



## Ten Top Considerations Regarding Capital Investment in Brazil

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## Ten Top Considerations Regarding Capital Investment in Brazil

Brazil is among the 10 largest economies in the world, and it represents one of the largest domestic markets in the world. As a long-standing democracy with institutional stability, Brazil is a natural destination for foreign investment. This brief guide aims at showing the main considerations one should have when planning to invest in Brazil.

### **1. Foreign Direct Investment vs. Portfolio Investment**

The first decision one should make is whether to invest in Brazil through foreign direct investment (“FDI”) or a portfolio investment. The three main differences between FDI and portfolio investment is that the portfolio investment (a) requires a local financial institution to serve as custodian of the portfolio investment; (b) the asset classes are those offered to investors in general (equity or debt securities issued by listed companies, government bonds, investment funds, and depositary receipts); and (c) the capital gain on the sale of equity securities held by non-resident investors is not taxable in Brazil (Paragraph 1 of section 81 of Law nr. 8,981/95). The yield of government bonds and the capital gain on the redemption of shares/quotas issued by private equity funds are subject to a 0% income tax rate (Sections 1 and 2, respectively, of Law nr. 11,312/06).

### **2. Foreign Direct Investment – Equity, Debt or a Combination of Equity and Debt**

Should the investor choose a foreign direct investment, which is an investment in a closely-held company, the investor must decide among three options: (a) equity; (b) debt; or (c) a combination of equity and debt. In a scenario where only debt is involved, the international investor will not have any influence on the administration of the borrower. Therefore, international investors usually opt for either equity only or a combination of debt and equity. Debt may be either interest-free or interest bearing.

The Central Bank of Brazil accepts international market interest rates in loans between related companies. However, one must consider that (i) if the interest rate is too high and the local borrower is under the “actual profit tax regime”, the deductibility of this financial expense will be limited (Section 22 of Law nr. 9,430/96) and (ii) the deductibility will also be impacted depending on whether the borrower is established in a low tax jurisdiction or entitled to a privileged tax regime.

Furthermore, the recipient of the international loans can be subject to a tax on financial transactions called “IOF” of 6% if the average term of the loan does not reach 180 days (Decree nr. 6,306/07, section 15-B, XI and XII).

### **3. Appointment of an Attorney-in-Fact in Brazil**

Regardless of the type of investment to be made in Brazil, an international investor must secure a federal taxpayer registration number and registration before the Central Bank of Brazil (respectively “CNPJ” and “CDNR”).

To seek this federal taxpayer registration, the investor must appoint an attorney-in-fact in Brazil with powers to manage the grantor’s assets and rights in Brazil. In the case of foreign direct investment (“FDI”) in equity of either a listed or closely-held company, a shareholder must also appoint an attorney-in-fact to receive service of process on his or her behalf (Section 119 of Law nr. 6,404/76 - Brazil’s law of corporations, which is a federal statute).

As a matter of practice, additional powers are added to this power-of-attorney such as the representation in shareholders’ meetings, transfer of shares, amendments to the articles of association (of limited liability companies) and the like.

Likewise, international owners of intellectual property registered in Brazil must also appoint an attorney-in-fact to receive service of process on their behalf (Section 217 of Law 9,279/96 - Brazil’s intellectual property statute).

### **4. Choosing a corporate form – Limited Company vs. Corporation**

In the event of foreign direct investment (“FDI”), the investor must choose the type of vehicle or corporate form to incorporate the local business. Although Brazilian law provides for several types of corporate forms, the two most popular forms are: (a) limited company and (b) corporation.

Most investors prefer the limited company. In a limited company, there is no statutory reserve. In a corporation, 5% of the net profits must be allocated to this reserve up to the limit of 20% of the capital stock. Therefore, this reserve reduces the local entity’s distribution capacity.

Additionally, limited companies do not need to have their financial statements published. With respect to the US, Brazilian limited companies allow for a “check the box” tax treatment in the United States, which tends to be more favorable (partnership treatment) than treating it as a controlled foreign corporation.

