

Taxation of investment funds: analysis of new regime

Changes have been introduced to the taxation of investments on several types of Brazilian funds, including those established as a closed condominium (“Closed Funds”). They will be subject to biannual advance collection of Withholding Income Tax (“WHT”), exception made for certain listed funds. The matter is dealt with in the Provisional Measure (“PM”) No. 806, from October 30, 2017. Much still has to be clarified by subsequent changes and/or regulations to the rule.

Changes to taxation on Closed Funds in general

Currently the biannual advance WHT levied according to the “come-cotas” method¹ applies only to funds established as an open condominium (“Open Funds”), with a few exceptions². As from May 31, 2018, it will also be applicable to Closed Funds, those that do not allow redemption of quotas during the fund’s duration term. The WHT due on May 31, 2018 will be levied over all gains accrued until that date, previously subject to deferred taxation.

The biannually collected WHT should be complemented upon the effective redemption of quotas, in case the income is then subject to WHT rates higher than those applied for the “come-cotas” collection.

In a recently issued [Executive Notice](#) (“EN RFB”), the Brazilian Federal Revenue Service (*Receita Federal do Brasil* – “RFB”) suggested that the “come-cotas” collection for Closed Funds in general would be subject to the same regressive tax rates applicable on the redemption of quotas (ranging from 22.5% to 15%, depending on the investments’ maturity terms). This is not our understanding, since PM No. 806/17 remits to legal provisions that set “come-cotas” tax rates at 15% for long-term funds and 20% for short-term funds.

Extension of the “come-cotas” taxation to Closed Funds had been announced by the Federal Government as another option for immediate cash generation and balancing of the federal budget. It however lacks legal ground and thus may be challenged in courts as Closed Funds do not allow intermediary redemption of quotas. Investors thus have no availability over the accrued gains before the fund’s liquidation or before an actual amortization of quotas as set forth in the fund’s regulations.

According to the PM, the following Closed Funds are free from the “come-cotas” taxation:

- funds established solely for non-Brazilian resident investors;
- real estate investment funds (“FII”) established according to Law No. 8,668, of June 25, 1993;
- receivables investment funds (“FDIC”) and investment funds on quotas of receivables investment funds (“FIC-FIDC”);
- stock investment funds (“FIA”) and investment funds on quotas of stock investment funds (“FIC-FIA”);
- equity investment funds (“FIP”); and
- other Closed Funds which, on October 30, 2017, expressly provide in their regulations for their non-extendable termination until December 31, 2018 (these funds shall remain taxable solely upon amortization of quotas or upon the fund’s termination).

Changes to taxation on Qualified FIPs

As from January 1st, 2018, gains from the disposition of any investments by FIPs qualified as entities with independent market investors in accordance with the regulations of the Brazilian Securities Commission³ (*Comissão de Valores Mobiliários* – “CVM”) (“Qualified FIPs”), although not subject to taxation at the portfolio level neither to “come-cotas”, will be deemed

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

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

³ CVM Ruling No. 579, of August 30, 2016.

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

Legal Bulletin
November 2017

distributed to investors. Such gains will be subject to WHT at a 15% rate as from the moment in which the total accrued gains, distributed or not, exceed the total capital invested in the fund. This is intended to prevent reinvestments of the gains with tax deferral. Although the PM is unclear, it appears that such WHT will be treated as definitive WHT payment rather than advance collection of WHT due upon redemption.

The qualification of a FIP as an investment entity may depend on discretion of the fund's administrator, which may cause uncertainty as to the applicable taxation.

EN RFB curiously suggests that Qualified FIPs shall continue to be taxed only upon amortization, disposition and redemption of quotas, at the rate of 15%, and that the PM's provisions shall not apply to gains accrued prior to January 1st 2018.

The PM also revokes the requirement that portfolios of FIPs and of Emerging Companies Investment Funds maintain a minimum holding of 67% in stock, convertible debentures, and subscription bonuses. Henceforth, only the rules in force issued by financial supervision / regulatory authorities concerning portfolio composition shall be applicable.

Changes to taxation on Unqualified FIPs

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

Income earned by the Unqualified FIP's portfolio will be taxed according to the same rules applicable to Brazilian corporate entities.

Any income earned by the FIP and not distributed to investors by January 2, 2018 will be deemed paid or credited to investors on that date and shall be subject to WHT at a 15% rate. This WHT is charged pursuant to a mechanics which is similar to the "come-cotas". The PM, however, does not clarify whether such WHT shall be deemed an advance collection of WHT due upon redemption or if it will be treated as definitive WHT payment.

It is unclear how investors of Unqualified FIPs will be taxed after January 2, 2018. Possible alternatives are (i) according to the same deemed distribution with 15% taxation applicable to Qualified FIPs, (ii) according to the "come-cotas" applicable to other Closed Funds, or (iii) no taxation applies to them, considering that the rules applicable to Brazilian corporate entities have already caused taxation at the portfolio level.

The third option seems more likely given the regulatory context. Recently issued EN RFB adopted the third interpretation.

Taxation on non-Brazilian resident investors

The tax exemption applicable to income earned in FIPs by non-Brazilian residents as set forth by Article 3 of Law No. 11,312/06 remains unchanged.

In the case of Unqualified FIPs available for resident and non-resident investors, however, taxation of its portfolio as described above could reduce income available for distribution to investors.

WHT levied on income stemming from funds established solely by non-Brazilian resident investors remains due exclusively upon redemption of quotas, as confirmed by EN RFB.

General provisions on taxation of funds' reorganization

The PM brought general provisions applicable to all types of investment funds concerning taxation in cases of spin-off, merger and transformation of funds. As from January 1st, 2018, such events will trigger taxation over the positive difference between the quotas' net equity value for each investor on the date of the reorganization transaction, and i) the value of the quotas on the date of the last WHT collection, or ii) if no WHT collection has yet taken place, their original acquisition cost.

If the PM passes Congressional approval, it is recommended that any intended fund

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

restructurings or reorganizations be made until December 31, 2017. Up to such date reorganizations can be made without the above tax impact under Normative Ruling RFB No. 1,585, of August 31, 2015.

Exceptions to the PM's provisions

The new rules are not applicable to income and net gains earned on fund investments held by financial institutions, insurance companies, pension and capitalization companies, securities and exchange brokerage companies, securities dealerships, and leasing companies.

Grounds for litigation

Besides the grounds for challenging the extension of the "come-cotas" taxation to Closed Funds as mentioned above, there is also basis to challenge the new forms of taxation imposed on undistributed gains accrued prior to January 1st, 2018 (when PM No. 806/17 is to become effective), previously subject to deferred taxation.

Congressional approval

Confirming the PM's evident collection-oriented purpose, its effects have already been considered in the 2018 projected federal budget. However, to be effective as from January 1st, 2018, it must be passed into law by the Brazilian Congress until December 31, 2017, as required by the Brazilian Constitution.

With less than one month left to the end of Congressional-year of 2017 (legislative sessions end on December 22), the PM's approval this year is unlikely. In case it is approved, its wording will need to be made clearer in several aspects.

Isabela Schenberg Frascino
ifrascino@levysalomao.com.br

Pedro Araujo Chimelli
pchimelli@levysalomao.com.br

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