office, and so forth. Hopefully, the new Brazilian Federal Revenue Office will not create further difficulties for taxpayers, but rather make their life easier.

At first impression, it appears that the federal government has hit the target, since MP 258 is extremely salutary in several aspects. However, the tool chosen to carry out the purpose has once again proved to be inadequate, as such a significant change would be more legitimate if made via a law proposed by the president of the Republic rather than via such a precarious instrument as a Provisional Measure, encroaching once more upon the full authority of the National Congress. ❑

# New "CRA" Agribusiness Security

by José Barreto Neto and Claudia Pinheiro (Levy & Salomão Advogados)

Brazil's Congress passed a law in 2004 creating a number of new securities, the most notable of which is the "agribusiness receivables certificate" (CRA) that aims to facilitate access to capital in Brazil's agribusiness sector. CRA securities are registered and freely negotiable, and represent a promise to pay in cash funds. They are based upon credit rights deriving from the production, sale or manufacture of agribusiness products and machinery, including financial operations between farms, cooperatives and third parties.

While the new certificates have been authorized by Congress, the application of Brazil's CPMF[1] tax to the commercial or industrial agribusiness transactions underlying CRAs has discouraged agribusiness securitization companies from issuing CRAs. In contrast, Brazil's CPMF tax is not levied on the proceeds of real estate and financial credits deposited into securitization companies' accounts. In addition, real estate and financial securitization companies could deduct expenses incurred in raising capital for the determination of the assessable basis of the PIS and COFINS[2] tax, this benefit again being unavailable to issuers of CRAs, as such securities are based on commercial or industrial activities. On June 15, 2005, however, a provisional measure was passed that extends to CRA issuers the deductibility privilege previously extended only to real estate and financial securitization companies.

The advent of CRAs demonstrates that Brazil's Congress is serious about creating new sources of capital for the country's agribusiness sector. Nevertheless, only when the tax cost associated with the transactions underlying CRAs achieves full parity with that of transactions underlying comparable real estate or financial credits will CRA issuances be rendered viable and permit the agribusiness sector in Brazil to have full access to capital markets.

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[1] The Provisional Contribution on Financial Transfers tax (Contribuição Provisória sobre Movimentação ou Transmissão de Valores e de Créditos e Direitos de Natureza Financeira—CPMF) is levied on proceeds deposited into companies' accounts at a rate of 0.38 percent.

[2] Both the Contribution for the Social Integration Plan tax (Contribuição para o Programas de Integração Social—PIS) and Contribution for Social Security Financing tax (Contribuição para Financiamento da Seguridade Social—COFINS) are levied on the gross income of companies at a rate of 0.65 percent and 4.00 percent, respectively (subject to alteration due to the entry into law of Provisional Measure No. 252, of June 15, 2005). ❑

# Central Bank Hints at Interest Rate Cuts in September

by Edwin Taylor

For the third consecutive month, Brazil's Central Bank in August chose to hold the Selic (Brazil's overnight rate) at 19.75 percent a year. The conservative decision of the bank's monetary policy committee (Copom) came despite the fact that inflation is in decline and the projection of the financial market for the Broad Consumer Price Index (IPCA) has fallen for thirteen straight weeks, now standing at 5.4 percent, close to the Central Bank's target of 5.1 percent. Copom gave no explanation for its decision but analysts speculated that it was caused by rising international oil prices and concerns with the impact of the political crisis on the financial market. Business leaders attacked the decision which they warned will maintain this year's stunted growth into 2006. Paulo Skaf, president of the São Paulo State Federation of Industries (Fiesp), charged that Brazil continues to be "an obstinate champion of high interest rates."

The minutes of the August meeting, however, indicated that bank directors will likely begin to lower the Selic rate starting in September. In the minutes, Copom described the inflation scenario as "benign" and dropped the language of the previous two months which spoke of holding the Selic rate unchanged for "a long time." The only inflationary pressure cited by Copom was the threat of an increase in the price of gasoline which has

***Despite a stronger local currency, exports continue to grow.***

Edwin Taylor is a *LALBR* special correspondent in Rio de Janeiro.

*Interest Rate, Continued on page 16*

## Interest Rate (from page 15)

not risen this year despite the record highs for the international barrel price of petroleum.

According to the National Petroleum Agency, the sector watchdog, there is a 30 percent gap between the domestic and international prices of gasoline. Part of this, however, has been covered by the year's firming of the real against the dollar. In the minutes, Copom pointed out that not only is inflation in decline but the projections of the financial market are moving closer to the Central Bank's year-end target.

### Public Accounts

Brazil's consolidated public sector posted a primary budget surplus of $2.1 billion in July, the highest surplus on record for the month and 32.9 percent over July 2004.

For the year through July, the primary surplus totaled $28.6 billion. The annualized surplus at the end of July was $40.4 billion, the equivalent of 5.16 percent of GDP, well in excess of this year's target of 4.25 percent of GDP. To reach the year-end target, the government must average a monthly surplus of $1.2 billion for the remainder of the year. The public sector's combined debt also rose in July, increasing from 51 percent of GDP in June to 51.3 percent of GDP. Because of the year's increase in the Selic rate, which adjusts 52.9 percent of the public debt, debt servicing costs have jumped 27.7 percent this year to $38.4 billion. This increase led the Central Bank to raise its projection for the year's nominal budget deficit from 2.67 percent of GDP to 3.6 percent.

***The continued strengthening of Brazil's foreign accounts has reduced significantly the country's vulnerability to foreign shocks.***

### Labor

The unemployment rate in Brazil's six largest metropolitan areas remained stable in July at 9.4 percent, according to the government's statistics bureau IBGE.

But while the job market stagnated, income levels improved. The average wage in July rose 2.5 percent from June and 1.6 percent versus July 2004. This was due almost entirely to the month's decline in inflation coupled with lingering effects of May's readjustment in the minimum salary.

Although the unemployment rate remained stable, July's job figures contained one worrisome development—industry registered a net loss of 40,000 jobs in the cities surveyed. July is normally a month when industrial firms begin hiring in preparation for the usual surge in demand in the final quarter.

This reluctance to hire is a reflection of the twin concerns of the private sector—interest rates and the exchange rate.

"The uncertainty regarding monetary policy inhibits investments and consequently the opening of new job posts," said IBGE employment coordinator Cimar Azeredo.

The annual job figure also showed a significant decline in July. For the 12-month period ending in July, 445,000 new jobs were created but this was far from June's annualized result of 647,000.

### Foreign Investment Remains Strong

Brazil in July posted a current account surplus of $2.6 billion, the highest monthly total on record. This raised the year's surplus to $7.9 billion, also an all-time record for the period and 27 percent over the total for the first seven months of 2004. The annualized surplus in July was $13.9 billion, the equivalent of 1.9 percent of GDP, up from 1.9 percent in June.

The continued strengthening of Brazil's foreign accounts has reduced significantly the country's vulnerability to foreign shocks. In July, the current account surplus was once more guaranteed by the trade surplus which also set a record for the month at $5.0 billion. For the year through July the trade surplus totaled $24.7 billion versus the year's services deficit of $18.8 billion. Another $2 billion entered the country through remittances from Brazilians living abroad.

For the year through July, the travel deficit widened to $408 million as Brazilians continued to travel abroad more, taking advantage of the year's firming of the real against the dollar. The Central Bank has now raised its projection for this year's travel deficit to $800 million.

Profit remittances, which averaged over $1 billion a month in the first semester, declined in July to $681 million. Central Bank economic department head Altamir Lopes said companies accelerated their remittances in the first half of the year because of the weakened dollar and are now reducing them.

Foreign direct investment also produced a surprisingly strong result in July, registering net inflows of $2.0 billion, the second highest total of the year. For the year through July, FDI stood at $10.6 billion and should easily reach the Central Bank's year-end projection of $16 billion.

*Interest Rate, Continued on page 17*

# Interest Rate (from page 16)

In July, the private sector continued to pay off a large portion of its maturing foreign debt. Only 45 percent of the maturing debt was rolled over in the month and the average for the year is now 68 percent. This is the reason why Brazil's foreign debt in May fell to $198.3 billion, the lowest level since December 1997.

Because of the government's decision to pay ahead of time a $5 billion debt with the IMF, Brazil's reserves declined in July from $59.9 billion to $54.7 billion. Net reserves, however, discounting IMF funds, showed little variation ending July at $40.4 billion versus $40.5 billion in June.

### Exports and Consumer Credit Purchases Spur Increases in Industrial Production

Brazil's industrial production expanded 1.6 percent in June from May, the fourth consecutive monthly expansion and the largest since May of last year.

Compared with June 2004, industrial output rose 6.3 percent and ended the first semester with growth of 5 percent over the same period last year. In the second quarter, production expanded 2.1 percent from the first quarter in which growth was stagnated.

June's results were led by durable consumer goods whose output rose 8.1 percent from May and 23.6 percent compared with June 2004. Intermediate goods expanded 0.9 percent versus May and 2.9 percent year-on-year. Capital goods also continued their expansion which began in May with a 5.2 percent increase and rose another 4.2 percent in June from the previous month.

The only area to present a reduction in the second quarter was semi- and non-durable consumer goods whose output fell 0.9 percent. In June, this sector expanded 0.7 percent.

Exports and expanding consumer credit were cited as the main factors behind June's strong growth results. Production of automobiles, appliances and cellular phones expanded at rates of 7 percent to 8 percent in June.

"Despite the firming of the real, we have not seen any sign of this appreciation in the export numbers. On the contrary, exports have surprised and set records. The other impulse has come from expanded credit. These two factors pushed up the sector of durable goods which has been showing the best results," said Sílvio Sales, coordinator of the industrial production survey for the Brazilian Institute of geography and Statistics (IBGE).

Industrial sales increased 1.53 percent from May, hours worked in production improved 0.68 percent, the industrial work force rose 0.08 percent and industrial payroll climbed 0.60 percent. Average capacity utilization went from 81.9 percent in May to 82.6 percent.

