

Illegal Tax Assessments against Private Equity Funds

After threatening to charge Withholding Income Tax (WHT) from local financial institutions acting as legal representatives of foreign investors if any Brazilian residents were identified as ultimate beneficial owners (UBO) of the foreign investments in local funds, the Brazilian Federal Revenue Service (RFB) has now begun to issue tax assessments against local Private Equity Funds (FIPs) that receive foreign investments from entities or other funds domiciled out of Brazil, without being able to prove who are the UBOs of these foreign entities.

In being unable to prove the inexistence of any Brazilian resident UBOs, local FIP administrators have started to receive tax assessment notices charging WHT at a punitive rate of 35% (applicable to payments made to unidentified beneficiaries) on income earned by non-resident quota-holders. This applies over a grossed-up basis deemed net of WHT, which increases the effective tax burden to 53.85%.

The tax assessments derive from a misinterpretation of the tax legislation, for there are no rules demanding from FIP administrators the knowledge and provision of detailed information and documents on UBOs of foreign investment structures. This obligation is imposed exclusively on the legal representative of the foreign investor.

Neither is it possible to deem as “payment to unidentified beneficiaries” the remittances made to foreign quota-holders who are known and perfectly identified, not only by the FIP administrators, but also by the RFB, as they must be registered with the National Registry of Legal Entities (*Cadastro Nacional das Pessoas Jurídicas* – CNPJ) prior to their investment in local FIPs.

Although the tax liability/responsibility belongs to the paying source (i.e. the FIP administrator), for the purpose of determining the proper taxation on the FIP’s investments what matters is that the direct foreign investor – taxpayer of WHT and holder of FIP quotas – is not resident in Brazil.

Indeed, the legislation granting tax benefits to these investments requires only that the quota-holder be a foreign investor not resident in a tax haven jurisdiction (as defined by the Brazilian legislation). According to the regulations currently in force, it is sufficient that the administrator of the foreign resources informs the Brazilian paying source that the investment originates from a foreign jurisdiction not deemed as a tax haven in order to ensure the application of the more favorable taxation. Only the lack of such information authorizes WHT to be levied at the same rates applicable to Brazilian resident investors, which range from 15% to 22.5%, but not 35%.

It is true that the 0% WHT rate applicable to income from investments in FIPs is limited to foreign quota-holders that do not own, alone or together with related parties, 40% or more of all the FIP quotas or the right to receive more than 40% of the FIP’s total income, and that this demands a certain level of knowledge from the FIP administrator as to the relationships among the quota-holders. But this does not mean that the administrator or the manager of a FIP must necessarily know any and all UBOs of the foreign investments. Neither does it mean that the impossibility to prove the inexistence of any Brazilian resident UBOs allows tax authorities to charge WHT at a 35% rate.

The tax authorities’ misinterpretation seems to stem from Normative Ruling (IN) RFB No. 1,634/16, as amended, which regulates the CNPJ (taxpayer registration) and, with regard to the registration of foreign investors, demands disclosure of the entire equity chain up to the individuals deemed as UBOs according to the specific definition provided by the IN, or up to certain types of entities, such as publicly-held companies in countries that demand disclosure of all relevant shareholders; pension funds and similar institutions regulated and supervised by a competent governmental authority; collective investment vehicles domiciled out of Brazil that fulfill certain requirements; among others. Tax authorities are also allowed to specifically request documents and information relating to other ultimate beneficiaries that fall out of the UBO definition provided by IN RFB No. 1,634/16.

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However, the obligations set forth by the IN are imposed on the legal representative of the foreign investor in Brazil, not on the administrator or the manager of the fund that receives the investments.

In case the legal representative fails to provide UBO information, the consequences are specific and limited according to the current regulations: the investor's enrolment with CNPJ may be suspended and the investor will thus be unable to operate with banks, except for the purpose of returning the investments to its country of origin and to comply with obligations undertaken prior to the CNPJ suspension, as expressly stated by the IN. The infringement does not interfere in the tax liability/responsibility rules directed at the payment source, and cannot directly cause an increase in the taxation of the investment or impede remittances of funds to the foreign quota-holder. Therefore, any obstacles to the redemption/amortization of quotas or to remittances of funds overseas with the adequate tax treatment lack legal grounds.

Negative effects of the tax authorities' unfounded claim can already be felt throughout the Brazilian fund industry. Fund administrators, frightened with the possibility of bearing a taxation of up to 53.85% plus interest and fines, have started to demand from their foreign peers detailed information and documents on UBOs of foreign investments and even to condition remittances of proceeds to the quota-holders to the provision of such information, even without legal or regulatory permission.

The level of details required worries foreign administrators and fund managers, who are used to international KYC/AML standards and rarely hold all the required information and documents to be promptly provided, forcing them to reach out to their investors (sometimes hundreds of them) on a time-consuming, bureaucratic, and stressful process. To make matters worse, as some local administrators are holding back remittances of funds to investors until the detailed UBO information is provided, the general feeling in the industry is that investor money is being "held hostage" in Brazil. In view of the illegal tax assessments and unauthorized withholding of investor money, it would not come as a surprise if new investments in Brazilian FIPs were postponed or even suspended.

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