

# What's new! In M&A Tax



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## ***Brazilian IOF levied on investments made via FIPs, the changes on the withholding income tax (WHT) legislation, some comments to the Brazilian Sugar and Ethanol Industry and the suspension of Spanish "ETVEs" from the Brazilian privileged tax regimes' blacklist***

Just as in the 2<sup>nd</sup> Edition of "What's new in M&A Tax", we call again M&A players' attention to the significant changes of the Brazilian Tax on Financial, Exchange and Insurance Transactions (IOF) levied on foreign investments made via private equity funds (the so called "FIPs").

In addition to the changes on the IOF taxation, some other new rules were recently introduced through Provisional Measure 517, issued on December 31, 2010, such as the reduction of the WHT levied on income derived from debentures and other publicly-issued bonds (acquired as from January 1, 2011), paid to foreign beneficiaries, to a "zero rate".

In this edition we also have some comments on the Brazilian Sugar and Ethanol Industry, its peculiarities, specific regimes of taxation and labor issues. This sector is currently in the focus of the M&A Market and there are several concerns which may justify the importance of carrying out a tax and labor review before bidding for the acquisition of interest in companies of this industry.

Finally, we highlight the recent suspension of the Spanish ETVEs from the Brazilian blacklist of privileged tax regimes. As from November 30, 2010, Spanish ETVEs are suspended from the adverse effects arising from tax deductibility, thin cap and transfer pricing rules applicable to companies subject to privileged tax regimes.

By Rodrigo Bastos – Tax M&A Partner and PE Tax Leader Brazil

# Brazilian IOF reduced to 2%

As an attempt to stop the increasing appreciation of the Brazilian Real against the USD and other foreign currencies, the Brazilian Government had increased (to a 6% rate) and afterwards reduced (to a 2% rate) the IOF levied on foreign investments made via private equity funds.

Back in October 2009, the Brazilian Government increased from 0.38% to 2% the IOF levied on exchange transactions related to all foreign investments made through the Brazilian Stock Market (BOVESPA) and via foreign investments in the Brazilian capital markets in general.

For most private equity players doing business in Brazil, this IOF did represent an additional burden as it affected not only the investments in the BOVESPA, but also the foreign investments made via the Brazilian most common Brazilian private equity instrument - the Investment Participation Fund (also known as FIP). Indeed, FIP structures are viewed as investments in the Brazilian capital markets (registered and regulated by the Brazilian SEC - CVM) and, therefore, subject to such IOF.

In October 2010, due to concerns over the exchange market, the Government decided to increase (firstly in October 4, 2010) to 4% the IOF levied on exchange transactions related to investments in the Brazilian financial market and also to investments in the Brazilian capital market (including the FIP), with the exception of the investments made through the BOVESPA.



Two weeks later (on October 19, 2010), as the Brazilian Real continued to appreciate, the Government increased again, to a surprising 6% rate, the IOF levied on exchange transactions related to foreign investments made in the local financial and capital markets (including FIP) and investments made by foreign investors in the Brazilian Commodities and Future Market (BM&F) in order to maintain their minimum reserve.

This 6% taxation becomes a significant threat to the FIP's short/mid-term projected profit margins, i.e., an important increase in the already high costs of permanent investment in Brazil. For this reason, after a great deal of lobbying from PE players and investors, the Brazilian Government decided, in the end of 2010 (actually, on December 30), to reduce the IOF tax on foreign investments made through the FIPs to the old 2% rate.

Now the foreign investments made via a FIP (and through other sort of private and venture capital funds – the Emerging Companies' Investment Funds or FIEE) are subject to the IOF taxation at a 2% rate<sup>1</sup>. The IOF is triggered by the exchange transaction made in order to translate the amount to be invested in the FIP, denominated in foreign currency, into Brazilian Reais. The IOF is not charged on the exchange transaction required to the return of the FIP investments or on the payment of the income derived from it.