In the second quarter, sales rose 1.5 percent from the first quarter which had registered a 1.4 percent decline versus the final quarter of 2004. For the semester, sales increased 4.5 percent compared with the same period last year, hours worked expanded 7.2 percent, employment improved 6.4 percent and payroll climbed 9 percent.

In June, nationwide retail sales volume rose 1.2 percent from May, according to the government's statistics bureau, IBGE. Versus June 2004, sales expanded 5.3 percent and ended the semester with a 4.6 percent increase versus the first half of 2004.

June's sales were again led by the sector of appliances and furniture. Heavily dependent on credit sales, the sector registered a 4.3 percent expansion in volume from May. For the semester, the sector's sales jumped 19.7 percent. Sales of office equipment and technological goods climbed 37.6 percent in the semester, another reflection of the importance of credit sales.

Semester sales of supermarkets, more dependent on salaries, rose only 3.3 percent and sales of clothing and footwear expanded a weak 2 percent. In addition to increased credit, economists attributed June's increased sales volume to the readjustment of the minimum salary in May and the decline of inflation.

***Foreign direct investment is expected to reach $16 billion this year.***

### Inflation

In July Brazil's Broad Consumer Price Index (IPCA) measured inflation of 0.25 percent. Although this was above June's deflation of 0.02 percent, the result was within the range expected by the financial market. Also for the year through July, the IPCA recorded an inflation rate of 3.4 percent, the lowest for the period since 2000.

July's rate would have been much lower were it not for the month's 4.2 percent increase in phone rates which accounted for 60 percent of July's inflation. Fuel prices also rose with gasoline increasing 0.9 percent and alcohol fuel climbing 2 percent—the two together were responsible for another 20 percent of the month's IPCA. None of the other categories, however, showed any sign of inflationary pressure, leading analysts to celebrate the July figure as another indication that inflation is under control.

Thanks in part to the weakening of the dollar, food prices declined 0.8 percent. Electricity rates fell 0.4 percent and urban bus fares dropped 0.2 percent.

The annualized IPCA fell from 7.3 percent in June to 6.6 percent, continuing a trend that has existed over the last three months.

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## Interest Rate (from page 17)

### Trade

Brazil in July continued to set trade records, registering the country's highest monthly surplus and largest export result in history.

Exports totaled $11.1 billion, 28.9 percent more than in July 2004 on a daily average while imports rose 14.7 percent to $6.05 billion. The resulting surplus of $5 billion was nearly $1 billion more than in June, the previous all-time high.

With July's result, the year's surplus jumped to $24.7 billion, 33.6 percent over the surplus for the same period in 2004. Exports for the first seven months of the year climbed 24.6 percent year-on-year to $64.7 billion. Imports rose 19.2 percent to $40.1 billion. The annualized surplus in July was $39.9 billion, another record.

Exports in July were helped by rising international prices for iron ore, coffee, sugar and pork. The export record was also assisted by $300 million in petroleum exports that actually were shipped in June but did not enter the country's books until last month.

On the import side, purchases of capital goods expanded 30 percent in July versus July 2004. Imports of raw materials and intermediate goods increased 15.7 percent and consumer goods rose 11.5 percent.

Following the release of July's trade figures, the Brazilian Foreign Trade Association (AEB) announced it was raising its projection for this year's trade surplus from $32.1 billion to $42.1 billion. While AEB remains critical of the exchange rate, it now believes that world demand for Brazilian products will remain strong through the end of the year. At the same time, imports are not increasing at the pace expected at the start of the year. ❑

CHILE

# New Mining Tax to go into effect in January

by Alvaro Mecklenburg (Deloitte Chile)

After extensive debate and controversy, a tax on mining income in Chile will be levied as from January 1, 2006. The new law imposes a tax of 5 percent of operating profits on mining operators that produce more than 50,000 metric tons of copper per year. A previous attempt to impose a royalty on mining income failed because the proposal was unable to get the requisite number of votes in the Congress.

The tax will be imposed on a progressive scale on the taxable operating income of mining operators depending on the amount of copper produced each year. Taxable operating income is calculated by making adjustments to the normal net taxable income of the company. Companies that produce less than 12 metric tons per year will not be subject to the tax; the rate for companies with a small amount of sales is between 0.5 percent and 4.5 percent, increasing up to a maximum of 5 percent for companies with annual sales of more than 50,000 metric tons of copper. To prevent taxpayers from using artificial structures and/or allocations to avoid or reduce the mining tax, the law provides that, in calculating the tax rate, the mine operator must include the total value of sales of mining products of the group of entities related to the mining operator (to the extent such persons are engaged in the exploitation of mining). Further, the Chilean tax authorities will be allowed to challenge transfer prices and make relevant adjustments to income as needed.

Taxpayers subject to the mining tax will be required to make monthly provisional payments at a rate that will be calculated on the basis of sales (monthly gross income), but at a minimum of 0.3 percent. The law introducing the mining tax also amends the foreign investment law (Decree Law 600) so that the tax treatment of mining investments protected under Decree 600 is in conformity with the new mining tax.

Investors in mining projects valued at more than $50 million will be entitled to enter into a "stability pact" with the Chilean government, whereby the rate of the mining tax will not increase for a period of 15 years. Chile is the world's largest producer of copper and the mining industry represents nearly 10 percent of GDP. ❑

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# Boost to Private Equity Funds

by Andres Williamson (Baker & McKenzie)

In an effort to diversify and attract investment into the productive sector, which would, in turn, expand the public securities market, the Colombian Superintendency of Securities issued Resolution 470 of June 16, 2005, under which the Superintendency will introduce certain rules fostering the establishment of Private Equity Funds. The main change introduced by Resolution 470 is to allow the incorporation of portfolios comprised primarily of assets other than securities registered in the National Securities and Issuers Registry, which traditionally form part of the portfolio of the securities investment funds that currently exist in Colombia.

Under Resolution 470, fund administrator companies (as broker dealers, fund managing companies or trust companies) will be able to set up closed funds that designate at least two thirds of the contributions made by the investors to purchase or acquire *(i)* shares or quotas of companies that are not listed in the Stock Exchange or registered with the National Securities and Issuers Registry, *(ii)* negotiable instruments issued by entities other than financial institutions, or *(iii)* any other assets with an economic value (oil wells exploration and exploitation rights, participation in commercial trusts, real estate projects, etc.).

**More Attractive to Foreign Investment Funds**

Resolution 470 creates possibilities for developing projects by attracting private equity, giving investors the possibility of a secondary market for liquidity, since the subscription rights of private equity funds are securities that must be registered in the National Securities and Issuers Registry and listed on the Stock Exchange. Because the securities are registered, foreign portfolio investment funds as well as Colombian institutional investors (such as pensions and severance pay funds) can invest in Private Equity Funds, thereby generating important dynamics for this type of investment, which are widely developed in the international markets.

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However, there are some economic restrictions. The minimum investment amount is 600 legal minimum monthly wages (about COP $230,000,000). Nevertheless, this requirement applies only at subscription of the investment and can be varied throughout the duration of the fund.

Another innovation introduced by Resolution 470 is that it introduces flexibility into the obligation to appraise Private Equity Funds, requiring valuations at least every six months. Furthermore, the resolution demands the integration of a Surveillance Committee for the Private Capital Funds, which must act as an executive branch of the fund and monitor compliance by the fund managers, investment analysis committees and professional managers (another new feature) with their functions and to ensure, among others, that investments are made in compliance with applicable law.

***The resolution is expected to increase the amount of savings that will be invested in private projects.***

**Management**

Private Equity Funds can now hire professional managers for the purpose of taking control of the managerial duties of the Private Equity Fund, but such delegation will not release the fund administrators from their responsibilities.

The professional manager can be a national or foreign individual or legal entity that can demonstrate national or international experience in managing Private Equity Funds.

The amendment is designed to implement common standards of practice in the international Private Equity Funds market, where it is customary to find professionals specializing in the administration of investment portfolios, usually with extensive knowledge of the industry or sector in which the investment is to be made.

Resolution 470 opens the door to increase the flow of savings towards investment in private projects requiring capital, whether start-up companies or companies in expansion. The possibility of an active participation by foreign portfolio investment funds and institutional investors in Private Equity Funds, as well as the creation of liquidity conditions required to facilitate the settlement of investments on the secondary market will contribute to greater dynamism in the Colombian securities market. ❑

# Renewable Energy Projects Incentives

by Jose Raúl Félix-Saúl and Federico Ruanov-Guinea (Baker & McKenzie)

**Mexico's current legal framework allows power generation projects that may use renewable energy sources under self-supply, small production, independent production and export schemes. The Law for the Public Service of Electrical Energy (Ley del Servicio Público de Energía Eléctrica) does not restrict power generation to a specific technology. Although environmental costs are not expressly considered when pricing in the Mexican power market, there are a few provisions under Mexican law that promote the use of renewable energy.**

The General Law of Ecological Balance and Environmental Protection (Ley General del Equilibrio Ecológico y la Protección al Ambiente) requires federal, state and local authorities to develop, within their respective jurisdiction, sound policies that include economic, financial, tax and market schemes that must grant a high priority to activities related to "the research and implementation of energy-saving mechanisms and the use of energy sources that reduce pollution."[1] This law proposes tax incentives to those who "conduct technology research leading to a reduction of pollutants."[2] Based on these provisions, a proposal was submitted to Congress to include article 227 of the Mexican Income Tax Law (ITL).

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### How Incentives Would Work

This proposal was filed on March 1, 2005, by Senator Gloria Lavara Mejia of the Mexican Green Party. If approved by the Mexican Congress, the proposal would grant the following tax incentives:

- Accelerated depreciation equal to 100 percent of the cost of the investment made in machinery and equipment that *(i)* diminishes pollutant gases that produce a greenhouse effect, and *(ii)* substitutes the use of substances that directly affect the ozone layer.
- Tax credits equal to *(i)* 10 percent of the taxable income in a given year to those taxpayers that perform service activities related to the maintenance of the machinery and equipment mentioned above, *(ii)* 30 percent of the amount of investments made in a given tax year to preserve agricultural soil, *(iii)* 50 percent of the total amount of investments made in a given year in research that aims to determine the actual behavior of pollutant gases and their effects to the ozone layer, and *(iv)* 100 percent in investments made in machinery and equipment that promote the usage of renewable energy.

