



MEMORANDUM TO CLIENTS

TAX AND CAPITAL MARKETS

16/11/2017

New rules for the taxation of closed-end funds and Brazilian Private Equity Investment Funds (FIP)

On October 30, 2017, the Brazilian Federal Government published the Provisional Measure No. 806 (MP 806), confirming rumors that had been growing in the market for several months with respect to the imminent enactment of substantial changes in the taxation regime of closed-end investment funds.

1. **New taxation system of closed-end funds**

According to the currently understanding of Brazilian tax authorities, Brazilian resident quotaholders of closed-ended investment funds are only subject to withholding income tax ("WHT") upon the redemption or the disposal of the respective quotas, as provided by paragraph 4 of article 9 of Normative Ruling No. 1,585 dated August 31, 2015.

On the other hand, Brazilian quotaholders of open-ended funds are subject to the WHT assessment on a semi-annual basis (on May and November, at rates of 15% or 20%, depending on the classification of the fund as long-term or short term). This twice-yearly taxation is also known as "*come-cotas*" taxation, which is deemed an advance payment of the WHT levied upon the redemption, amortization or disposal of the quotas.

Accordingly, whereas there could be grounds for tax authorities to impose the *come-cotas* taxation upon closed-end funds, by revoking paragraph 4 of article 9 of Normative Ruling 1,585 (and whereas such revocation would certainly generate discussions as to the definition of the taxable base of the future *come-cotas* imposition), MP 806 creates a different *come-cotas* taxation for closed-end funds.

According to the proposed come-cotas taxation, WHT would be levied every May and November (or, if occurred before such dates, upon the amortization or redemption of the quotas) at regressive rates ranging from 22.5% to 15% (if the relevant investment fund is characterized as a long-term fund) or from 22.5% to 20% (if characterized as a short-term fund) based on the investment duration.

Attention Points

- Difference in comparison with open-end funds come-cotas taxation: differently from what had been speculated, the come-cotas taxation proposed for closed-end funds is different from the one applicable to open-end funds. As noted above, the rules applicable to open-end investment funds determine that the WHT due on May and November is levied at flat rates of 15% (for long-term fund) and 20% (for short-term funds), and such WHT collection is an anticipation of the WHT levied upon amortization or redemption of the quotas. On the other hand, the closed-end funds come-cotas taxation proposed by MP 806 can be levied at higher rates and is definitive, not subject to adjustments upon quotas amortization or redemption, hence potentially submitting closed-end funds' quotaholders to a more costly position compared to open-end funds' investors.
- Funds investing in illiquid assets: in addition, there may be operational difficulties associated with closed-end funds investing in illiquid assets, once the administrator will not have access to enough cash required to collect the WHT.

1.1. Taxation of accrued appreciation

Furthermore, MP 806 determines that the difference between the net worth value of the quota on May 31, 2018 and the acquisition cost should be subject to WHT in accordance with the same regressive rates mentioned above. Therefore, according to the MP 806, all accrued appreciation of the quotas up until that date, which taxation had been deferred until further amortization or redemption according to the previously applicable rules, would be subject to WHT on May 31, 2018. We anticipate that this measure will generate a great amount of tax litigation from taxpayers, especially in the case of funds with illiquid assets.

1.2. Funds excepted from the rule

The quotaholders of the following investment funds are not subject to the *come-cotas* taxation system abovementioned: (i) Real Estate Investment Funds (FII); (ii) Credit Rights Investment Funds (FIDC); (iii) Investment Funds in FIDC quotas (FIC-FIDC); (iv) Listed Shares Investment Funds (FIA); (v) Investment Funds in FIA quotas (FIC-FIA); (vi) funds that will be closed by December 31, 2018; (vii) FIP classified as investment entities; (viii) FIP non-classified as investment entities; and (ix) non-residents investors (NRI) exclusive funds.

There is an asymmetry in this last hypothesis, since NRI investing in open-end funds are not subject to *come-cotas* Taxation, and there is no logical reason to subject the NRI to a more burdensome treatment when investing in non-exclusive closed-end funds.

