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NEWS

COMING ROUND TO IFCs

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International finance centres provide an ideal route for deploying capital. It's time Brazil came round to their advantages, argues Rolf Lindsay, partner at Walkers in the Cayman Islands

The global fascination with all things Brazilian looks firmly set to be one of the definitive trends of this generation. With an economy not mired in the Western malaise, and with the prospect of forthcoming events tailor-made to showcase the country's vibrant energy, the optimism from São Paulo to Rio de Janeiro is palpable. That optimism is mirrored in international financial centres (IFCs) like the Cayman Islands, the British Virgin Islands, Jersey and Ireland given the renewed sense of the benefits that the efficient raising and deployment of global capital have for economic prosperity. One of the challenges that we face is in devising an effective mechanism for that capital to be deployed where it will be most valuable.

There is growing sentiment that Brazil has now leapfrogged China as the most attractive destination for deal making in the emerging markets. A recent survey by Coller Capital, who are investors in private equity's secondary market, and the Emerging Markets Private Equity Association, confirmed a significant increase anticipated for investment into Brazil over the next 12 months. The development of projects ahead of the football World Cup in 2014 and the 2016 Olympic Games in Rio, coupled with the more prosaic needs of an upwardly-mobile populace, mean that Brazil will need to spend what observers estimate to be an additional 3 per cent of its GDP on infrastructure. Because the development of infrastructure is a strategy regarded for steady, rather than spectacular, returns it is absolutely critical that any inefficiencies to the investment process are to be eliminated if margins are not to be eroded.

There is no better time than now to examine the mechanism for foreign investment into Brazil, the costs of doing business and how the IFCs such as Cayman, Jersey and the BVI can assist.

It is a well-established consensus of opinion, and reinforced by a rich body of academic research, that the free and efficient movement of capital through IFCs has advanced global prosperity significantly over the past 30 years. The presence of IFCs in the global economy has also been central to economic liberalisation and the reduction of poverty in the developing world, encouraging the first embers of growth in emerging markets and fanning the flames when it has ignited. A recent study by Professor Jason Sharman of Griffith University in Brisbane, Australia, found that IFCs help domestic and foreign investors in developing countries access the kind of efficient institutions that are necessary to drive growth but which are often unavailable locally. IFC platforms provide a readily available mechanism for capital from developing nations to access the stability of investments in developed nations and for investors in larger countries to take advantage of opportunities in the emerging markets.

Writing for the BBC, economics editor Stephanie Flanders raises concerns that have emerged from recent studies into the effectiveness with which Brazil invests the capital at its disposal. Comparing growth over 30 years in Brazil (3 per cent) with that in China (10 per cent), Flanders notes that only 4 per cent of the gap is attributable to quantity of the capital invested. The remainder is because China makes more efficient use of the capital and labour at its disposal. Put another way, the more efficient deployment of its existing resources over the last three decades could have doubled the rate of growth in Brazil.

It is fair to say that one of the reasons Brazil is so attractive now is that those internal inefficiencies are being consigned to the past. But one critical area where Brazil remains behind the curve is in relation to its openness to foreign investment structures. Brazil's current honeymoon period will come under pressure for a sustainable long-term commitment from investors wary that the benefits of economic growth may be offset by the cost of doing business – inefficiencies in deploying capital and realising returns. And competition for global capital will only increase as margins inevitably return to recovering Western economies.

An outdated view

The typical route for foreign investment into Brazil involves the use of Fundo de Investimentos em Participações – commonly called FIP structures – which are essentially private equity funds designed to provide significant regulatory and fiscal incentives for foreign investors. The FIP structure is predominantly utilised for private equity investments including: acquisition finance, management buyouts, turnaround investments, bridge financing, mezzanine investments and private investment in public equity (PIPE). The FIP structure provides an exemption on income tax for foreign holders of the shares – up to 40 per cent of the issued shares of the fund – which works well for investments structured in certain jurisdictions such as The Netherlands, Spain, most US states and the UK. However, there are two notable restrictions on their use. First, the income tax exemption is not applied to investors using vehicles formed in "tax havens" or "paraiso fiscal". Foreign investments structured through these jurisdictions are instead treated as Brazilian investors and required to pay the same 15 per cent tax to which domestic investors are subject. Second, foreign FIP investors do not receive the income tax exemption where investment funds hold more than 5 per cent of securities in the form of debt.