Another interesting aspect about the limited companies is that they allow for the disproportionate distribution of dividends, whereas in a corporation all shares of the same class must receive the same dividend. Brazilian corporations can have two types of shares: common

and preferred; each type can have more than one class. Despite the flexibility afforded by the limited company, in certain circumstances a corporation may prove to be more advantageous such as when the equity contributions must be made with a premium.

#### **5. Having a Holding Company coupled with an Operating Company or just an Operating Company?**

While dealing with setting up a corporate structure for FDI in Brazil, many investors decide on whether to have one or two entities (a Brazilian holding company coupled with an operating company). This decision will largely depend on whether the law in the investor's domicile country allows for "equity pick-up", which is a way of deferring tax liability on the investee's equity book/adjusted basis appreciation.

If the investor's domicile country does not allow for "equity pick-up," it is possible to achieve this in Brazil by setting up a holding company in Brazil to either buy an already existing business/entity in Brazil or start a business from scratch in Brazil through a newly incorporated entity. In addition to the "equity-pick" benefit, some investors decide to incorporate a holding company in addition to an operating company in Brazil to create a second layer of protection.

Therefore, the Brazilian holding company is an attempt to partially protect the headquarters or subsidiaries located outside Brazil from the potential reach of Brazilian law. However, in some areas of Brazilian law (labor law, antitrust law, consumer law, and environmental law), all companies belonging to the same economic group or conglomerate may be deemed joint and severally liable. Furthermore, a court award may pierce the corporate veil of the entities.

#### **6. Regardless of the Type of Cross-Border Investment, it shall always be registered with the Central Bank of Brazil ("BACEN").**

Brazil is a country where there are exchange controls in place. This basically means that nearly all wire transfers in hard currency to Brazil must be converted into local currency ("reais"). Likewise, companies and individuals that have liabilities payable in hard currency must enter into an exchange agreement with a Brazilian bank to make a wire transfer of funds abroad.

All types of foreign investment (Portfolio, Equity, and Debt) must be registered electronically in the Central Bank's data system called "Sisbacen." This allows the Central Bank to monitor the inflow and outflow of hard currency, as well the foreign investment stock.

The foreign investment made by Brazilian companies and individuals abroad is also monitored by the Central Bank of Brazil. As few entities have access to the "Sisbacen" data system, law firms and other professionals work in partnership with exchange houses and other professionals to secure these registrations in the "RDE" sub-system. "RDE stands for "Electronic Declaratory Registration."

The three basic electronic forms are: RDE-Portfolio, RDE-IED (“foreign direct investment-equity”), and RDE-ROF (“financial transaction registration”). These documents are extremely important because without them, one cannot enter into an exchange transaction involving the payment of interest on a loan, the repayment of principal, the payment of dividends or interest on equity, and the sale of the investment or equity interest in Brazil. These registrations must be updated constantly. Therefore, keeping them current must be a goal for every international investor in Brazil.

## **7. Choosing the most Favorable Income Tax/Social Contribution on Net Profits (“CSLL”) Regime - Actual Profit vs. Deemed Profit**

The Brazilian taxation system is one of the most complex and burdensome in the world. The overall tax burden in Brazil is around 36% of Brazil’s Gross Domestic Product. Besides the income tax and the social contribution on net profits, which is like an income surtax, Brazil has a whole array of taxes at the federal, state, and local levels (the import tax, the excise tax, the value-added tax, the services tax, PIS-Cofins (which is assessed on gross revenues) and other “social contributions”).

Therefore, one extremely important piece of advice to any investor is to always understand the tax impact of any activity or investment made in Brazil. An inefficient tax analysis of a company’s business may simply ruin it. With respect to Brazilian/local entities, the marginal tax rate is 34% (income tax – 15%, income surtax – 10% plus the social contribution on net profits (“CSLL”) – 9%).

However, there are two major ways for assessing a Brazilian company’s taxable income: (a) the actual profit system and (b) the deemed profit system. This option exists for companies with gross revenues of up to 78 million reais (US \$14.5 million) per annum. Companies with annual gross revenues above 14.5 million dollars are obliged to be taxed under the actual profit tax regime.

