

Legal Bulletin
August 2018

Taxation of investment funds: the new intended regime

The Brazilian government again intends to change the taxation of investments in certain Brazilian funds, especially FIPs and closed-end funds, effective January 1st, 2019.

Similar changes had already been attempted via Provisional Measure (“PM”) No. 806, of October 30, 2017, which was not timely converted into law by Congress and thus expired. Now President Michel Temer has submitted a new bill to Congress (Bill No. 10,638/2018) with similar contents.

Closed-end funds, which currently are taxed only upon amortization or liquidation, would be subject to biannual Withholding Income Tax (“WHT”) collection, with past-accumulated gains being taxed at once, which may be challenged on Constitutional grounds.

Closed-end funds in general

Currently, the biannual WHT levied according to the “come-cotas” method¹ applies only to open-end funds, with a few exceptions². As from May 31, 2019, it would also be applicable to closed-end funds, i.e. those whose shares are not redeemable. Accumulate gains accrued until May 31, 2019, which are currently taxed only upon liquidation or amortization, would be taxed at once on that date.

The biannually collected WHT would be complemented upon distribution or redemption in case the WHT rate then applicable is higher.

The bill makes it clearer that this “come-cotas” would follow the usual rates of 15% for long-term funds and 20% for short-term funds³.

Extension of “come-cotas” taxation to closed-end funds had been announced by the Government as a means to help balance the federal budget. It however may be challenged in courts on constitutional grounds: income tax can only be imposed on income that is accessible to the investor, which does not occur in the case of closed-end funds before the fund is liquidated or amortized.

According to the bill, the following closed-end funds would remain free from “come-cotas” taxation:

- Funds established solely for non-Brazilian resident investors;
- Real Estate Investment Funds (“FII”);
- Receivables Investment Funds (“FIDC”) and funds-of-funds (“FoF”) specialized in FIDC shares (“FIC-FIDC”);
- Stock Investment Funds (“FIA”) and FoF specialized in FIA shares (“FIC-FIA”);
- Private Equity Funds (“FIP”) and FoF specialized in FIP shares (“FIC-FIP”);
- Infrastructure FIPs (“FIP-IE”) and FIPs for Intensive Economic Production on Research, Development, and Innovation (“FIP-PD&I”); and
- Other closed-end funds which, on the date of publication of the new law, expressly provide in their regulations for their non-extendable termination until December 31, 2019 (these funds shall remain taxable solely upon amortization or liquidation).

Qualified FIPs

As intended by the bill, certain changes would apply as from January 1st, 2019 to the taxation of income earned by FIPs qualified as entities with independent market investors in accordance with the regulations of the Brazilian Securities Commission⁴ (*Comissão de Valores Mobiliários* – “CVM”) (“Qualified FIPs”).

São Paulo

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

Rio de Janeiro

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

Brasília

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

contato@levysalomao.com.br

¹ The term is a reference to the mechanics by means of which the WHT is paid: shares representing the amount of WHT due are liquidated in order to pay the WHT, therefore shareholders have a reduction in the quantity of fund shares owned. This WHT is levied as an advance collection of WHT, which would otherwise become due only upon redemption.

² For example, Stock Investment Funds and Pension Funds, among others.

³ In an [Executive Notice](#) issued while PM 806/17 was in effect, the Brazilian Federal Revenue Service had suggested that the “come-cotas” collection for closed-end funds in general would be subject to the same regressive tax rates applicable upon redemptions (ranging from 22.5% to 15%, depending on the investments’ maturity term).

⁴ CVM Ruling No. 579, of August 30, 2016.

Legal Bulletin August 2018

Income earned by Qualified FIPs from the disposition of invested companies and other qualified assets, minus expenses and costs, as well as income received from amortization of shares in other FIPs, would be deemed distributed to investors (if not previously distributed) on the last business day of the month following receipt of the income.

WHT at a 15% rate would be levied as from the moment in which the total accrued income, distributed or deemed distributed as described above, exceeds the total capital invested in the fund.

This is intended to prevent the FIP from reinvesting the gains with tax deferral, as currently permitted.

Although the bill is unclear, it appears that such WHT will be treated as definitive WHT payment rather than advance collection of WHT due upon redemption.

Qualification of a FIP as an investment entity may depend on a certain level of discretion and subjectivity of its administrator, which may cause uncertainty as to the applicable taxation.

The bill also revokes the requirement of Law No. 11,312, of June 27, 2006, that portfolios of FIPs and Investment Funds in Emerging Companies keep a minimum holding of 67% in stock, convertible debentures, and subscription bonuses. Henceforth, only rules issued by financial supervision/regulatory authorities concerning portfolio composition would apply.