The purpose of the initiative is to broaden the tax incentives already in place in the ITL since FY2004, which currently provides a tax incentive equal to depreciating the full costs (100 percent) of machinery and equipment that generate energy from alternative sources (solar, wind, nitrogen, etc.), in the year that it was purchased. This incentive is only valid where the machinery and equipment being depreciated at a 100 percent rate is placed to work at least for a five-year period. Where the machinery and equipment is not operated at least for the five-year period, the taxpayer will be required to recapture the percentage of the deductions corresponding to those years in which the machinery was not operated and characterize the recaptured amount as taxable income.

[1] Ley General del Equilibrio Ecológico y la Protección al Ambiente-General Law of Ecological Balance and Environmental Protection, section III, article 22 Bis.

[2] Id, section III, article 166. ❑

# Policy Options (from page 3)

this is an uncertain and variable source. Further government appropriations for Pemex might be feasible this year and next because the government calculated its revenue from oil based on a price of $27 per barrel for the Mexican oil mix, and the actual average export price has risen to almost $40 per barrel. This kind of financing may not be available year after year.

In other words, in order to let Pemex keep an extra $20 billion each year, tax collections would have to rise by at least that amount—and probably more, because a budget of 18 percent of GDP is inadequate to meet the need for better education and health care and a safety net for the old and the poor. The question of privatization could be finessed for now if Mexico were able to let Pemex operate as a normal company using its own earnings to make and carry out its own investment decisions. The "if" is a big one, but many Mexicans prefer this option in order to keep oil in Mexican hands. Earlier in its history, Pemex was able to make investments from its own revenue even after paying federal taxes, but this has not been the case for several decades.

The Mexican Congress recently passed legislation to reduce the taxes Pemex pays as of January 1, 2006. The

*Policy Options, Continued on page 21*

## Policy Options (from page 20)

bill is complex and the tax imposed on Pemex would vary with the price of oil and gas, but it was an effort to address the problem of Pemex financing. The early indication is that President Vicente Fox will veto the bill, presumably because it does not specify how the Treasury would get the revenue needed to make up the shortfall that would result. The president has until September 1 to act on the bill. If he does exercise his veto, a two-thirds majority in each chamber of the Congress could override it.

### Opening to Private Investment

Choosing the other option of permitting private investment does not require the privatization of Pemex, only a willingness to allow joint ventures between Pemex and private interests, including foreign direct investment. Mexico would still own the oil in the ground, but the private investment would permit a risk-reward model that does not now exist. This model exists in Canada and Brazil and other countries that have government-owned oil companies. Action like that of Argentina, where the government-owned oil company YPF (Yacimentos Petrolíferos Fiscales) was completely privatized in 1995 during the Menem administration, is not necessary in Mexico. The Brazilian and Canadian models are working well.

The Mexican government could, of course, do both: relieve Pemex of some of its tax burden so that it can operate as a normal oil company; and also accept private-public joint ventures, especially for expensive deepwater exploration. When I last discussed the issue of deepwater drilling, several Mexican officials and experts said they hoped it would be possible to identify a suitable site that straddled the territorial waters of Mexico and the United States, thereby permitting a joint venture that did not require a constitutional amendment, obviating the need to face the controversial and emotional issue of private investment in Mexico's oil and gas resources.

The dangers Mexico faces are running out of oil both for domestic use and export in a relatively short period; of having to meet a growing bill for natural gas imports; and of failing to provide energy to all would-be users, or providing it at a cost that is so high as to encourage producers to move to locations where energy is cheaper. Unless good fortune intervenes, the decisions will probably have to be taken in the new administration that comes into office next year. Mexico has shown that it is able to make controversial decisions when it looks as if there will be economic hardship if nothing is done but economic benefit if long-standing policy is revised. One good example of this was the abandonment of import substitution policy—keeping high import barriers in order to protect domestic industries—following the financial collapse in 1982. This led to lowering import protection, joining the General Agreement on Tariffs and Trade, and later entering into the North American Free Trade Area with the United States and Canada. The two issues, trade protection and permitting private risk ventures for oil and natural gas, do not have the same emotional resonance in Mexican history, nor is trade policy a constitutional issue. But both require the readiness to adapt when the economic well-being of the population is at stake.

The internal debate on oil, gas, and energy policy is going on, as the recently approved bill on Pemex shows. The head of Pemex has declared that he believes policy change is urgently needed. President Fox tried early in his administration to change tax policy, but he failed to make headway because of congressional opposition. The debate may take on new resonance in the campaign for the presidency once it moves into high gear later this year and early in 2006, but a frontal argument in favor of change is unlikely. Those who seek change will probably seek to frame the debate around economic growth and meeting the country's social needs, while opponents will likely emphasize the constitutional question of accepting private investment and advocate spending cuts rather than raising tax collections. The presidential candidates are apt to discuss the future of Pemex but dance around the policy issues involved.

### The Political Problem

It would be hard, probably suicidal in terms of winning an election, for a presidential candidate to run on a platform that goes against a history of shunning foreign investment in the oil sector or that favors raising taxes. Carlos Salinas did not run in 1988 on a platform of free trade with the United States. He came to that position subsequently, when it became evident that the needed foreign investment for development would not come from Europe, or elsewhere, without a welcome mat of legal assurance for investment in Mexico and the promise of the large U.S. market. In hindsight, it is clear that Salinas chose the right moment for his free-trade initiative; and he made his case on economic development grounds.

It is hard to predict when these two fundamental criteria—the impending energy shortage and the proper timing—will become simultaneously evident to the Mexican public. Unless something unforeseen happens soon, such as a new oil find or discovering a large deposit of unassociated (i.e., not associated with oil) natural gas, the timing for some action to change oil, gas, and energy policy will probably come some time after the 2006 election, but during the next presidential *sexenio* (six-year term).

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[1]The May 2005 *Issues in International Political Economy*, no. 65, dealt with this theme of politics dominating oil and gas policy in many Latin American countries.

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# How Mexico Taxes Interest Earned in Mexico and Paid Abroad

by Rene Cacheaux and Miriam Name (Cacheaux, Cavazos & Newton)

Making interest payments to residents abroad is common when dealing with countries such as Mexico, particularly in cases where domestic companies receive money from their foreign parent companies or loans from third parties residing outside Mexico. In general terms, Mexican interest rates are higher than U.S. rates. This is true even when one takes into consideration the dollar-peso devaluation factor.

Mexican law considers a taxable source of wealth to exist in Mexico when: *(i)* loan proceeds are invested in Mexico; or *(ii)* interest is paid by a Mexican resident, or by a foreign resident with a permanent establishment in Mexico.

## Broad Definition of Interest

Mexican law defines interest as including not only payments made in connection with loans and public debt, bonds and obligations, but also payments resulting from stock loans, factoring and similar transactions with bonds or placement of debt obligations, commissions or payments made for obtaining or guaranteeing loans, payments made to a third party for the acceptance of an unconditional guaranty or collateral, and payments resulting from profits from the sale and transfer of publicly-traded stock.

The Mexican Income Tax Law also considers as "income" any yield from a loan obtained by a foreign resident resulting from acquisition of credit rights of any type, whether present, future or contingent. In this case, the source of wealth is considered to be in Mexico when the credit right is sold and transferred by a resident in Mexico, or by a foreign resident with a permanent establishment in Mexico.

The Fifth Paragraph of Article 11 of the Tax Treaty between Mexico and the United States includes within the definition of "interest," income considered by the law in the country of origin as proceeds resulting from money that has been lent. That said, the United States Department of the Treasury has interpreted this definition not to include penalties or fines for late payment.

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## Tax Caps

Thus, under Article 11 of the Treaty, interest accrued in one country and paid to a resident in another country may be subject to taxation by the latter country. That is, interest originating in Mexico paid to a United States resident may, in addition to being taxed in Mexico, also be taxed in the United States; however, if the effective beneficiary of the interest is a resident of the United States, or in the opposite case a resident of Mexico, limits exist on taxable rates that can be imposed in the source country. In Mexico's case, this rate may be up to 30 percent in 2005. The treaty imposes the following rate caps:

- 4.9 percent of the gross amount of interest arising from loans granted by banks or insurance companies, as well as those derived from bonds and/or negotiable instruments that are traded in a recognized stock market;
- 10 percent if the effective beneficiary is not a financial institution and the interest is paid by banks or by the purchaser of machinery and equipment sold and transferred by means of a credit sale;
- 15 percent in all other cases.

Additionally, the Treaty establishes certain cases in which interest may not be subject to taxation by the country in which the interest accrued, for example, when the effective beneficiary is the other country.

In Mexico, the tax is paid by means of a withholding made by the person that is making the interest payment and is computed by applying the corresponding rate, taking into consideration the rate limits set forth in the Treaty, to the interest received by the taxpayer, without any deductions.

## Payments by Company Office

For Mexican permanent establishments of foreign residents, when payments for interest and other items discussed above are made by the main office or other office of the company abroad, the withholding should be made within 15 days following the date on which the payment is made abroad, or the payment is deducted by the permanent establishment, whichever occurs first.

Account statements and payment receipts issued by financial institutions, money exchange houses or retirement fund administrators, function as withholding receipts for interest paid.

Notwithstanding the fact that the Treaty does not require foreign residency certification, Mexican miscellaneous tax regulations provide that a foreign residency must be demonstrated to the authorities through a corresponding residency certificate in order to take advantage of the Treaty's preferential tax rates. ❑

# Thin Capitalization in Mexico: Transition Rules

by Marc Schwartz (Schwartz Advisory Services, Inc.)
and José Juan Miranda (M&V Consultores)

Mexico's new tax law incorporates thin capitalization rules, which in theory become fully effective on January 1, 2010. This article examines the broadly drafted transition rules which discuss how taxpayers should manage their debt:equity ratio in the five-year period prior to January 1, 2010.[1]

### Transitory Rules

In general, the transitory provisions provide a mechanism for taxpayers whose debt:equity ratio exceeds 3:1 on January 1, 2005 to comply with the ratio by the January 1, 2010 date. The rules stipulate that taxpayers should reduce such excess debt in equal parts in each of the following five years (i.e., 20 percent per year) until reaching the established limit.