It is important that an investor has a clear amount of the ordinary and necessary business expenses of his or her business. This will be the factor that will drive the decision on which of the two taxation regimes to select. If the business has substantial ordinary and necessary expenses, it will probably be wiser to choose the actual profit system.

Conversely, if it is a service business, and the ordinary and necessary expenses are not so high, the deemed profit system would make more sense. In the actual profit system, the credit/subtraction of eligible ordinary and necessary expenses is allowed. In the deemed profit taxation regime, a “profit margin” is pre-established by law according to the type of business/activity (v.g., 32% for services).

As a result, the same tax rates are applied to the “deemed profit margin” and no business expenses are eligible for purposes of reducing the tax burden. The deemed profit regime applies only to the operational earnings. If a company (taxed under the deemed profit regime) has a non-

operational item of income (*v.g.*, the sale of a fixed asset or investment), this specific transaction will be taxed according to the actual profit regime.

## **8. Be Fully Aware of the Labor-Related Impacts of your Business**

Although not strictly related to “Capital Investment,” it is of utmost importance that an international investor be advised of the labor laws in Brazil. Although labor laws have become more flexible over the past 6 years in Brazil, the core of Brazilian labor legislation, which dates from 1933, is still very pervasive.

Federal law provides for a minimum protection of employees, and the relevant collective bargaining agreements usually expand those rights. Even if an employee is not unionized, he or she is still entitled to the protection afforded by the relevant collective bargaining agreement.

Brazil has a special court system to adjudicate work-related disputes (the Labor Court System), which is federal. As a rule, and depending on the specific activity, an employee will cost his or her employer approximately 90% of his or her basis salary. This means that for a basis salary of R\$ 5,000.00 (five thousand reais), an employer will have to pay an additional amount of R\$ 4,500.00 (four thousand and five hundred reais) in mandatory payments to the Brazilian government. Therefore, planning the Brazilian entity’s labor and compensation structure is key to be successful in business in Brazil.

## **9. Protect your Company’s Intellectual Property**

In a knowledge and ever-growing intangible economy, the protection of intellectual property is paramount. Brazil is a party to many important intellectual property conventions (the Paris Convention, the Patent Cooperation Treaty, TRIP’s, etc.). However, as in many other parts of the world, infringements to one’s intellectual property (be it marks, patents or copyrights) abound. Therefore, before making any foreign direct investment in Brazil, make sure you own or have licensed rights to use the relevant intellectual property in Brazil. If you expect to receive royalties from your Brazilian subsidiaries, the respective license agreement must be registered with the Patent and Trademark Office (“PTO”) of Brazil (called INPI). Although software is protected under copyright law in Brazil, their source-code must be registered with the PTO of Brazil to allow the respective writer protection and ability to pay royalties abroad.

## **10. Divesting from Brazil**

Winding-up a company in Brazil is a lengthy and burdensome process because it usually attracts federal, state, and municipal tax audits. As a strategy, some investors keep their Brazilian companies dormant for a period of six years, which is a safe period of time for most tax-related

statute of limitations to run out, before they officially dissolve their Brazilian entity. An alternative solution is to sell the Brazilian entity. The good news here is that an entity domiciled outside Brazil is treated as an individual (domiciled in Brazil) for tax purposes. Therefore, the taxation will be on the actual capital gain accrued, rather than on the gross revenues originated from the sales price (Section 18 of Law nr. 9,249/95). The capital gains tax for a foreign company in Brazil will range between 15% and 22.5% (section 21 of Law nr. 8,981/95, as amended by Law nr. 13,259/16) rather than the 34% rate applicable to Brazilian corporate taxpayers.

## **CONCLUSION**

Overall, Brazil's business environment is quite friendly to international investors. One major example is that dividends distributed by Brazilian companies are not taxable in Brazil (Section 10 of Law nr. 9,249/95). However, as Brazil has federal, state, and local/municipal bodies of law, an international investor must be well advised on all aspects that may affect his or her investment.

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