2. New rules concerning FIP taxation

2.1. Non-investment entity FIP

As proposed by MP 806, all appreciation accrued to the quotas of FIP classified as non-investment entities (as per currently applicable regulation issued by Brazilian Securities and Exchange Commission ("CVM") Instructions No. 478 and 479) should be subject to WHT on January 2, 2018. The accrued appreciation corresponding to deferred income and gains at the non-investing entity FIP portfolio will subject to 15% WHT, regardless of any amortization or redemption event, as if such appreciation had been paid or credited to the quotaholders. Please note that there might be a potential lack of proceeds for the fund administrator to collect the WHT in the case of accrued appreciation is not reflected in liquidity at the fund level.

Once the accrued appreciation is subject to WHT, the FIPs would be subject to corporate income tax ("CIT") at a combined 34% rate, and potentially to revenues taxes ("PIS/COFINS") as well, when applicable. The rule does not make it clear if the fund, treated as a legal entity, after taxing its results, could distribute the proceeds to the quotaholders as exempt dividends likewise dividends distribution.

2.2. Investment entity FIP

On the other hand, quotaholders of FIP classified as investment entities according to the CVM regulation are assured the same tax regime currently provided by Law No. 11,312 of June 27, 2006 (that is a 15% WHT in case of taxable quotaholders, or exempt in case of qualifying quotaholders), with two main alterations.

Firstly, any proceeds received by the fund from the disposal of invested companies will be deemed to be distributed to the quotaholder, and subject to WHT (if such WHT is applicable), regardless of the proceeds actual distribution. Nevertheless, WHT will only be deemed to be due once income attributed to the quotaholders exceeds the respective total paid-up capital in the FIP.

Finally, MP 806 eliminates the tax portfolio requirement currently set forth by Law No. 11,312/06 (which sets forth that in order for quotaholders to be eligible to the tax regime applicable to FIPs, the fund must invest a minimum of 67% of its portfolio in shares, warrants and convertible debentures issued by Brazilian corporation, in addition to complying with additional CVM portfolio requirements). Accordingly, as of the conversion of MP 806, the FIP should only comply with CVM portfolio requirement in order to qualify as such. The one remaining tax portfolio requirement constrain is the one that states that the FIP must not hold more than 5% of debt in its portfolio (except for convertible debentures and Brazilian government bonds) in case certain foreign quotaholders intend to be eligible to the exemption set forth by Law No. 11,312/06.

Attention Points

- The relative degree of subjectivity that may permeate FIP's classification as an investment entity may lead to uncertainties about the applicable tax treatment.
- The automatic taxation of gains realized in the FIP portfolio in case of investments disposal prevents deferral strategies by means of reinvestment of the proceeds derived from disposal events.



3. Investment funds reorganization as of 01.01.2018

As proposed by MP 806, spin-off, merger and transformation events of investments funds should be deemed to trigger WHT as of January 1, 2018. The calculation basis of the WHT due upon these events should be the positive difference between the net worth value of the quota and the acquisition cost, adjusted by previous amortizations or redemption events.

Attention Points

- MP 806 provided legal basis to taxation on investment funds reorganizations (including the transformation of funds), which did not exist until this point.
- If MP 806 is converted into law, it will no longer be possible to carry out reorganizations without tax adverse impacts (which may be feasible according to RFB's current understanding expressed in article 13 of IN 1,585/15), and so it is strongly recommended that fund administrators and managers anticipate potential reorganizations they may wish to carry out prior the end of 2017.
- Possible discussion if such rule should only apply to reorganizations of funds subject to specific tax rules, as defined by MP 806 (Section 1.2 above).

4. Validity and effectiveness

In order to be effective as of January 1, 2018, MP 806 should be converted into law by December 31, 2017. There is no assurance that Brazilian Congress will be able to review and vote the MP in that time.

The purpose of this memorandum is to inform our clients about important changes and developments in the area of law. We remain at the reader's disposal for any additional information that may be desired regarding the subject matter herein.

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