While the tax authorities have attempted to provide helpful guidance for taxpayers to meet the requirements of the thin capitalization rules by the 2010 date, the role of the transitory rules is not clear. Whether the current wording of the transitory rules results from a mere oversight or an intention for taxpayers to reduce the excess debt by 20 percent per year, there is no stipulated consequence for taxpayers that do not meet the 20 percent reduction.

### Practical Issues

Taxpayers and advisors are currently struggling with very real, practical issues regarding the transitory rules. For instance:

- What happens if a taxpayer does not meet the transitory rules' 20 percent reduction each year but fully complies with the thin capitalization rules by January 1, 2010? Here, the taxpayer would technically seem to be in compliance because it would have an "appropriate" debt:equity ratio by the effective date of the thin capitalization provisions in 2010.
- What happens if a taxpayer meets the 20 percent reduction in some years and not in others? Does the answer change if the taxpayer also does not meet the 3:1 ratio by 2010? In other words, does meeting the 20 percent reduction in a "transitory" year provide any type of safe harbor for that year?
- What role should new business-related debt play in the interim five-year period? Should it matter whether new debt results from a merger or acquisition, as opposed to an internal financial restructuring not related to a specific business endeavor?

An interesting aspect is that the law passed by Congress provides that the new thin capitalization rule takes effect in 2010. If there are tax consequences of not meeting the annual 20 percent requirement, have the tax authorities in effect applied separate thin capitalization rules prior to 2010 and, if so, do the tax authorities have such power? Taxpayers and their advisors are debating these very issues since there could potentially be large dollar amounts at risk.

***Taxpayers and advisors are currently struggling with very real, practical issues regarding the transitory rules.***

### Conclusion

It would seem that the five-year period in the transitory rules exists to encourage taxpayers to begin addressing thin capitalization today, as opposed to waiting until December 31, 2009. In that regard, the transitory rules provide helpful guidelines. However, in our experience, unless there are real consequences (i.e., tax and/or penalties due) for not complying with the 20 percent rule, it is unclear whether many companies will attempt to meet such guidelines. Tax and finance departments face such pressure from supporting company operations, including assisting with new projects and investments, mergers and acquisitions, and sales, that even when there is time to focus on the internal financing structure, debt:equity ratios are constantly changing and difficult to manage. This situation is made even more tenuous when it is not clear whether there are "real" consequences to not meeting the 20 percent rule.

It is our understanding that Congress has empowered the tax authorities to provide additional guidance on this issue. Hopefully the tax authorities will issue such guidance sooner rather than later, especially if not meeting the 20 percent annual rules could create a tax liability.

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[1] This article focuses solely on the transition rules. It does not discuss the general nature of the thin capitalization rules and the mechanics of the 3:1 debt:equity ratio. It also does not examine the potential legal arguments behind whether the rules should successfully withstand a constitutional challenge. ❑

# Analysis of the Dominican Republic-Central America-U.S. Free Trade Agreement

by Kirk Ross (Katten Muchin Rosenman)

On August 2, 2005, President Bush signed H.R. 3045, the Dominican Republic-Central America-U.S. Free Trade Agreement (DR-CAFTA or Agreement) Implementation Act (Act). The law implements the DR-CAFTA, a free trade agreement among the United States, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras and Nicaragua.

The DR-CAFTA is the latest in a string of free trade agreements (FTAs) entered into by the United States in recent years. After passage in the Senate, the Act was approved in the House of Representatives, but only after several weeks of intense lobbying by the White House.

The razor thin margin by which the Act passed the House (217-215) suggests that future FTAs may be a tough sell in Congress.

Implementation of the DR-CAFTA is not expected to have a major impact on the U.S. economy or those of the other party-countries. The combined 2004 gross domestic product of the six Central American countries party to the Agreement was about $92 billion, approximately one-seventh that of Mexico's. In addition, roughly 80 percent of U.S. imports from the other parties are already duty free. However, the Agreement eliminates most remaining duties and, importantly, eliminates or reduces duties on U.S. exports to the other parties.

The Act authorizes the president to enter into the Agreement by proclamation for those parties that have also ratified it. The DR-CAFTA has already been ratified by El Salvador, Honduras and Guatemala. Costa Rica, Nicaragua and the Dominican Republic are expected to do so soon. The Agreement will not actually enter into force until the president makes the authorized proclamation.

### General Market Access

Under the DR-CAFTA, duties on most types of industrial and consumer "originating" goods will be eliminated as soon as the Agreement enters into force. However, tariffs on U.S. automotive exports will be phased out over five years, and most of the few remaining tariffs (excepting agriculture) will be phased out over ten years.

One foundation concept in the DR-CAFTA is that of "originating goods." Only goods that qualify as "originating" under the Agreement's Rules of Origin can qualify for the DR-CAFTA's preferential tariff treatment. Subject to a number of exceptions (which will be explained below), the Agreement generally provides four criteria under which goods may qualify as originating: first, goods that are wholly obtained or produced in a party-country, i.e., crops grown or minerals extracted in that country; second, goods that are manufactured or assembled from non-originating materials that undergo a specified change in tariff classification within one of the party countries (a "Tariff Shift"); third, goods that meet an applicable regional value content requirement; fourth, goods that are produced in a party-country entirely of other originating materials.

Under the Tariff Shift criterion, goods may still qualify as originating goods even if they are not made wholly of materials that have undergone a tariff shift. If the value of non-originating materials in the goods which do not undergo a tariff shift do not exceed 10 percent of the adjusted value of the goods, then the goods may still qualify as originating. This *de minimis* exception does not apply to certain agricultural or textile goods or in calculating regional value content.

**_The Agreement maintains tariff rate quotas for some agricultural products, although they will be phased out over time._**

In order to meet the applicable regional value content criterion, a specified percentage of the value of the goods must be attributable to originating materials. In general, the Agreement provides for two methods for calculating that percentage: (1) the "build-up" method which is based on the value of non-originating materials in the goods; and (2) the "build-down" method which is based on the value of originating materials in the goods. However, a special exception is made for certain automotive goods, whose regional value content may be based on the net cost of the goods.

In order to claim preferential tariff treatment under the DR-CAFTA, an importer must be prepared to submit a statement to the appropriate customs authority, explaining why its importations qualify as originating goods. A party-country may only deny a claim for preferential tariff treatment in writing and must provide legal and factual findings. A claim for preferential tariff treatment may be made up to one year after importation, including a refund of any overpaid duties.

### Agriculture

The Agreement includes special provisions for trade in agricultural goods. As with other types of goods, duties

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## DR-CAFTA (from page 24)

on most agricultural goods will be eliminated as soon as the Agreement enters into force. However, the duties on a specified list of agricultural products will remain in place, to be phased out over various periods of time. Most of those will be phased out over ten years. A few more will be phased out over fifteen years. The final ones will be phased out over twenty years.

The Agreement maintains tariff rate quotas (TRQs) for some agricultural products, although they will be phased out over time. The Agreement requires each of the parties to administer its TRQs in a transparent, non-discriminatory manner, and each party may not condition utilization of its TRQs on the re-export of goods.

In addition, each party has agreed to eliminate all agricultural subsidies for goods that are destined for another party, although there is an exception for situations where one party believes that a third party is subsidizing competing exports. In that case, the two involved parties will consult in order to address the problem.

***Duties on most originating textile or apparel goods will be eliminated when the Agreement comes into force.***

As a protective measure, the parties retain the right to temporarily impose additional duties on specified agricultural products if imports of those products exceed a volume trigger established in the Agreement. The safeguard duty will remain in force until the end of the calendar year in which the measure is applied.

Some of the most publicized elements of the DR-CAFTA are its special provisions applicable to the importation of sugar into the U.S. from other party-countries. Imports of sugar are subject to relatively low TRQs. Sugar imports are then limited to the lesser of *(i)* the quantity established in the TRQs or *(ii)* the exporting party's trade surplus in certain sugar goods, specified in the Agreement. The quantities established in the TRQs begin at 107,000 metric tons in the first year and increase to 151,000 metric tons in year fifteen.

The DR-CAFTA also contains special provisions related to trade in ethanol. Specifically, the United States has agreed to continue to treat the other party-countries as beneficiary countries under the Caribbean Basin Initiative (CBI) for ethanol imports. In other words, the other party-countries will continue to share in the duty-free quota for ethanol that the U.S. makes available to CBI beneficiary countries.

### Textiles

The DR-CAFTA also includes a special regime for trade in textiles. As with other categories of goods, duties on most originating textile or apparel goods will be eliminated when the Agreement comes into force. In a provision that offers a potentially significant opportunity for U.S. textile importers, the preferential duty treatment under the Agreement may be made retroactive to January 1, 2004. Such action would allow importers to recover any duties paid after that date on any textiles that would have qualified as originating if the Agreement had been in force at the time of importation.

The textile provisions of the Agreement include particular protective measures. Each party may impose a safeguard duty—up to its normal duty rate—on textile imports from another party that cause or threaten to cause serious damage to a domestic industry. However, a party cannot impose a safeguard duty on the same product more than once, and the duty can only last for three years. The ability to impose these safeguards will expire five years after the Agreement enters into force.

A party that chooses to impose such safeguard duties on particular textile imports must provide the affected exporting party with mutually agreed-upon compensation in the form of trade concessions on other textile goods. Those trade concessions must be substantially equivalent in value to the increased duties resulting from the safeguard measures. In the event the involved parties cannot agree on the right form of trade concessions, the exporting party may raise duties on any imports from the importing party in an amount that is substantially equal to the value of the increased duties resulting from the safeguard measure.