By Fábio Dantas – M&A Tax Senior Manager

<sup>1</sup> Foreign investments in fixed income funds and other financial instruments (not FIP, FIEE and investments made in the Brazilian Stock and Exchange Market), as well as investments made by foreign investors in the Brazilian Commodities and Future Market (BM&F) in order to maintain their minimum reserve, continue subject to the IOF at a 6% rate.

# **Brazilian WHT levied on income derived from debentures and other public bonds, paid to foreign investors, reduced to a zero rate**

Aiming to foster a long-term credit and financing market in Brazil, the Brazilian Government issued on December 31, 2010 a Provisional Measure (the Provisional Measure 517) establishing amongst other rules the reduction to a “zero rate” of the WHT levied on the income arising from publicly-issued debentures and other bonds issued by Brazilian companies and paid to foreign beneficiaries.

The “zero rate” benefit is valid only for debentures and bonds not issued by local financial banks that were acquired by foreign investors as from January 1, 2011 and is applicable only to foreign investors not based in low tax jurisdictions (tax havens) or subject to privileged tax regimes<sup>2</sup>. In addition, in order to benefit from these favorable tax terms, the publicly-issued debentures and bonds must in summary: (i) consist of long-term instruments - subject to an average four-year maturity term; (ii) cannot be repurchased by their issuer in the first two years from their issuance date; (iii) cannot be subject to any binding resale agreement agreed to the debenture holder; and (iv) any income arising from such debentures and bonds must be paid to the holder within 180 days or more<sup>3</sup>.

The Provisional Measure 517 also established, subject to certain conditions, (i) the reduction of the WHT levied on the income arising from Equity Investment Funds for Infrastructure Projects (called “FIP-IE”) paid to individuals and companies to a zero and a 15% rate, respectively and (ii) the reduction of the WHT levied on income derived

from debentures and other bonds issued by special purpose companies set up for the development of infrastructure projects (considered as priority by the Brazilian Government), paid to individuals and companies, also to a zero and a 15% rate, respectively.

There are also other rules in the Provisional Measure 517/2010 which, as mentioned above, intend to help the formation and development of a long-term credit and financing market in Brazil. According to the Government, the BNDES (the National Bank for Economic and Social Development) currently is the only long-term financier in Brazil. The Government estimates that with the incentives established by the Provisional Measure 517, R\$ 350 billion would be raised from the private sector.

Some of the tax rules above still need to be detailed by the Brazilian IRS and are still under discussion. Despite this, the important point to be noted is that the reduction of the IOF levied on investments made via FIPs, together with the reduction of the Brazilian WHT, indicates that the Government wants to encourage long-term and major foreign investment in Brazil, and perhaps submit them to a lower taxation. Good news at last!

By Fábio Dantas – M&A Tax Senior Manager



<sup>2</sup> According to the “blacklist” recently issued by the Brazilian IRS through the Normative Instruction 1,037, from July 4, 2010.

<sup>3</sup> In addition, it must be documented, under a simplified procedure to be established by the Brazilian Government, that the funds obtained through the debentures and bonds shall be used to finance local enterprise projects.

# Brazilian Sugar and Ethanol Industry at a glance

Sugar and ethanol industry has been in the focus of the Brazilian M&A Market for a while. Both domestic and foreign companies have been frequently looking at companies in this industry during such a consolidation process.

The sector's taxation is quite peculiar in Brazil. There are several specific tax regimes applied mainly to VAT and taxes on revenues, such as tax suspensions, deferrals, presumed tax credits and special regimes, among others.

Besides the fact that the market is quite active, the due diligences performed during the last couple of years demonstrated that this economic sector, not that different from many others in Brazil, raises several concerns which enhance the importance of carrying out a review before making a binding offer or even before closing a transaction.

First of all, there are many family owned sugar and ethanol enterprises in Brazil. Some of them do not possess the corporate governance level required by world class companies. This means that despite the fact that those industries are in a very favorable environment with quite profitable forecasts, many companies still have significant downsides when it comes to tax, labor and social security compliance and indebtedness.

