Private Equity Investments: Tax Advantages of Brazilian FIPs

(Published in Issue 14/14 of Associação Brasileira de Private Equity e Venture Capital – ABVCAP's newsletter of September 2, 2014)

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FIPs (Fundos de Investimento em Participação) are one of the preferred vehicles for structuring private equity investments in Brazil. And this is mostly because of their favorable tax regime. If certain conditions are met, the benefits may be substantial.

FIPs are flow-through entities and are not subject to the usual income and revenue taxes applicable to Brazilian companies (IRPJ – corporate income tax, CSLL – social contribution on net profits, PIS – profit participation program, and COFINS – social security financing contribution). At the investor's level the gains obtained with the investment in FIPs may be subject to income tax in Brazil[1], which (as well as the applicable rate) will depend on how the gains were obtained and where investors are resident or domiciled.

Investors, whose equity share in FIPs are called quotas, may realize gains through five different manners: (i) redemption of the FIPs quotas (which may only occur when the term of the fund expires or upon d**[1]**issolution of the FIP); (ii) amortization of the FIPs quotas (which consists in paying to investors part of the value of their quotas without any change in the total number of quotas); (iii) sale of the FIPs quotas to third parties; (iv) direct distribution of dividends by the companies the FIP invests; or (v) direct payment of interests on net equity (juros sobre o capital próprio) by the companies the FIP invests.

For investors resident and domiciled in Brazil, the gains will be subject to income tax as follows:

(1) at the moment of the redemption of quotas, at a fixed rate of 15% of the investors' capital gain, calculated as the positive difference between the redeemed value and the quotas' acquisition cost;

(2) at the moment of the amortization of quotas, at a fixed rate of 15% of the amount that exceeds the quotas' acquisition cost;

(3) with regard to sales of quotas to third parties, at a fixed rate of 15% of the investors' total net gain within the respective month of all transactions (however, if the investor is a natural person and the transaction does not occur in a stock exchange, the 15% rate shall be calculated on the capital gain of each separate transaction);

(4) dividends paid to investors directly by the companies invested by the FIP are exempt from income tax; and

(5) interests on net equity paid to the investors directly by the companies invested by the FIP are subject to income tax at a 15% rate.

The income tax due in a redemption or amortization of quotas will be withheld and paid by the FIP's administrative manager on the investor's behalf. The income tax due in a quota sale will be paid directly by the selling investor. If the i**[2]**nvestor is domiciled in Brazil and a natural person, the income tax withheld or paid is final and no additional amount is due to the Brazilian IRS. If the investor is a legal entity set up in Brazil, the gains realized through redemption, amortization or sale of quotas, as well as the corresponding tax withheld and paid, will be taken into account for the calculation of the investor's total taxable profit and additional payment of income tax may be necessary[2].

The special tax regime applicable to the redemption, amortization and sale of FIPs' quotas will only apply if certain requirements are met. The composition of the FIP portfolio must comply with the rules set forth in the CVM's Instrução 391 and the FIP must invest at least 67% of its net asset in shares, convertible debentures and subscription rights certificates. If these requirements are not met, the gains arising from the proceeds distributed or paid by the FIP to its investors will be subject to the same income tax regime applicable to general long-term financial investments in Brazil. In this case, the following income tax rates (varying according to the time period elapsed between the investment date and the redemption, amortization or sale date) will apply: (i) up to 180 days: 22.5%; (ii) from 181 up to 360 days: 20%; (iii) from 361 up to 720 days: 17.5%; and (iv) for more than 720 days: 15%.

To encourage foreign investments in the Brazilian private equity sector, investors domiciled outside the country enjoy**[3]** a more favorable tax treatment. Provided certain requisites are met, the rate of the income tax levied on the gains resulting from the redemption and amortization of quotas held by investors domiciled outside Brazil is zero (instead of the 15% rate applicable to Brazil-domiciled investors). The requisites that have to be met are the following: (i) each investor or group of related investors[3], must not own more than 40% of all quotas issued by the FIP or be entitled to receive more than 40% of the FIP's income; and (ii) the FIP cannot invest more than 5% of its net assets in debt securities (except convertible debentures or public bonds).

If the requisites above are not fulfilled, investors domiciled outside of Brazil will be subject to the same 15% withholding income tax applicable to Brazil-domiciled investors. Moreover, if the FIP does not comply with the portfolio composition rules or does not invest at least 67% of its net assets in shares, convertible debentures and subscription rights certificates, the investors' gains will be subject to the same income tax regime applicable to general long-term financial investments (rates starting at 22.5% and decreasing to 15% based on the investment period).

The sale of quotas by non-Brazil-domiciled investors in stock exchanges is exempt from income tax. Gains arising from sales outside stock exchanges will be subject to the payment of income tax depending on whether the requisites above are fulfilled or not. If they are fulfilled, such gains will be subject to an income tax rate of zero (similarly to the redemption and amortization of quotas); if the requisites are not fulfilled, the applicable income tax rate will be 15%.

When it comes to dividends and interests on net equity distribution, non-Brazil domiciled investors are taxed similarly to Brazil-domiciled investors. Dividends are exempt from income tax and interests on net equity are subject to a 15% withholding income tax (other tax rates may apply depending on the terms of treaties between Brazil and the investor's country of domicile to avoid double taxation of income).

Different rules apply to investors domiciled outside Brazil in jurisdictions that do not impose any income tax or charge income tax at a rate lower than 20% (frequently referred to as tax havens) or that are organized under a business entity type considered to have a privileged tax regime. **[4]**In such cases, the investors do not benefit from the special regime applicable to other non-Brazil domiciled investors and are subject to the same tax treatment applicable to individuals resident in Brazil in the redemption, amortization and sale of quotas: 15% fixed rate or, if certain rules are not observed, rates starting at 22.5% and decreasing to 15% based on the investment period. Dividends paid to tax-haven domiciled and "privileged tax regime" foreign investors are – as usual – exempt from income tax. Interests paid on net equity for those investors, on the other hand, are subject to a 25% (rather than the normal 15%) withholding income tax.

In addition to income tax, FIP's investors are subject to a financial transaction tax, the IOF-TVM tax, levied on transactions with securities. However, and most important, the Federal Government has reduced the IOF-TVM tax rate to zero with respect to all transactions carried out 30 days after the acquisition of the securities, which is almost always the case in PE/VC investments.

Investors domiciled outside Brazil would also be subject to another financial transaction tax, the IOF-Câmbio tax, levied on foreign exchange transactions. In reality, though, such tax does not affect investors, since the Federal Government has also reduced to zero the IOF-Câmbio rate applicable to foreign exchange transactions involving investments made in FIPs.

Taxation is one of the most important factors taken into consideration by investors when choosing an appropriate investment vehicle. The FIP has considerable tax advantages and stands out as a premier vehicle for private equity investments in Brazil.

[1] This article deals only with taxation in Brazil. It does not address the foreign taxation of gains obtained by investors with their investments in FIPs.

[2] The additional tax due, if any, will depend on the tax regime adopted by the investor in Brazil.

[3] For this purpose, a related investor means (i) with regard to a natural person, her/his close relatives (parents, children, grandparents, grandchildren and siblings), legal entities controlled by such investor or by any of his/her close relatives, and partners, directors or officers of a legal entity under the control of such investor or his/her close relatives; (ii) with regard to a legal entitiy, its controlling shareholder, controlled companies and affiliates.

[4] Instrução 1,037/2010 of the Brazilian IRS lists the jurisdictions considered to be tax havens and the business entity types that are considered to have a privileged tax regime (for example, the Uruguaian Sociedades Anónimas Financieras de Inversión).