As a general rule, textiles will qualify as originating goods under the Rules of Origin only if all the processing after fiber formation takes place in a party-country or there is an appropriate tariff shift under the specified schedule. However, there are a number of special origin rules applicable only to textile goods. First, a textile-specific *de minimis* rule provides that textile goods that would ordinarily not be considered originating because certain of their constituent fibers do not undergo an applicable tariff shift will still qualify as originating as long as the non-tariff shift fibers constitute ten percent or less of the total weight of the component of the good that determines origin.

Second, the Agreement includes a list of fabrics, yarns and fibers that party-countries have determined are not available in a timely manner from producers in DR-CAFTA countries. Consequently, textile goods that contain these materials will still be considered originating as long as they meet the other applicable requirements. This list is subject to on-going revision.

*DR-CAFTA, Continued on page 26*

# DR-CAFTA (from page 25)

### Trade Remedies

Beyond the various safeguard measures available for agricultural and textile goods, the Agreement also provides general safeguard measures that are available for all classes of imports. Each party retains the right to impose temporary duties on imported originating goods if, as a result of the reduction or elimination of duties provided for under the DR-CAFTA, the goods are being imported in such increased quantities or under such conditions that they cause or threaten to cause serious injury to a domestic industry which produces a "like" or "directly competitive" product. These general safeguards, unlike those for agricultural goods or textiles which are applied only against specific parties, are applied to imports from all party-countries, unless a particular party's import market share for the good is *de minimis*.

For the majority of goods, a safeguard measure can only be imposed during the ten-year period following the entry of the Agreement into force. However, for those goods whose duties under the Agreement are phased out over a period of longer than ten years, a safeguard may be imposed until the end of the applicable phase-out period.

The Agreement allows for two types of safeguard measures. A party may increase duties on a particular product up to its normal tariff level, or a party may simply suspend further reductions in the preferential duty provided for under the Agreement. In either case, the safeguard may only be in place for a maximum of four years, including extensions. As with textiles, if a party imposes a safeguard measure, it must compensate other affected parties with trade concessions that offset the value of the safeguard.

Beyond the safeguards included in the DR-CAFTA, the party-countries explicitly retain their trade remedy options available under their membership in the World Trade Organization.

### Other Topics

The Agreement also addresses a number of other topics that relate to various aspects of trade relations between the parties. For government procurement, the Agreement provides that each government and its various procuring entities must treat goods, services and suppliers from other party-countries in a manner that is no less favorable than the treatment it affords their domestic counterparts. The provisions on government procurement only apply to purchases of goods and services that exceed threshold amounts included in the Agreement.

The Agreement also provides protections for investors from one party who attempt to invest in another party. In the Agreement, the term "investment" is construed broadly and includes investments already in place when the Agreement enters into force. Most generally, the DR-CAFTA requires that foreign investors enjoy treatment no less favorable than that enjoyed by domestic ones. In addition, the Agreement provides a number of other protections to investors such as the free transfer of funds related to an investment and the power to hire key managerial personnel without regard to nationality.

Financial services provided in one party-country by institutions of another party also enjoy the right to treatment no less favorable than that enjoyed by domestic institutions. In addition, the Agreement prohibits certain quantitative restrictions on market access for financial institutions and disallows restrictions on the nationality of senior management.

***The Agreement also provides protections for investors from one party who attempt to invest in another party.***

In the area of intellectual property, the Agreement obligates the parties to ratify or accede to several international agreements. By the date of entry into force of the DR-CAFTA, the parties must accede to the WIPO Copyright Treaty and the WIPO Performances and Phonograms Treaty. Within specified time periods, the parties must also accede to several other intellectual property agreements. The United States is already a party to each of the applicable agreements. In addition, each party is obligated to adopt a series of other measures that are intended to broadly protect intellectual property rights.

The Agreement also contains provisions for telecommunications, electronic commerce, labor and environmental concerns. The provisions for the telecommunications industry are designed to ensure that service suppliers of each party have non-discriminatory access to the telecommunications networks of the other parties. The provisions on electronic commerce establish rules designed to prohibit discriminatory regulation of electronic trade in digitally-encoded products such as computer programs or sound recordings. In particular, no party may impose duties on products transmitted digitally. The labor provisions obligate each party to enforce its own labor laws effectively and transparently. Last, the environmental provisions obligate each party to maintain a high level of environmental protection. ❑

# Organic Law on Prevention, Work Conditions and Work Environment (LOPCYMAT)

by the Labor Department of the Caracas office of Baker & McKenzie

The restated Organic Law on Prevention, Work Conditions and Work Environment (New Law) was published in Official Gazette No. 38,236 on July 26, 2005. The New Law revokes and supersedes the Organic Law on Prevention, Work Conditions and Work Environment published in Special Official Gazette No. 3850 of July 18, 1986 (Former Law) and it became effective on the date of its publication, except for those provisions concerning the monetary indemnities provided by the Occupational Safety and Health System that will enter into effect on the date of implementation of the Social Security Treasury.

The purpose of the New Law is: *(i)* to establish institutions, rules, and guidelines for the policies, agencies, and entities intended for guaranteeing the workers safe, healthy and comfortable conditions in adequate work environments, favorable for the full exercise of their physical and mental faculties through the promotion of safe and healthy work, the prevention of work accidents and occupational diseases, the integral redress of injuries suffered, and the promotion and incentive for the development of programs intended for recreation, use of leisure time, rest, and social tourism; *(ii)* to regulate the rights and duties of workers and employers in connection with the safety and health of the work environment, as well as in connection with recreation, the use of leisure time, rest, and social tourism; *(iii)* to develop provisions of the Constitution and the Occupational Safety and Health System set forth in the Organic Law of the Social Security System; *(iv)* to establish penalties for violation of the law; *(v)* to regulate benefits derived from the substitution by the Social Security System of the material and objective responsibility of employers upon the occurrence of work accidents or occupational diseases; and *(vi)* to regulate the responsibility of the employer and its representatives for the occurrence of work accidents or occupational diseases in the cases of fraud or negligence on their part.

Following is a summary of the more salient aspects of the New Law.

For further information, please contact Carlos Felce, Partner (carlos.felce@bakernet.com) or Manuel Diaz Mujica, Partner (manuel.diaz@bakernet.com) at the Caracas office of Baker & McKenzie. This version has been shortened for publication. Full versions can be requested from the Editor by writing to sstudebaker@wtexecutive.com.

## Registration with, Affiliation, and Contributions to the Indemnity System

***Obligation to Register***

All employers are obliged to register with the Social Security Treasury. Also cooperatives and other forms of community association of a productive or service kind are required to register.

***Obligation to Affiliate***

Employers that have one or more dependent workers are required to register them with the Social Security System within the first three business days following the commencement of the employment relationship. The workers' affiliation must be made by the employer regardless of the form or terms of the employment contract. Cooperatives and other forms of community association of a productive or service kind also have this obligation for their dependent workers and their associates.

***Contributions***

Contributions will be the sole responsibility of the employer, the cooperative or other forms of community association of a productive or service kind. Such contributions may range between 0.75 percent and 10 percent of each worker's salary or of the income of each associate to the cooperative or other form of community association of a productive or service kind.

For the fixing of contribution rates, companies, exploitations, establishments, or tasks will be classified into the following types of risks:

| | |
|---|---|
| Type I | Minimum Risk |
| Type II | Low Risk |
| Type III | Medium Risk |
| Type IV | High Risk |
| Type V | Maximum Risk |

Risk types, in turn, comprise a risk degree scale ranging from 14 through 186. For each type a minimum limit, a weighted average value, and a maximum limit are established according to the following chart:

**Risk Degrees**

| Type | Minimum | Average | Maximum |
|---|---|---|---|
| I | 14 | 21 | 28 |
| II | 21 | 35 | 49 |
| III | 35 | 64 | 93 |
| IV | 64 | 93 | 122 |
| V | 93 | 102 | 186 |

The amount the employer will have to pay for company workers is determined by multiplying the aggregate amount of salaries by the risk degree assigned to the company and by a constant factor equal to 5.375, divided by 10,000. Thus, for instance, a Type V company (maximum risk) qualifying in the weighted average and paying salaries in a monthly amount of Bs.40,000,000,

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# LOPCYMAT (from page 27)

should contribute the amount of Bs.2,193,000 monthly to this indemnity system.

### Other Obligations of the Employer

Employers must adopt such measures as may be required in order to guarantee their workers health, hygiene, safety, and well-being in conditions at work, as well as recreation programs, use of leisure time, rest, and tourism. Among their specific obligations are the following:

- to consult workers, their organizations, and the Occupational Safety and Health Committee before implementing any measures implying changes in the work organization that might affect any or all the workers, or important decisions concerning the safety and hygiene at work;
- to notify workers, in writing, about the principles for prevention of unsafe or unhealthy conditions, both upon their hiring and upon the occurrence of any changes in the work process or in the job, and train and instruct them for the promotion of health and safety, the prevention of accidents and occupational diseases, as well as for the use of personal safety and protection devices;
- to refrain from showing any offensive, malicious, or intimidating conduct or form any other act that may cause psychological or moral damage to workers;
- to notify in writing the National Institute for Occupational Prevention, Health and Safety and the National Institute for Workers Training and Recreation about any programs developed for workers' recreation, use of leisure time, rest, and social tourism, the condition of the infrastructure for the execution thereof, the impact on life quality, health, and productivity, as well as any difficulties in the workers' incorporation and active participation therein;
- to prepare, jointly with workers, the company's Occupational Safety and Health Program, policies and commitments, as well as any internal regulations concerning the matter, and plan and organize production in accordance with such programs, policies, commitments, and internal regulations;
- to take adequate measures to avoid any form of sexual harassment and establish a policy intended for the eradication thereof from the work place;
- to refrain from discriminating employment candidates and workers and, within the requirements of the productive activity, respect workers' freedom of conscience and of speech;
- to take adequate measures to guarantee workers' right to privacy regarding mail and communications and free access to all data and information directly concerning them;
- to mandatorily notify the National Institute for Occupational Prevention, Health and Safety of any occupational diseases, work accidents, and any other pathological conditions that may occur and keep a record thereof;
- to keep an updated registry of all occupational prevention, safety and health conditions, as well as of the recreation, use of leisure time, rest, and social tourism activities;
- in case of activities that the Regulations of the New Law deemed to be susceptible of special controls because of the damage that they might cause to workers or the environment, to notify the National Institute for Occupational Prevention, Health and Safety, in writing, of the unsafe conditions and of any measures developed to control such conditions under the criteria as may be established by said institution;
- to organize and maintain the Occupational Safety and Health Services provided by the New Law.

