

THE BENEFITS OF OFFSHORE FUND STRUCTURES IN PARTICULAR SMART FUNDS IN THE BAHAMAS AS A SOPHISTICATED, LOW COST AND FLEXIBLE WEALTH PLANNING TOOL FOR BRAZILIAN WEALTHY FAMILIES

INTRODUCTION

Currently many Brazilian wealthy families are facing similar issues when it comes to the way in which they hold their collective assets. Generally, family assets are held through various financial institutions around the globe, many family members reside in countries other than Brazil and only a few of them are actively involved in the asset-investment decisions. The lack of alignment of individual and collective needs fosters opportunity for tension. Further the interplay between the location of the assets and family member's triggers in many cases different local foreign exchange controls parallel to increasing reporting and payment of taxes at the individual level.

This article explores the benefits of offshore fund structures in particular SMART Funds in the Bahamas as a sophisticated, low cost and and flexible wealth planning tool for Brazilian wealthy families.

A BRIEF BACKGROUND ON THE BRAZILIAN TAX SYSTEM AND FOREIGN EXCHANGE SYSTEM RELATED TO FUNDS HELD ABROAD

The two bodies that control the currency and the tax systems in Brazil are the National Monetary Council and the Ministry of Treasury, respectively.

The current Brazilian taxation system introduced by the Federal Constitution implemented in 1988 granted power to Federal, State and Municipal Governments to collect taxes. Each of these governmental instances enact several rules, which makes the Brazilian taxation system very complex, leading to an environment in which taxpayers are required to constantly follow up on updates to ensure that they are compliant. For purposes of the issues discussed here, references to the Federal Tax System shall be to the system that imposes capital gain taxes on the analysis on offshore funds discussed ahead. The Ministry of Finance, represented by the Internal Revenue Department ("SRF") imposes and control such taxes on its taxpayers.

For individuals, the SRF imposes a progressive taxation system under which individuals are taxed up to a maximum of 27.5% of their income. Capital gains are generally subject to tax at 15%. The sale of assets held abroad will then be subject to a 15% capital gain tax, which is due upon the sale, in accordance with SRF Normative 118/00 of December 28th, 2000.

The National Monetary Council sets Brazil's policy regarding exchange controls through the issuance of Resolutions, and the Central Bank of Brazil is responsible for implementing them through the issuance of Circulars and Letter-Circulars. Under those rules, Brazilians nationals and residents may remit funds abroad, through financial institutions authorized by the Central Bank.

On April 10, 1996, the Central Bank issued Circular 2,677/96, which amended and consolidated the rules in connection to accounts in Brazilian currency held by individuals and/or legal entities resident, domiciled or based abroad ("non-resident accounts") as well as determined the proceedings for the international transfers in Reais ("TIR") made through such accounts. In 2004, Circular 2,677/96 was revoked.

In a recent article about the particularities Brazilian wealthy families face when dealing with offshore planning¹, emphasis was given to how Brazil has demonstrated over the past 20 years some interesting developments with respect to internal rules in connection to foreign currency controls. Among other changes, these rulings have provided for the unification of the Brazilian exchange market, which is now no longer divided into different segments. This exchange market is under control of the Brazilian Central Bank and is ruled by the International Capital and Foreign Exchange Market Regulation ("*RMCCI*"). In any event, both the Brazilian Government and Brazilian corporations need hard currency to pay for their foreign currency liabilities. Therefore, such exchange controls have been the pillar of Brazil's macroeconomics policy.

Early in 2008, the Brazilian Securities Commission ("*CVM*") introduced important rules to remove restrictions subject to certain conditions on Brazilian funds from investing their capital overseas. Notwithstanding the simplification of the rules, very few Brazilian fund managers took advantage of the regulatory changes, likely given the financial instability of international markets and Brazil's focus on domestic investments which benefited from high fixed rate returns.

¹ The Trust concept from a Brazilian legal perspective, by William Heuseler, *Wealth Management & Private Banking Review*, 2011/12, *Euromoney Yearbook*

Over time, however, certain wealthy families had and continue to have a preference for the offshore route using personalized offshore funds structures, such as the Specific Mandate Alternative Regulatory Test Fund in the Bahamas, also known as SMART Fund. In the Bahamas, funds can be set up with great efficiency, flexibility and at a low cost. Individuals investing outside of Brazil can also take advantage of the Bahamas' neutral status, which allows for international transactions with no restrictions on the ability to transfer funds in and out of a SMART fund.

