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Exemptions for real estate investment funds targeted by the Brazilian Federal Revenue Service

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According to Law 8668/1993 and regulations issued by the Brazilian Securities Commission, or *CVM* (*Comissão de Valores Mobiliários*), Real Estate Investment Funds, or *FIIs* (*Fundos de Investimento Imobiliário*), are pools of money raised by a public offering of fund units, aimed at investing in real estate developments.

FIIs were created in the context of efforts to promote investment in the real estate sector. As a rule, income earned and gains associated with real estate investments realized by FIIs are not subject to taxation, as long as the fund does not invest "in real estate enterprises in which a unitholder holding more than 25% of the fund's units is a developer, construction company, partner or shareholder". If the FII does invest in such enterprises, it will be subject to corporate incomes taxes, according to article 2 of Law 9779/1999.

The Explanatory Notes to the bill that became Law 9779/1999 explain that this provision was intended to *"avoid predatory competition by FIIs with legal entities that conduct the same business activities"*. The legislator's intention, therefore, was to prevent real estate developers and construction companies from conducting their business through FIIs, which enjoy more favorable taxation than legal entities.

Article 2 also refers to "partners or shareholders" (*sócio*) in a real estate enterprise, and the tax authorities have taken a broad view in applying the provision. In one case, for example, an FII unitholder holding more than 25% was also a "partner" of a company, which, after transferring properties to the FII, became the lessee of the transferred properties. According to the tax authorities, the concept of "partner" encompasses any party that has an economic interest in the enterprise and is present at "both sides" of the structure: in this case, an FII unitholder was also the controlling shareholder of the company that leased properties owned by the FII. The RFB's interpretation was confirmed at the administrative level by the Administrative Tax Appeals Council (*CARF*), but has not yet been analyzed by the courts at the judicial level.

There are a number of points in the legislation that are unclear, such as when and how frequently the FII's administration is required to assess the unitholders to determine if any of them hold 25% or more of the fund while at the same time being a developer, construction company, partner or shareholder in any of the fund's invested enterprises, which would expose the fund to taxation as a legal entity.

Nor is it clear whether, if such a situation were to arise, the fund would always be treated as a legal entity for tax purposes, or whether it could "adjust" its unitholder base or portfolio to meet the requirements for the tax exemption.

Unitholders who are individuals enjoy an exemption from income tax on earnings distributed by FIIs, if (i) the units are negotiated exclusively on the stock exchange or organized over-the-counter market, (ii) the FII has at least 50 unitholders, and (iii) the unitholder holds less than 10% of the units or units that represent the right to earnings equal to or less than 10% of the FII's total earnings.

Even though it has not taken a formal position on the question, there has been noticeable action by the RFB, in connection with FIIs with few unitholders and little or no trading in their units, looking into the composition of the funds' unitholders and the dispersion of units, despite the fact that the law does not require that FII unitholders be "independent" (or not related parties) or that FIIs meet any liquidity threshold in order to enjoy the income tax exemption. This matter has significant implications for the FII market, especially because liability for income tax on distributions to unitholders that was not withheld can fall on the shoulders of the FIIs and their administration.

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