### Administrative Responsibility of the Employer; Cases of Administrative Infringements

The employer's administrative infringements are classified as follows:

- *Minor infringements:* These are punished with fines of up to 25 Tax Units per exposed worker. This punishes conduct such as not guaranteeing all the elements of basic health in the work place; failure to place in public and visible areas of the company updated records of the indices of work accidents and occupational diseases; failure to provide workers with sufficient training in the prevention of work accidents and occupational diseases, among others.
- *Serious infringements:* These are punished with fines ranging between 26 and 75 Tax Units per exposed worker, and include acts such as failure to notify workers, in writing, the principles for prevention of hazardous or unhealthy conditions; the failure to submit for approval by the National Institute for Occupational Prevention, Health and Safety the draft Occupational Prevention, Safety and Health Program; failure to provide workers with adequate personal protection equipment and utensils; failure to develop programs for promoting safety and health at work and preventing occupational accidents and diseases, among others.
- Very serious infringements: These are punished with fines ranging from 76 to 100 Tax Units per exposed worker. The closing of the company for up to 48 hours by the National Institute for Occupational Prevention, Health and Safety is also contemplated. Very

*The new law provides for fines and even criminal sanctions.*

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# LOPCYMAT (from page 28)

serious infringements include and penalize acts such as failure to guarantee the effective enjoyment of workers' annual vacation period; failure to guarantee effective rest from the daily work; violation of rules concerning the maximum work hours and night time work, or provisions concerning business days; failure to provide immediate help to an injured or sick worker; failure to report work accidents or the diagnosis of occupational diseases to the National Institute for Occupational Prevention, Health and Safety within 24 hours following the occurrence thereof; failure to constitute, register, or maintain operative the Occupational Safety and Health Committee; dismissal, impairment or transfer of workers due to the exercise of their rights under the New Law; failure to relocate workers in positions or to adapt their chores for reasons of health, rehabilitation or labor reinsertion; and obstructing, impeding or hindering any inspection or supervision performed by the National Institute for Occupational Prevention, Health and Safety.

***The actions of sub-contractors can expose contractors to liability.***

- *Recidivism:* An infringement repeated within a 12-month period will be regarded as recidivism. In such cases, the relevant punishment may be increased twofold.

### Punishment in Case of Infringements concerning Contribution and Affiliation Matters

An employer that infringes the provisions of the New Law concerning the contributions and affiliation of workers will be punished with a fine of up to 100 Tax Units for each worker not affiliated or affiliated outside the regulatory period, or for any inaccurate information provided, according to the seriousness of the infringement, without prejudice to any civil, administrative and criminal liability for damages caused to its workers. In such cases, the employer will also have to pay all unpaid contributions and the relevant interest for late payment, and will have to refund in full to the Social Security Treasury the payment of indemnities and expenses generated from work accidents, occupational diseases, or the death of its workers.

### Suspension of the Company Business

Where there is a serious or imminent danger, or where there occur situations that pose a threat for the safety and health of the workers, the National Institute for Occupational Prevention, Health and Safety may suspend, either in whole or in part, the business or production of the company, establishment, exploitation activity or task until it is demonstrated that such situations have ceased to exist, without prejudice of the corresponding sanctions. In cases of suspension, the infringer employer will be obliged to pay the salaries and other socio-economic benefits of its workers for the duration of the sanction or measurement adopted, as if they had effectively been rendering services.

### Labor and Civil Liability of the Employer: Indemnities

Regardless of any monetary indemnities payable by Social Security, the employer will be liable for work accidents or occupational diseases occurring as a result of the violation of rules governing safety and health at work. The indemnities provided for by the New Law do not exclude indemnities for economic and moral damages (these being additional thereto), and do not prevent the establishing of criminal liability.

The amount of the indemnity payable in these cases by the employer will depend on the type of disability suffered by the worker, according to the following scale:

- *temporary disability:* twice the salary corresponding to the sick leave days;
- *permanent partial disability of up to 25 percent of the physical or intellectual capacity for performing the profession or usual trade:* salary corresponding to not less than one year and not more than four years calculated in calendar days;
- *permanent partial disability greater than 25 percent of the physical or intellectual capacity for performing the profession or usual trade:* salary corresponding to not less than two years and not more than five years calculated in calendar days;
- *permanent total disability for performing the usual trade:* salary corresponding to not less than three years and not more than six years calculated in calendar days.
- *permanent absolute disability for performing any type of labor activity:* salary corresponding to not less than four years and not more than seven years calculated in calendar days;
- *great disability:* where associated with permanent absolute disability, the indemnity will be equivalent to that payable in the case of death of the worker. Where it is associated to temporary disability, the indemnity will be equivalent to three times the salary corresponding to the duration of the disability;
- *death:* salary corresponding to not less than five years and not more than eight years, calculated in calendar days.

### Criminal Liability of the Employer or its Representatives

Where the employer has committed serious or very

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# LOPCYMAT (from page 29)

serious infringements of the rules governing occupational safety and health and as a result a worker has died or been disabled, the employer or its representatives will be subject to the following sanctions:

- *temporary disability:* imprisonment from two months to two years or from two to four years if the worker is not able to perform the most elementary acts of daily life;
- *permanent partial disability:* imprisonment from two to four years;
- *permanent total disability for performing the usual trade:* imprisonment from four to seven years;
- *permanent total disability for performing any type of labor activity:* imprisonment from five to eight years;
- *permanent total disability associated to the worker's inability to perform the most elementary acts of daily life:* imprisonment from five to nine years;
- *death:* imprisonment from eight to ten years.

### Joint Liability with Contractors, Sub-Contractors, and Temporary Work Companies

The contracting or principal company will be jointly liable with any intermediaries, contractors, and sub-contractors for infringement of rules on occupational safety and health matters applicable in connection with workers rendering services at the contracting or principal company's work centers. When contracting the services of workers supplied by temporary work companies, the principal company (beneficiary) will inform said workers and the temporary work company, in writing, of the risks associated to the work and any prevention measures required for facing them. The beneficiary will be responsible for any work accidents or occupational diseases caused to the temporary worker due to its fault or on account of its failure to comply with the rules governing occupational and health matters.

***The employer or its representatives can be imprisoned for up to two years when a violation has disabled an employee.***

### Express Derogation of the Rules Regulating Temporary Work Companies

The New Law expressly derogates Articles 23, 24, 25, 26, 27 and 28 of the Regulations of the Organic Labor Law, which constitute the only regulation existing in Venezuela concerning temporary work company matters. Also, the New Law provides that temporary work companies duly registered with the competent authority will have the status of intermediaries. The hiring of workers through labor intermediaries entails the joint responsibility of the beneficiary company and the intermediary for the payment of rights and benefits of the intermediary's workers, and generates the right of such workers to receive the same benefits and work conditions enjoyed by workers of the beneficiary company. ❑

# Venezuelan Legal and Business Developments

by Vera De Brito de Gyarfas (Travieso Evans Arria Rengel & Paz)

### Energy

PDVSA (Venezuela's state oil company) announced that it will build an asphalt refinery next to the Guanoco natural asphalt lake (with an estimated investment of $600 million) and expand its existing San Roque refinery, which currently produces 60,000 tons of kerosene per annum to 80,000 tons.

It was announced that PDVSA is considering developing the Abreu E'Lima refinery in Pernambuco (Brazil) to which heavy crude would be shipped and undertaking offshore exploration in Argentina.

CVG Ferrominera Orinoco (FMO) entered into a financing agreement with ABN AMRO Bank N.V. for $135 million in order to progress in the construction of an iron ore concentration plant.

Chevron found four trillion cubic feet of gas in one of the Plataforma Deltana exploration blocks.

PDVSA will invest approximately $500 million in the installation of three new thermoelectric generation plants located in the States of Anzoátegui, Falcón, and Zulia.

SENIAT (Venezuelan Tax Administration) has made tax claims against Harvest Vinncler and Shell of Bs. 183 billion (approximately $85 MM) and Bs. 281 billion (approximately $130 MM), respectively, for income tax, on the theory that their service agreements with PDVSA should instead be taxed as oil exploitation activities.

The Ministry of Energy and Petroleum (MEP) authorized the company Termobarrancas C.A. to generate electric power at the Central Temprana Sipororo located between the Municipalities of Guanare and San Genaro de

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Boconoito, Portuguesa State, and to connect to the National Electric System (Sistema Eléctrico Nacional—SEN).

The Caracas Energy Cooperation Agreement between Venezuela and the Republic of Bolivia executed on December 9, 2004 was published in Official Gazette No. 38,226 dated July 12, 2005.

It was reported that Venezuela will invest up to $1 billion in the enlargement and modernization of the La Teja refinery in Uruguay in order to process heavy crude.

The following resolutions issued by the Ministry of Energy and Petroleum were published in Official Gazette No. 38,226 dated July 12, 2005: *(i)* Resolution No. 247 that establishes the provisions for ground transportation of refined products, hydrocarbon derivatives, their waste, and products resulting from the industrialization activity of hydrocarbons or refined products, other than fuel; and *(ii)* Resolution No. 248 that governs the issuance of permits and registries, as well as the follow-up, control, and supervision of companies engaged or to be engaged in the activity of industrialization of hydrocarbon refining derivatives or refined products obtained from the same.

## Banking and Finance

Through a resolution published in Official Gazette of July 15, 2005, the National Securities Commission issued new Instructions establishing the documents and information required to request authorization to make a public offer of securities.