The comparison with China is striking. Having undergone the most successful poverty reduction programme in history, China is acutely aware of the benefits of foreign investment flows both inward and outbound. As Professor Sharman notes, the primary conduit for that investment has been IFCs. The two countries that have consistently been the greatest sources of foreign investment to China are Hong Kong and the BVI, which both appear on Brazil's outdated list of tax havens. Professor Sharman notes that the cost-effective and efficient capital deployment afforded by the IFCs was a major contributing factor to growth and the reduction of poverty.

With the growing complexity of cross border M&A and private equity investment, the ideal solution for structuring such transactions is to make use of a jurisdiction that offers tax neutrality and a flexible legal framework. Increasingly, there is an imperative to structure and effectively manage portfolio companies with numerous investors and multiple layers of debt and equity, and the common law-based IFCs offer almost infinite commercial flexibility, stability and certainty of outcome. Documents can be adapted to create bespoke corporate governance structures, which will give effect to agreements reached between joint venture partners. At the same time, lenders are afforded a level of protection with which they are extremely familiar and comfortable. International investors have been using offshore structures for many years in order to achieve these goals. Offshore investment funds also allow the efficient pooling of capital from multiple jurisdictions around the world. These funds are still subject to taxation and investors still pay tax when they receive the funds in their home countries; however, the tax neutral IFC platform ensures that the fund vehicle does not face an additional third level of tax in the jurisdiction where the funds happen to be aggregated.

The focus of the Brazilian investment rules on the tax regime of the investment entity's domicile is out of step with thinking in the US and Europe. The regulations appear to be based on the prevention of expatriation of funds by Brazilians, rather than attracting investment into Brazil. In the west, the debate over tax avoidance in relation to IFCs and the rhetoric at the onset of the global financial crisis has been replaced by a more meaningful focus on transparency, information exchange, anti-money laundering and the management of systemic risk. This shift

has been in some part due to the efforts of the IFC Forum, which was formed by a number of private organisations in the leading IFCs that came together in late 2009. The mission was to ensure that global policy makers fully appreciate the vital role that small IFCs play in global economic development and providing liquidity and efficiencies to international capital markets. The IFC Forum's website (www.ifcforum.org) acts as a central resource for balanced and authoritative information about IFCs and their place in the global economy, as well as to commission research and address some common misconceptions. The group has also had meetings with representatives of G20 governments, as well as with ambassadors and economic advisors from a number of these states.

The IFC Forum roundly condemns tax evasion as a crime, while noting that numerous independent studies – such as the UK Treasury commissioned independent review of British offshore financial centres – routinely confirm that the true levels of tax avoidance and evasion in most offshore centres bears no resemblance to what has typically been asserted in popular fiction. Geographically smaller IFCs such as the Cayman Islands, the BVI and Jersey, typically have high governance ratings and rank very highly in the Financial Action Task Force (FATF) anti-money laundering and anti-terrorist financing evaluations. These IFCs also appear on the OECD's "White List" of countries that have substantially applied the OECD's internationally agreed standards on information exchange, with new Tax Information Exchange Agreements (TIEA) continually being signed. At the time of writing, the Cayman Islands, the BVI and Jersey have signed a combined total of 54 such TIEAs.

Some of the more recent developments in Brazil are a good start and extremely positive. In March 2009, the CVM, Brazil's securities regulator, signed a Memorandum of Understanding (MoU) with the Cayman Islands Monetary Authority to go alongside the MoU that has been in place with the Brazilian Central Bank since 2006. More recently, an initiative was launched by the Alternative Investment Management Association (AIMA), the global alternative investment fund association, to engage with the Brazilian funds industry. The new AIMA representative for Brazil has said that with the understandable interest in Brazil, AIMA intends to facilitate dialogue between the Brazilian industry and the international hedge fund community. At the start of 2011, meanwhile, the Brazilian government cut the tax on foreign investments in private equity funds in order to attract more long-term financing into the country. The tax on foreign exchange transactions by international investors into FIPs and venture capital funds was cut from 6 per cent to 2 per cent, reversing the increases that were put in place the previous year that had been aimed at halting the strong appreciation of the local currency. There are also discussions currently taking place between the government of the Cayman Islands and Brazil regarding a Tax Information Exchange Agreement between the two countries. These positive developments are to be encouraged and will go some way toward removing the roadblocks to international investment in Brazil.

The Brazilian economy is notorious for false dawns and there are several challenges that will need to be overcome to ensure that this is not another. Many of the necessary fundamentals are already in place, and the Brazilian authorities should be encouraged to exploit their enviable position by focusing their legislative efforts on devising rules that encourage the efficient and cost-effective investment into and from Brazil.

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