

HOW TO INVEST IN THE BRAZILIAN ETHANOL INDUSTRY



Ana Cecília Manente



Bolívar Moura Rocha



Beatriz Visnevski

The ethanol boom has heightened the scrutiny of Brazil's investment framework from global companies. Partners Ana Cecília Giorgi Manente and Bolívar Moura Rocha and senior lawyer Beatriz Visnevski of Levy & Salomão Advogados detail the key legal aspects of investing in the industry

Concerns with energy security, oil prices and climate change are driving strong interest in biofuels in general and in ethanol in particular. Brazil's competitiveness has been attracting significant amounts of foreign direct investment in the ethanol industry. This article discusses relevant legal aspects in connection with such investment inflow.

Title to rural real estate property

Ethanol businesses in Brazil are typically vertically integrated, with industrial plants and some proportion of sugarcane production under the same business and third parties supplying the balance. As sugarcane is perishable, title to land around industrial plants is key to the competitiveness of greenfield plants.

The Brazilian Federal Constitution guarantees Brazilians and foreigners resident in the country the right of property. More specifically, it provides that the law regulates and restricts the acquisition or lease of rural real estate property by foreign individuals or legal entities, and establishes those cases in which the authorisation of the National Congress is necessary. Subsequent laws have established that acquisition of rural real estate property is prohibited to foreign individuals not resident in the country and to foreign legal entities not authorised to conduct business activities in Brazil.

With regard to foreign legal entities authorised to conduct business activities in Brazil, the main restrictions are:

- the acquisition of the real estate property is conditioned on the implementation of a project which is related to the corporate purpose of the company and whose nature is agricultural, related to cattle raising, industrial or concerning land settlement;
- the project must be previously authorised

by the Ministry of Agriculture, following its review by the relevant federal authority, depending on the type of activity.

With regard to foreign individuals residing in Brazil, the main restriction concerns the limit on the size of the real estate property that can be acquired. Should the real estate property be of an area less than or equal to 3 MEI, the acquisition will not require any

The total area owned by foreigners of different nationalities cannot exceed 25 per cent of the area of each municipality

authorisation or licence (MEI is defined by the National Institute of Land Settlement and Agrarian Reform (INCRA) and corresponds to 100,000 square metres for certain cities in the countryside of the state of São Paulo). Buyers will however need the previous authorisation of INCRA, which in turn is conditioned on the authorisation

of the relevant agency with regard to the exploration project: when the acquisition is of a rural real estate property between 3 and 50 MEI; as well as when the acquisition of more than 1 real estate property, regardless of the area, is made by a single individual. Areas larger than 50 MEI may only be acquired upon Presidential approval by decree.

There is an additional general limitation regarding the acquisition of rural real estate property by foreigners which is applicable to both individuals and legal entities. The total area owned by foreigners of different nationalities cannot exceed 25 per cent of the area of each municipality. Should two or more foreigners of the same nationality be entitled to ownership of real estate property in the same municipality, the total area owned by them cannot exceed 10 per cent of the area of the municipality. However, should the real estate in question be part of a project considered a priority to the development of the country, the President of Brazil may authorise foreigners by decree not to be bound by these restrictions.

Tax efficiency

Two aspects concerning the tax efficiency are discussed below: regulations regarding Private Equity Funds (FIP) and taxation at the state level.

FIPs – tax-efficient vehicles for non-portfolio foreign investment

Investments in Brazilian companies via FIPs, created by the Brazilian Securities and Exchange Commission in 2003, have become particularly tax efficient since changes were introduced to the applicable tax rules in July 2006, and this vehicle has indeed been increasingly used by foreign investors.

The FIP may acquire shares, debentures, subscription bonds and other convertible

securities of public or private companies, and is required by applicable regulation to participate in the decision-making process of the company. The FIP may also issue more than one class of quotas, subject to different voting rights and fees. Thus, the same vehicle can accommodate investors of distinct particularities. Nonetheless, FIP quotaholders, regardless of the class, will always have the right to an undivided interest in the fund's portfolio, which cannot be segregated among classes of quotas.

It is possible, depending on the particular case, to reduce to zero the Brazilian taxation on any and all return a foreign investor might have on investment in operational companies

The withholding income tax rate applicable to earnings from FIP investments is reduced to zero when the earnings are paid to an individual or collective beneficiary domiciled abroad, as long as:

- the FIP investment was made in accordance with National Monetary Council rules;
- the beneficiary, individually or together with related parties, does not hold 40 per cent or greater of the quotas issued by the FIP, nor has the right to receive more than 40 per cent of the income generated by the FIP;
- the FIP's portfolio does not, at any time, consist of more than 5 per cent bonds or fixed-rate financial instruments, except for convertible debentures and bonds issued by the Brazilian government; and
- the beneficiary is not domiciled in a tax haven jurisdiction.

Where all such conditions are not met, earnings generated by the FIP will be subject to withholding income tax at a rate of 15 per cent, so long as the fund meets the diversification requirements and complies with the investment rules established by the CVM and, further, has a portfolio at least 67 per cent comprised of shares of corporations, convertible debentures and subscription bonds.

Even the 15 per cent tax rate the FIP could be subject to is relatively low. Additionally, the requirements indicated in subitems (i) and (iv) above being present, the capital gains from the sale of FIP quotas will be free from income tax should the sale be made via a stock exchange or similar entity. Thus, it is possible, depending on the particular case, to reduce to zero the Brazilian taxation on any and all return a foreign investor might have on investment in operational companies via FIP.

State tax regimes

Other factors being equal, the 'competitiveness' of state tax rules is key to investment decisions. A few states that feature favourable logistics and availability of land have been competing for the bulk of investments directed at greenfield projects.

Sales of goods are subject to value-added tax (ICMS) levied by states. Even though there are legal constraints and political arrangements in place directed at limiting the degree to which states can look to tax incentives as a means of attracting investment, this is still common practice. States are increasingly resorting to incentives that are financial in nature, generally in the form of indirect tax discount. The state of Goiás, for instance, has adopted a programme under which the taxpayer may defer up to 73 per cent of its tax obligations, with a grace period of 12 months for the payment of outstanding amounts. In addition, at the end of this grace period the taxpayer may reduce its tax obligations by applying certain allowed discount factors provided for under the relevant rules, which may result in a 100 per cent discount.

Some of the state tax incentives in force have a doubtful legal basis. Investors should, thus, seek legal advice in their regard to avoid being affected by possible adverse later developments such as the revocation of the relevant rules by court decision.

The regulatory environment

The recent boom in the ethanol industry has significantly altered the environment under which the Brazilian sugarcane industry operates. This includes prospects for an ever-growing demand for ethanol, with

corresponding pressure on domestic supply; increasing importance of bioelectricity – ie, surplus power resulting from co-generation using bagasse from sugar cane and sold to the electric energy grid; and prospects for the development of second generation (cellulose) ethanol. Such developments already call for a review of the legal and regulatory framework under which this industry operates in Brazil. Brazilian producers are currently initiating discussion on this regulatory agenda with the federal administration. It would be in the interest of foreign players to join early in the process.

Other factors being equal, the 'competitiveness' of state tax rules is key to investment decisions

At both state and federal levels, the Brazilian government is broadly welcoming the investment inflow from the ethanol industry with a favourable legal and regulatory framework. Nonetheless the boom in the industry will inevitably affect the current agenda in a number of ways; for example, the negative environmental effect of ethanol production may result in tighter regulations on that aspect of the industry. In any eventuality, close attention must be paid to new developments to ensure that the return on ethanol investments is protected.