Resolution No. 05-06-01 of the Venezuelan Central Bank was re-published on July 18, 2005. Said resolution prescribes that the interest rate to be paid by the banks, savings and loan associations, and other financial institutions will only be applicable to the certificate of investments issued for terms equal to or longer than 28 days.

The National Securities Commission issued instructions to request authorization to act as securities brokerage houses and companies that manage collective investment entities and request the ratification of such authorizations. These are additional to the existing norms that establish as a new obligation the presentation of an economic-financial feasibility study and business plan, as well as the request for ratification of the authorization by the persons who purchase securities brokerage houses or companies that manage collective investment entities that have already been authorized.

## Labor

The Organic Law on Prevention, Work Conditions and Environment was published in Official Gazette No. 38,236 of July 26, 2005. The law substantially expands the scope of responsibility of employers for work-related health and safety obligations, placing upon them joint and several liability for health and safety of workers of contractors and outsourcing firms. The new law expressly covers domestic and janitors' work, as well as that performed by those who work at cooperatives or other forms of community associations with a productive or service character, including non-profit activities.

The main purposes of said Law are:

- to establish the institutions, standards, and guidelines of the policies, and the agencies and entities allowing to guaranty to the workers safety, health, and well-being conditions in an appropriate work environment that favors the exercise of their physical and mental abilities, by means of the promotion of safe and healthy work; prevention of industrial accidents and occupational diseases, integral reparation of damage suffered, and promotion of, and incentive to, development of programs for recreation, use of free time, and rest and social tourism;
- to regulate workers' and employers' rights and duties in relation to safety, health, and work environment and recreation, use of free time, rest, and social tourism;
- to develop provisions of the Constitution of the Bolivarian Republic of Venezuela and the Regime regarding the Benefits of Safety and Health at Work established in the Organic Law of the Social Security System;
- to establish the penalties for non-compliance with the provisions;
- to rule the benefits and obligations derived from the subrogation of the Social Security System to employers' pecuniary and strict liability in the event of an industrial accident or occupational disease; and
- to rule the liability of employers and their representatives in the event of an industrial accident or occupational disease when there is willful misconduct or negligence on their part.

The provisions of the Law are applicable to works performed under a subordinate relationship for the account of an employer, whatever the nature of the works and the place where they are performed may be, with or without profit-making purposes, whether they be public or private, existing or established in the territory of the Republic and, in general, any provision of personal services in which there are employers and employees, whatever the form adopted may be.

This Law constitutes a change in direction in the safety and health policy adopted by the National Executive since 1986. It includes, among other important changes, a modification of the criteria regarding employers' civil and criminal liability, the establishment of a new term for the statute of limitations of the actions derived from the Law, the inclusion of a significant number of new notices to governmental entities, the granting of competence to the communities to supervise and denounce violations of the safety and health technical standards by employers, as well as new responsibilities and competence of the safety and health committees of com-

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panies. Employees are now entitled to participate in decisions concerning safety matters. Compliance with this Law is mandatory as from the date of its publication in the Official Gazette.

### Taxation

The Supreme Tribunal of Justice issued a clarification of the March 4, 2004 decision regarding the right of municipalities to tax activities carried out offshore or in aquatic spaces by stating that such interpretation is valid as from the date of enactment of the new Constitution, 1999, and not as from March 4, 2004 (the date on which the decision was issued).

Ruling No. 0503 was published on July 20, 2005 (Official Gazette No. 38,232). It establishes that taxpayers categorized as special taxpayers by the SENIAT and those receiving Certifications of Exempted Fiscal Debit must file the value added tax returns through the Site http://www.seniat.gov.ve. According to Article 3, the SENIAT will only acknowledge excess fiscal credits generated in returns filed through the Site after the entry into force of this ruling. The obligation to file the returns as aforesaid will become applicable as from January 2006.

Ruling No. 0456 that establishes the special Provisions on invoicing for Service Stations was published on July 21, 2005 (Official Gazette No. 38,233). It prescribes that authorized service stations that sell fuel will substitute invoices for each sales transaction with a statement reflecting the daily total transactions (except for the sales invoiced to taxpayers requiring the invoice as a proof of the expense). The statement may be issued in the same form as that of the invoices, indicating that they are issued in accordance with this ruling.

Resolution No. 1661 was published on July 22, 2005 (Official Gazette No. 38,234), issuing the Instructions on the Procedure for Issue, Placement, Custody, and Handling of Tax Refund Special Certificates (CERT). Said Instructions detail the procedure for the issue and use of certificates, and clarify that the recovery of taxes will be made only through the CERTs, which fact will be placed on record in the rulings providing for the recovery of fiscal credits.

Decree No. 3774 was issued on July 27, 2005 (Official Gazette No. 38,237). Said Decree exempts from the Value Added Tax transactions of national sale of goods and the provision of services made, or benefited from, in the country that are necessary for construction works and for reconditioning of works and outfitting of the same with educational purposes in the framework of the Program *Fortalecimiento, Modernización, y Reactivación de las Escuelas Técnicas Industriales, Comerciales y Agropecuarias* (Strengthening, Modernization, and Reactivation of Technical Industrial, Commercial, and Agricultural Schools) of the Ministry of Education and Sports.

On July 28, 2005, (Official Gazette No. 38,238), the Law of Partial Amendment to the Law of Tax on Alcohol and Alcoholic Species was enacted.

### Telecommunications

On July 10, 2005, CONATEL (National Telecommunications Commission) published the Schedule of Telecommunications Tax Obligations corresponding to the second quarter of 2005. Said Schedule is also available on the following web page: http://www.conatel.gov.ve/

### Anti-dumping

Decision CASS-ADP-004/05 issued by the Venezuelan Antidumping Commission was published in Official Gazette No. 38,222 dated July 6, 2005. The Decision initiates an investigation aimed at determining if the expiration of the definitive antidumping duties established through Decision No. 006/00 dated June 19, 2000 would give rise to the continuation or repetition of the damage to the national production of similar goods.

### Consumer Protection

A Joint Resolution of the Ministries of Light Industries and Commerce, Agriculture and Land, Food, and Health and Social Development published in Official Gazette No. 38,233 dated July 21, 2005 established the requirements of commercial and health information that must be contained on labels of canned preserved tuna fish and preserved tuna fish-based products for human consumption.

### Miscellaneous

The Regulations on the Andean Migration Card for purposes of the Registry of Migratory Movements entrusted to the Ministry of Interior and Justice were published in Official Gazette No. 38,224 dated July 8, 2005.

The Ministry of Housing and Habitat provided through a Resolution published in Official Gazette of July 7, 2005 that long-term mortgage loans granted at the social interest rate under the Special Law for the Protection of the Mortgagee Debtor that qualify for the minimum mandatory percentage of 10 percent over the gross credit portfolio of banks and other financial institutions will be only those granted to family groups with a monthly income that does not exceed 500 Tax Units (currently Bs. 14,700,000).

The Law of Civil Aeronautics was published again in Official Gazette No. 38,226 dated July 12, 2005.

Resolution No. 297 of the Ministry of Health and Social Development was published in Official Gazette No. 38,226 dated July 12, 2005. A rate of 700 Tax Units is established by said Resolution as the rate to be paid for the request of the control number of the cigarettes manufactured, imported, and commercialized in the national

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territory or intended for exportation. Such control number must be annually renewed.

The X Exceptional Plan of Economic and Social Development for the Reactivation of Small and Medium-sized Industries was published in Official Gazette No. 38,228 dated July 14, 2005.

Through Decision No. 1376 dated June 28, 2005 published in Official Gazette No. 38,231 dated July 19, 2005, the Constitutional Chamber of the Supreme Tribunal of Justice partially annulled Letter b) of Article 34 of the Law on Lease of Real Property. The reference to "adopted children" for purposes of requesting that a real property be vacated was prohibited.

The Law of Partial Amendment to the Law of the Venezuelan Central Bank was published in Official Gazette No. 38,232 dated July 20, 2005. PDVSA is now allowed to keep dollar proceeds in offshore accounts to meet its dollar investment and expense obligations. The excess is to be contributed to a social development fund controlled by the National Executive through FONDES. The Central Bank must also make a one-time contribution to said Fund of $6 billion.

The following Rulings issued by the National Institute of Civil Aviation (INAC) were published in Official Gazette No. 38,234 dated July 22, 2005: *(i)* Ruling No. PRE-CJU-020-05 that issues Venezuelan Aeronautic Regulation 80 RAV 80 on Inspection, Certification, Continuous Monitoring, Permanent Supervision, and Investigation into ATS Incidents to support Administrative Penalizing Procedures conducted by the Aeronautic Authority; *(ii)* Ruling No. PRE-CJU-156-05 that issues the Norms governing Air Transport Specialized Services; *(iii)* Ruling No. PRE-CJU-157-05 that issues the Norms governing the Services of Air Works; and *(iv)* Ruling No. PRE-CJU-158-05 that issues Venezuelan Aeronautic Regulation 3 RAV 3 on Procedures for Consultation on Aeronautic Regulations. ❑

## Special Interview (from page 5)

have a lame duck president in a weakened position, and the extreme left wing of the PT [the Workers' Party of President Lula] would try to change the direction of the economic policies. And there will not be anyone in power in the PT who will stand as the defender of the current economic policies. The likely replacement for Palocci would be Murilo Portugal [the current Secretary of Economic Policy]. He is very competent, and would carry on the current policies. The problem would be that his ability to withstand the pressure of the left wing of the PT would be limited if Lula is a lame duck. But even if Lula declares that he will not run again, so long as Palocci remains in the government the current economic policies will be continued.

***LALBR: Should we be surprised by the extent of corruption that is being revealed in the Brazilian Congress?***
**Welch: No, but neither should we be surprised to see that others in Congress are weeding out this corruption. Brazil's democracy is quite mature, and the way that this scandal is being investigated and revealed is evidence of this maturity.**

### Silver Lining

***LALBR: So, you see a silver lining to this crisis?***
**Welch:** Absolutely. Just like there was a silver lining to the Collor resignation [see box]. This crisis is a little different; it looks like part of the PT tried to set itself up as government and party at the same time concentrating a huge amount of power in a few people's hands, à la Chavez [i.e., Hugo Chavez, President of Venezuela]. You can see how this type of thing is anathema in Brazil. Brazilians will never accept something like that, which is also positive.