In addition to the abovementioned, whenever looking at a sugar/ethanol company in Brazil, there are some aspects which must be analyzed carefully, such as:

- losses arising from derivative financial instruments considered as deductible for corporate taxes (IRPJ and CSL) purposes;
- disallowance of ICMS, IPI, PIS and COFINS tax credits recorded on intermediary materials, spare parts and consumption materials, among others;
- expenses considered as deductible for corporate taxes purposes in connection with the adoption of the accelerated depreciation for non-agricultural enterprises;
- material amounts involved in tax litigation (including contingent tax assets);
- PIS and COFINS taxation based on the special regime as from 2008 (fixed price per volume); and
- compliance and validity of tax incentives granted to sugar / ethanol enterprises, among others.

Regarding the labor area, besides the potential hard work conditions for employees, there are some peculiarities in the sector which should be also observed. While the general rule states that social charges should be based on the payroll costs, the sugar/ethanol industry calculates and pays its charges based on the gross revenues, as these companies are considered agricultural industry. According to Brazilian legislation, companies which have both agricultural and industrial activities are considered as agricultural entities for social security purposes and, therefore, must calculate its social charges based on its gross revenues. In order to avoid the taxation based on the gross revenues some groups create two different entities, one industrial and another with a focus on agricultural/harvesting activity. This procedure may be questioned by the social security authorities if they understand that, in reality these entities are both part of the some agricultural industry and this structure reflects only a tax planning adopted to save social charges, but without proper business reasons.

Another important aspect which can trigger tax and labor risks to the buyer are the agricultural contracts. There are currently three types of contracts usually adopted by the sugar/ethanol companies and rural producers: the rural partnership; the rural lease and the sugarcane supply agreement. The Land Statute, however, was amended in 2007 by the Law 11,443 bringing new guidelines to the relationships between the parties referred above. As the industry is still adapting to these new guidelines, many rural agreements do not reflect current legislation triggering tax and labor risks for the companies, such as the characterization of these agreements as an operating lease agreement subject to the WHT taxation.

Such a complex tax, social security and labor environment combined with a historical weakness in internal controls and an inadequate corporate governance level requires a great deal of attention in transactions involving agribusiness in order to assure that the sugar/ethanol companies are prepared for the new requirements of the current economical, accounting and tax environment in Brazil.

By **Fernanda Cavalcante**, M&A Tax Manager; **Marcos Tabatschnic**, M&A Tax Senior Manager and **Rachel Barreira**, M&A Tax Senior Manager

# Spanish “ETVEs” suspended from Brazilian privileged tax regimes’ blacklist

Following the same procedure adopted for Switzerland and the Netherlands, the Brazilian IRS, via the Executive Declaratory Act 22, issued on November 30, 2010, has suspended from the Brazilian privileged tax regimes’ blacklist<sup>4</sup> the Spanish companies incorporated as “Entidades de Valores Extranjeros” or “ETVEs”.

As from that date (November 30, 2010), the effects arising from tax deductibility, thin cap and transfer pricing rules applicable to companies subject to privileged tax regimes are suspended in relation to the Spanish ETVEs.

Like the Dutch and Swiss companies, investments from Spain are abundant in Brazil and there are many Spanish multinational corporations here installed. The blacklist would adversely affect many companies, transactions and businesses already engaged in Brazil. The inclusion of Switzerland, Dutch HoldCos and Spanish ETVEs in the tax havens and privileged tax regimes’ blacklist had been not very well accepted by the market. For this reason, the local tax authorities decided to suspend the effects of the blacklist in those cases, aiming to consider all the relevant aspects involved.

By Fábio Dantas – M&A Tax Senior Manager



<sup>4</sup> The Blacklist was established by the Normative Instruction 1,037, issued on July 4, 2010.

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