Legal Bulletin
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Foreign investment in Brazil via FIP

There has been a significant increase of investment in Brazilian companies via Private Equity Funds ("FIP"), created under Brazilian Securities and Exchange Commission (CVM) Instruction No. 391, dated July 16, 2003. The grant of tax benefits to foreign investors investing in FIPs is one of the reasons for this phenomenon.

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.

As private companies are not registered with the CVM, in order to be eligible to receive investments from a FIP, they must adopt certain minimum corporate governance practices. Among other requirements, corporate disputes of the company must be resolved through arbitration and the company must submit its financial reports for audit on a yearly basis by CVM-registered independent auditors.

The FIP must have an administrator authorized by the CVM, as well as written regulations relative to investment policy, investors' rights, capital calls and redemptions. The FIP may issue more than one class of interests, subject to different voting rights and fees. Thus, the same vehicle can accommodate investors of distinct particularities. Nonetheless, FIP investors, regardless of the class of interests they hold, will always have the right to an undivided interest in the fund's portfolio, which cannot be segregated among classes of quotas.

Especially for foreign investors, the FIP receives a favorable tax treatment on the basis of current legislation.

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, cumulatively:

i. the FIP investment was made in accordance with National Monetary Council rules (Resolution No. 2.689, dated January 26, 2000);

ii. the beneficiary is not resident or domiciled in a tax haven;[1]

iii. the beneficiary, individually or together with related parties, does not hold 40% or more of the quotas issued by the FIP, nor has the right to receive more than 40% of the income generated by the FIP;

iv. the FIP's portfolio does not, at any time, hold bonds debt instruments exceeding 5% of its net asset value, except for stock-convertible debentures, subscription bonuses, and bonds issued by the Brazilian government;

v. the FIP's portfolio includes at least 67% of stock of corporations, stock-convertible debentures, and subscription bonuses; and

vi. the FIP conforms to the diversification limits and investment rules set forth by the regulations enacted by CVM.

[1] Defined for this purpose as a jurisdiction that does not impose income tax or imposes income tax at a maximum rate of less than 20%.

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Withholding income tax applies at a 15% rate on distributed income in case any of the above conditions are not met, provided that at least those mentioned in items “i” and “ii” or “v” and “vi” are complied with. In case the FIP does not meet the conditions indicated in items “i” or “ii” and also with any of those under items “v” or “vi” above, withholding income tax applies according to the same regressive rates of 22.5%, 20%, 17.5% and 15% applicable to Brazilian fixed income funds in general.

Even the 15% rate is relatively low. Additionally, the requirements indicated in items “i” and “ii” above being present, capital gains from the sale of interests/quotas in the FIP will be free from income tax should the sale be made by a foreign investor within a stock exchange or assimilated entity, exception made to certain combined transactions that produce previously established income.

Foreign currency exchange transactions relating to inflows and outflows of funds into/out of the country in connection to foreign investments in FIPs and Investment Funds in quotas of FIPs currently benefit from a 0% rate of the Tax on Financial Transactions (“IOF”).

Thus, it is possible, depending on the particular case, to reduce Brazilian taxation to zero on any and all returns a foreign investor might have on investments in operational companies via a FIP.

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