***LALBR: You are saying that Lula will not be impeached given what we know so far?***
**Welch:** I don't think so; at least no one wants him to be impeached.

***LALBR: Lula took office promising that he would do something for the poor in Brazil. Are the programs that***

*Special Interview, Continued on page 34*

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# Special Interview (from page 33)

*were targeted at the lower sector of the Brazilian economy dashed?*
**Welch:** No, but this is not because the PT did so well in designing programs that would help Brazil's poor. Rather the present government has benefited by expanding the *bolsa escola* program that was put into place by Cardoso (Fernando Henrique Cardoso, Brazil's president from 1995 until 2002).

### Lula has Delivered Economic Growth

*LALBR: Lula came to office promising growth in the economy. Has he kept that promise?*
**Welch:** Yes and no. The question is; at what rate should the economy grow? If you think Brazil can grow 5 percent year in, year out—which is what I think many of the people in the PT think—then you would probably say no. Brazil's long run growth rate is structurally about 3.5 percent, so we saw a very strong recovery last year. It will slow down a little bit this year and probably go back up next year, so I would say that he has delivered. The other thing Lula has delivered is stability, and certainly stability is one of the necessary ingredients needed to bring down inflation, which is also compatible with long-term growth.

*LALBR: Is the level of investments enough to sustain growth at 4 percent?*
**Welch:** Right now, Brazil's growth investment rate is about 19 percent of GDP, depreciation is 5 percent which gives a net investment rate of about 14 percent. It's not bad; it is about 2 percentage points above what it has been since the 1980s but it still should be a bit higher.

### Investments in Capital and Equipment

*LALBR: The economy is running at close to full productive capacity. Are companies investing so that they can produce more?*
**Welch:** They have been investing. Last year we had a huge growth of investment, mostly in the exporting sector, with agro industry investing the most. For one reason or another, agriculture is not going to have that good a year this year. Some of the prices have come down. They had some serious problems with drought. That is a problem that Brazil faces right now but the investment rate is pretty robust. It is being affected on the margin, not on the whole.

*LALBR: Is the export sector largely immune to the political crisis?*
**Welch:** Yes, unless the political crisis should suddenly translate into something really bad. I am speaking of something like the government or regulators imposing capital controls or other blocks on investor-money getting out of the country. But I do not expect these kind of actions to happen.

### Export Growth Not Dampened by Stronger Currency

*LALBR: The* **real** *is strengthening, which tends to make Brazilian goods more expensive in foreign markets. Will the stronger* **real** *dampen sales of the important export sector?*
**Welch:** Well, some of the export sectors are certainly import intensive. But generally speaking, we have been seeing continued strong exports despite a strengthening *real*. So the currency fluctuation is not making much of a difference.

*LALBR: What are the prospects for steady growth of the local economy? By that, I mean the local consumer market.*
**Welch:** It is very good. We are seeing a little bit of a contraction with job creation and in income this last month. But once the Central Bank gets things back to more normal interest rates, I think growth of the local economy will be good.

### Increases in both Formal and Informal Sectors

*LALBR: Estimates vary, but about half of Brazil's workers are employed outside the formal economy, where they may work selling goods on the street or in the informal labor market. Are more workers being brought into the formal economy?*
**Welch:** We have not yet seen a reduction in the informal economy but we are seeing an increase in formal employment. [Editor's note: Estimates as to the size of the parallel economy vary by region, but in many states 25 percent to 50 percent of the work force is employed in the informal economy.] Both sectors are growing, which

*Special Interview, Continued on page 35*

### The Scandal that Brought Down an Earlier Brazilian President

Fernando Collor de Mello was elected in 1989 by winning over labor party candidate and current president Lula da Silva. In early 1992, allegations surfaced in the press of possible corruption in the government. The Congress impeached Mr. Collor in September after four months of lengthy televised congressional hearings in which officials and the president's brother revealed bribes and kickbacks to the closest aids to Collor and possibly the president himself. The vice-president assumed the presidency when Collor was suspended by the Congress in October. Collor resigned in December, 2002, rather than face a trial in the Brazilian Congress.

In addition to his impeachment, Mr. Collor is remembered–not fondly–as the president who locked up bank accounts of most account holders for 18 months in an ill-conceived attempt to stop inflation. — *SPS*

## Special Interview (from page 34)

means that many frustrated workers are coming back to work again which is a sign of economic health. The government has made changes to the tax system to make it easier for workers to enter the formal economy, and these changes are having an impact. The government wants to do more to reduce the tax burden on small and medium sized businesses, and this is all for the better.

### True Interest Rates are Lower than Selic Rate

***LALBR: The Central Bank left interest rates (i.e., the Selic rate) unchanged at 19.75 on August 17. Many analysts were expecting to see the bank drop rates. What happened?***

**Welch:** The crisis may have influenced the bank to a more conservative position. But we are continuing to see deflation of general price levels and consumer prices are falling as well. So there is room for the Central Bank to ease interest rates. I think that this delay in cutting interest rates is going to cause some bad news to come out of industry, although so far there are no signs that interest rates are having a huge negative effect on growth. When the Central Bank increased rates by a full point back in February it seemed to me that it could have halted the increases. At that time I revised my growth rate to 2.8 percent and it is still there. So, I think we will see lower growth for a little while. On the other hand, certainly the Central Bank has done a very good job overall. We have inflation converging very, very quickly to this year-end number and well below next year's target. On the whole these are good things. My criticism is that of timing and degree rather than what the Central Bank has done.

***We have been seeing continued strong exports despite a strengthening* real.**

***LALBR: Why are interest rates in Brazil so stubbornly high?***

**Welch:** The question is, what is the best way to fashion a monetary policy? If you have raising interest rates but you are buying dollars at the same time—which Brazil did through May—then you are basically undoing the tightening of higher interest rates by printing money when you buy dollars. The bank has stopped buying dollars and the dollar, as a result, has fallen, and inflation has fallen. The Central Bank is more or less hitting its targets. There is another aspect to the interest rate issue in Brazil. When one talks about interest rates, we need to ask which interest rates do you mean? Because the Selic rate is not the average rate for the financial system. Brazil still has a very segmented financial system. For the Central Bank to control the system through the interest rate, it affects a quite small part of the financial system and a small part of the real sector. Brazil still has many policies of directed credits in effect. These are basically programs where the government, through social or industrial programs, requires banks to lend to certain sectors or groups at below market interest rates. If you look at average borrowing costs even for private-sector borrowers, apart from directed credits, those interest rates have actually fallen; they've gone up on the margin but over a five-year term, they have fallen rather significantly. The average rate is much less than 19.75 but rates are still quite high. And I do not think they have to be as high as they are.

### Reducing the "Crowding Out" of Available Credit by Government

***LALBR: You wrote recently that the Brazilian government could well balance its budget within three years even if legislation that forces a balanced budget is not passed. What would the effect of a balanced budget be on interest rates? Aren't the interest rates kept high by government borrowing?***

**Welch:** Certainly. If the government balanced the budget, real interest rates would come down. Risk premium and government debt would come down; that would further bring down interest rates. But, a country does not earn credibility overnight. It can lose it overnight but it can't earn it overnight. The government is just going to have to stick to the straight and narrow and at some point we will see a very significant drop in the interest goal especially as a percentage of GDP.

***LALBR: What interest rates be in three years?***

**Welch:** We are forecasting sixteen percent. I was quite conservative with the interest rates. But even under a rather conservative interest rate scenario, the nominal debt will decline to zero, because the debt will continue to fall as a percentage of GDP.

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### *Bolsa Escola* Program

Adopted by the Brazilian federal government in 2001, the *bolsa escola* program was designed to counter the high rate of dropouts of children from school, often after just a few years of elementary school education. The program provides cash payments to low income families who keep children in school. The cash payments are designed to offset the money that the child might bring home if the child were working. To qualify, a poor family must maintain all school-aged children [between the ages of 6 to 15] in the classroom. Families can be dropped from the program if a child misses more than two days of school a month. Monthly payments are made directly to families by way of bank ATMs and special access cards. The federal government adopted the program after several states and municipalities started similar programs beginning in 1995.

## Special Interview (from page 35)

### Diverse Exports

***LALBR:** The export sector has been one of the most robust pieces of the Brazilian economy. But some have criticized Brazil's exports as being too concentrated in basic goods, such as soy beans and iron ore. Are Brazilian companies not focused enough on higher value-added goods?*

**Welch:** I don't think so. Brazil already exports quite a bit of finished goods, including capital goods, and the country has a good diversity of exports, as shown by the export data. I do not think there is any reason for Brazil to try to shape exports by a controlled industrial policy. Rather, Brazil needs to rationalize its imports. It could do this by making import tariffs more even across different sectors. If it did this, we would see the emergence of further strategic advantages. Brazil is well on its way to having a very dynamic export sector. But to export and compete in international markets manufacturers must be able to import the latest technology and the lowest cost inputs. This government has made some progress in this area, but there is still plenty of room for improvement.

### Basic Problems in Basic Education

***LALBR:** Foreign companies that are operating in Brazil have long complained that their workers come to the job without adequate basic education. Has this government, headed as it is by the former head of the Workers' Party, made significant progress in reforms to basic education?*

**Welch:** The average level of schooling in Brazil has increased. However, one of the most difficult problems facing not just Brazil but many governments in Latin America is to refocus education to the primary and secondary levels. Much of the education budget is spent on universities, and any government that tries to change this situation runs into some very strong special interest groups, in this case mainly professors and others with an interest in a well-funded university system. Brazil's Minister of Education has proposed that more of the education budget go toward basic education. We may see some progress yet on these proposals, but as long as the current scandals continue to come out of Brasilia, I do not think that much attention will be given to this area. ❏


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