Unqualified FIPs

The bill provides a different treatment to FIPs that are not qualified as investment entities ("Unqualified FIPs").

As from January 1st, 2019, income earned by the Unqualified FIP's portfolio would be taxed according to the rules applicable to Brazilian corporate entities.

Moreover, any income and gains earned by the FIP and not distributed to investors by January 2, 2019 would be deemed distributed to investors on that date and subjected to WHT at a 15% rate, to be collected by the administrator of the FIP until May 31, 2019. In determining the income and gains subject to such taxation, the FIP should abide by accounting rules enacted by CVM for Unqualified FIPs.

Investors must provide the FIP administrator in advance with funds needed for the WHT collection. Otherwise, while the WHT is not fully paid the FIP would be prohibited to distribute or transfer funds to the investors, and to make new investments and reinvestments, and interest and fine would apply on WHT paid after May 31, 2019.

Although the bill is unclear, it appears that such WHT would be treated as definitive WHT payment rather than an advance collection of WHT due upon redemption.

It remains unclear how investors of Unqualified FIPs would be taxed after January 2, 2019. Possible alternatives are (i) according to the same deemed distribution rule with 15% taxation applicable to Qualified FIPs, (ii) according to the "come-cotas" applicable to other closed-end funds, or (iii) no taxation applies to them, considering that the FIP would already have been taxed at the portfolio level.

The third option would be the most appropriate, because if the Unqualified FIP is treated as a corporate entity for tax purposes, it should also be able to distribute its profits to investors tax-free after taxation at the portfolio level. It also seems to be the most likely option, since the Federal Revenue Service (*Receita Federal do Brasil* – "RFB"), in an Executive Notice enacted at the time PM 806/17 was published, did not refer to taxation of income/gains after January 2, 2019.

Non-Brazilian investors

The bill does not affect the tax exemption of income earned in FIPs by non-Brazilian residents, as set forth by Article 3 of Law No. 11,312/06. WHT levied on income stemming from other funds, as long as they are established solely by non-Brazilian resident investors, remains due exclusively upon redemption, as had been confirmed by the RFB in the Executive Notice issued in 2017.

São Paulo

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

Rio de Janeiro

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

Brasília

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

contato@levysalomao.com.br

Legal Bulletin
August 2018

Such investors could be indirectly affected only in the case of Unqualified FIPs available for resident and non-resident investors, since the taxation at the level of the FIP's portfolio could reduce income available for distribution to investors.

Closed-end funds' reorganizations

The bill brought back the general provision of PM 806/17 on investors' taxation in cases of spin-off, merger or transformation of investment funds, but limiting it to closed-end funds only.

As from January 1st, 2019, such events would trigger taxation over the positive difference between the shares' NAV on the date of the reorganization transaction, including the income attributed to each investor, and (i) the NAV on the date of the last WHT collection, or (ii) if no WHT collection has yet taken place, the shares' original acquisition cost, adjusted by any past amortizations.

If the bill passes Congressional approval this year, it is recommended that any intended restructurings or reorganizations of closed-end funds be completed until December 31st, 2018, since starting January 1st, 2019 it would no longer be possible to implement them without the above tax impact, as currently permitted by Normative Ruling RFB No. 1,585, of August 31, 2015.

Other excluded investors

The aggravated taxation rules set forth by the bill, as with PM 806/17, would not be applicable to income and net gains earned on investments held by financial institutions, insurance companies, pension and capitalization companies, securities and exchange brokerages, securities dealers, and leasing companies.

Litigation

There are grounds to challenge not only the extension of the "come-cotas" taxation to closed-end funds, but also the new forms of taxation imposed before the fund's amortization or liquidation on undistributed gains accrued prior to January 1st, 2019. Both the fund administrator (liable for withholding and collecting the WHT) and the investor (taxpayer and bearer of the WHT burden) would be legitimate to litigate⁵.

Congressional approval

In order to take effect in 2019 the bill must be approved by Congress until December 31st, 2018, as required by the Constitution. The Government expects it to be approved before the October elections, but chances are low, since the bill has only been distributed to the commissions of the House of Representatives on August 14th. It could still be approved after the elections, but this will depend on the outcome of the elections themselves.

Moreover, considering what happened in the case of PM 806/17, it is expected that the bill will be subject to numerous proposed amendments in Congress, extending discussions.

São Paulo

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

Rio de Janeiro

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

Brasília

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

contato@levysalomao.com.br

Isabela Schenberg Frascino
ifrascino@levysalomao.com.br

Pedro de Araujo Chimelli
pchimelli@levysalomao.com.br

⁵ See precedents from the Superior Court of Justice (STJ) and the Regional Federal Court of the 3rd Region, and provisions of Normative Opinion No. 1, of September 24, 2002, from the General Tax Coordination (Cosit).