The Brazilian FIP: Recent Clarification: What is a Private Equity Entity? What are the Tax Consequences of Not Being a FIP?

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Brazil's Private Equity industry began to take shape amid 1980's and 1990's, with the formation of the first local PE houses and arrival of international houses, both attracted by promising opportunities brought by the privatization process run by the Brazilian government back in the day, as well as by the inclusion of Brazil in the context of global economy.

Conscious of that trend, the Brazilian Government took actions to conceive a proper ecosystem for boosting private equity and venture capital activity on the ground.

The first step was the creation of the first type of regulated fund addressed to investing in small companies, the *Fundos Mútuos de Investimento em Empresas Emergentes (*FMIEEs). The FMIEEs (a vehicle that was more suitable for venture capital investments) was created in 1993, by way of Instruction n. 209/94, enacted by the Brazilian Securities Exchange Commission, *Comissão de Valores Mobiliários* (CVM).

Although it represented an important step for the development of Brazil's alternatives' environment, the Venture Capital Fund vehicle presented some important limitations that needed to be addressed, such as the possibility of using it to invest only in companies with annual net revenues lower than BRL 150 million.

As a response, the CVM created, upon issue of Instruction 391 in 2005, the *Fundos de Investimento em Participações* (the FIPs).

Amongst other things, a FIP offers investors (using it as an investment entity pursuant to current regulations) a favorable tax framework, considering that it is generally tax exempt and withholding income taxes on capital gains accrued by the FIP become due only upon amortization of any investments or liquidation of the fund.

However, despite the motivations the CVM had for creating the FIPs, the *legal* meaning of *investment entity* and, thus, the *legal* purpose of the FIP have never been clear enough.

Aware of this gap in the applicable regulations, many players, not necessarily acting in the private equity and venture capital spectrum, saw the FIP as an interesting means of implementing tax efficient family assets / wealth planning structures.

This practice has presented a two-fold challenge for those involved in the private equity industry:

(a) **Data:** Access to comprehensive, standard, transparent data, especially during fundraising cycles, about local industry profiles and track records is of key interest to all participants in the alternative investment sector. Gathering uniform data was challenged by the fact that the broad description of a FIT allowed for some use by family asset and wealth planners as well as by intended investment entities; and

(b) **Tax:** the FIPs were put in the spotlight of investigations by local tax authorities, who would simply disregard FIP structures (and their associated favorable tax framework) that were used in any context other than as an investment entity. Given the very broad scope of scrutiny generally made by local tax authorities on the basis of the "substance over form" principle, managers started shy away from contemplating FIPs in their fund structures.

In a nutshell, something initially conceived to incentivize private equity in Brazil had suddenly become a burden.

In a first attempt of at least addressing the problem described in "(a)" above and, as a consequence, create some protection against the problem described in "(b)" above, in 2010 ABVCAP (the Brazilian Private Equity Association) and ANBIMA (*Associação Brasileira das Entidades dos Mercados Financeiros e de Capitais*, an association of investment banks, commercial banks, broker-dealers and other market participants) enacted a self-regulatory code of best practices to the market of private equity funds and venture capital funds, applicable to all members of these associations (known as the Code).

The main purposes of the Code are to standardize and bring credibility to management practices and processes, enable transparency, allow that private equity and venture capital activities in Brazil are closely monitored, enhance fiduciary duties and best practices, maintain high ethical standards and enable integration of the Brazilian market of private equity funds and venture capital funds with the international private equity and venture capital market.

The provisions of the Code clearly differentiated FIPs that were meant to be investment entities from FIPs used in the context of family assets / wealth planning. Besides, it has become necessary to submit the FIP documents to ABVCAP and ANBIMA in order to certify it as a FIP that abides by the Code. This certification became a good evidence of "best practices", a "must do" for all those managers willing to build a reputable track record of investments in Brazil.

Yet a great development for the industry, it was still a self-regulatory measure, with no further consequences to those not abiding by the Code other than not being certified by ABVCAP and ANBIMA.

In August 2016, CVM finally created boundaries for purposes of legally classifying a fund as an investment entity, through the issue of Instruction 579, which, together with Instruction 578, brought substantial changes to the regulatory framework applicable to FIPs and FMIEEs. These new Instructions completely replaced Instructions 391 and 209, which were applicable to FIPs and FMIEEs, respectively (FMIEEs were actually extinguished by these new regulations—now the only private equity regulated vehicles are the FIPs).

Such Instruction 579 outlines, amongst other things, specific conditions that must be met before a fund can be classified as an investment entity (and, therefore, enjoy the tax benefits associated to FIPs). The fund's administrator is in charge with making this classification pursuant to the criteria laid out in Instruction 579, which, in addition to certain mandatory elements that the fund must abide by[1], are based on the number members participating in a fund, the fund's portfolio of investments, the form of contribution of assets to the fund and the level of influence exercised by the fund's members in the management of portfolio companies.

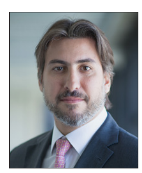
It is now finally clear what is an investment entity pursuant to the Brazilian regulations.

Only upon issue of Instruction 579 we can safely say that a FIP is quintessentially a private equity entity.

Recently the Brazilian government issued the Provisional Measure 806 which, amongst other things, state that FIPs that do not qualify as investment entities pursuant to Instruction 579 should be subject to the same tax treatment applicable to Brazilian legal entities (such as Brazilian Corporations, Limitadas etc, i.e., those that generally do not benefit from any exemptions or deferral of the income tax on capital gains). In addition, even gains not yet distributed by these entities should be subject to withholding tax at a rate of 15%.

Although this provisional measure is also challenging (including from a technical perspective), it represents a clear message by the Brazilian government that FIPs should not serve the purpose of family assets / wealth planning. The deadline for conversion of this provisional measure into law is April 8th, 2018.

About the Authors



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1. Pursuant to Article 4 of instruction 579, funds can be qualified as investment entities provided that they, cumulatively:
   I - Raise funds from one or more investors, which should be managed by a qualified portfolio manager with discretion in the representation and decision making on behalf of the fund towards the invested entities, without having to consult with the fund's shareholders;
   II – Undertake, towards investors, to invest with the purpose of getting return out of the invested capital, income or both;
   III – Substantially measure and appraise the portfolio performance based on their fair value; and
   IV – Contemplate, in their bylaws, clear exit strategies, with authority granted to the portfolio manager for implementing them within the deadlines factored into these strategies.