SPECIFIC MANDATE ALTERNATIVE REGULATORY TEST FUND - SMART FUNDS AND BRAZILIANS

In a recent conference in São Paulo, Brazil², one of the main topics was how important the offshore fund industry has grown in the past decade, thanks, especially, from the high demand from Brazilian investors. There is no doubt that the most common offshore jurisdictions for the establishment of such funds are the Cayman Islands, the British Virgin Islands and the Bahamas. Altogether, there are over 15,000 funds established in these jurisdictions. There are also a significant number of unregulated and closed ended funds in each of these jurisdictions which are not generally included in the statistics.

From a legal perspective, there are several similarities among these jurisdictions, but each also has certain distinguishing features. The Bahamian legal system, for example, is based on English common law, which, since 1964, has been complemented by an "Americanized" constitutionalism which declares the existence of certain fundamental principles that are to be observed and enforced. These rights are enshrined in Article 15 of the Bahamas Constitution. Finally, similar to the Cayman Islands and the British Virgin Islands, the Bahamas has the Privy Council in London, England at the top of the court hierarchy for its judicial system. The Judicial Committee of the Privy Council serves as the ultimate Court of Appeal in all matters where appeal is permissible.

Brazilian wealthy families investing in SMART funds have access to local support and expertise from qualified lawyers and service providers in the Bahamas, including custodians and fund administrators. Investors and regulators such as the CVM also will take comfort from anti-money laundering laws and regulations in the Bahamas, which impose owner verification requirements to record the identity of investors and sources of investment commitments.

Back to the similarities between these jurisdictions, each one has a upright and reliable legal regulatory system, each has a stable and business friendly government, each is tax-neutral for international fund

² Summit Brazil – Developments in the Alternative Fund Industry (May 3rd, 2011)

vehicles and without exchange controls in relation to international fund vehicles and each has a well developed regulatory system that is compliant with international standards. In addition, the regulatory approach in each jurisdiction in relation to funds is based primarily on the principle of full disclosure of material terms to sophisticated investors rather than on a prescriptive approach. This gives operators significant flexibility when structuring their funds. However, the SMART Fund program, as mentioned by the Bahamas Financial Services Board, “was designed to provide [the] industry with a new Private Wealth Management tool with the flexibility to find application within areas not traditionally associated with investment fund administration. The primary facility offered by the SMART Fund concept is an open architecture which allows practitioners to design innovative structures, akin at times to special purpose vehicles, without reference to inflexible regulatory criteria predefined in legislation”³.

There is no doubt that all offshore jurisdictions offer flexibility in the structure of investment funds, which may be established as companies, partnerships or unit trusts depending on the client's requirements. The beauty of the SMART Funds concept, however, is that they are more often driven by clients’ needs vis-à-vis their principles and statutes. The Bahamian legislator, for example, understood that many times, without creating a “disregarded” structure for purposes of substance of form, could still come up with a solution that would not have a mandatory requirement for a traditional lengthy offering memorandum, but merely a term sheet; and where a license may be issued by the Fund Administrator under a delegate authority of the Securities Commission of the Bahamas, to name a few of simplified but safe procedures.

CONCLUSION

Notwithstanding the enormous increase in the assets managed by Brazilian domiciled hedge funds in the last several years, the Brazilian hedge funds industry faces several obstacles to greater development, especially when compared to some offshore jurisdictions. The main ones, in our view, can be summarized as follows:

The existence of strict portfolio investment rules applicable to hedge funds in Brazil.

The complexity of the local control systems especially when compared to jurisdictions such as the Bahamas, which via the SMART Fund solution can have a more simpler solution and also guarantee the

³ The Investment Funds Act 2003

deferral of capital gain taxes and even more, do not impose tax on foreign investors investing in funds domiciled in the Bahamas.

Even though the changes on the Brazilian local funds to invest abroad and the facts above mentioned, the strong appetite of Brazilian wealthy investors for sophisticated wealth planning tools, combined with the flexibility and strong regulatory framework provided in the Bahamas make the SMART Funds an ideal vehicle choice in terms of wealth, estate and tax planning solution.