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Marcos Valadao

Nara Galeb Porto

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BRAZILIAN UPDATE: SECURITIZATION IN BRAZIL, TAX REFORM, AND INTERNATIONAL TRADE ISSUES

Marcos Valadão* and Nara Galeb Porto**

I. SECURITIZATION IN BRAZIL

DESPITE the sub-prime mortgage crisis in the United States and the unfortunate misconception that the process currently brings, securitization can offer important benefits to Latin America. For instance, it can develop financial markets, mitigate sovereign risk, improve the resilience of markets in periods of stress, and provide a source of funding for the housing finance system.¹ The Brazilian securitization market has expanded considerably throughout the years.² Together with Mexico, they are the two largest markets for structured securities in Latin America.

The enactment of the National Monetary Council Resolution No. 2907 of November 29, 2001, that created the *Fundo de Investimento em Direitos Creditório* (FIDC) (receivable investment fund) has caused the growth of the structure finance market in Brazil. FIDC is a financial vehicle that works under the financial structure and administrative shell of a fund, in both open and closed-end types, but it is also a bankruptcy-remote entity that demonstrates characteristics of both structured finance

* Marcos Aurélio Pereira Valadão, Professor of Law (Universidade Católica de Brasília School of Law, Brazil); S.J.D. (SMU), L.L.M. (UnB, Brazil), L.L.M. International and Comparative Law (SMU), L.L.B. (UCG, Brazil), M.B.A. (IBMEC, Brazil), B.S. (UnB, Brazil). The author may be reached by e-mail at mvaladiao@mail.smu.edu or profvaladiao@yahoo.com.br.

** Nara Galeb Porto, L.L.M. International and Comparative Law (SMU), L.L.B. (PUC/SP, Brazil); licensed to practice law in Brazil and New York. Attorney at Andrews Kurth LLP. The author may be reached at naraporto@andrewskurth.com.

1. See Michela Scatigna & Camilo E. Tovar, *Securitisation in Latin America*, BIS Q. REV. 71, Sept. 2007, http://www.bis.org/publ/qtrpdf/r_qt0709h.pdf.

2. The basis of the Brazilian securitization market was first set with Federal Law No. 9514 of November 20, 1997, which established a new approach to real estate finance and a legal framework for real estate securitization. This law and its subsequent regulations issued by the Banco Central do Brasil (Central Bank of Brazil) and *Comissão de Valores Mobiliários* (CVM) (Brazilian Securities and Exchange Commission) are the turning point, representing the legal foundation for nearly all real estate transactions that have been done in this market since its passage. Lei No. 9514, de 20 novembro de 1997, D.O.U. de 21.11.1997 (Braz.), available at <http://www6.senado.gov.br/sicon/ListaReferencias.action?codigoBase=2&codigoDocumento=147649>.

transactions and investment funds.³ This resolution determined that FIDC investments should be predominantly in credit rights and that they should be administered by financial institutions subject to Central Bank regulations. It also authorized the *Comissão de Valores Mobiliários* (CVM) (Brazilian Securities and Exchange Commission) to regulate this activity.

This resolution was further reinforced by the passage of CVM Directive No. 356 of December 17, 2001, which determined that FIDCs could purchase collateral from virtually any sector of the economy, including real estate, and that those purchases could be from the originators of that credit or third parties. Among other provisions, it also provided that receivables from investment funds may (1) be either open or closed-ended, (2) have their shares traded on the secondary market, and (3) issue securities publicly, targeted to qualified investors, as defined by the CVM.⁴ In subsequent years, additional regulations have been issued and have further built confidence among both investors and originators.⁵

According to a report published in July of 2007 by Standard and Poor's Ratings Services, the Brazilian structured finance market continues to expand significantly through the stable performance of existing transactions and ongoing diversification into new asset types. Brazilian 2007 structured financings packaged mostly personal loans, trade receivables, and the future flow generation of utility receivables and auto loans. Interest is also growing in esoteric assets, such as *Federal Precatórios* (the judicial public obligations against a public entity), agribusiness assets, and nonperforming assets.⁶

To date, however, even though Brazil has significantly developed its structure finance market, it still needs to develop the residential mortgage-backed securities (RMBS) sector.⁷ The securitization of residential loans can be an enhanced source of funding for housing finance. The pooling of mortgages and the creation of new securities sold in the secondary market provide a mechanism through which loans can be made without being funded by saving deposits; in this manner, securitization addresses a possible maturity mismatch problem that could constrain the extension of housing loans.⁸ The RMBS is a key driver in any structured market but is still virtually nonexistent in Brazil.⁹

3. See *The Next Big Step for Brazilian Securitization*, STANDARD & POOR'S STRUCTURED FINANCE, Aug. 2006, http://www.securitization.net/pdf/sp/BrazilianSec_28Aug06.pdf.

4. Instrução CVM No. 356, de 17 de dezembro de 2001 (Braz.) available at <http://www.felsberg.com.br/biblioteca/regulamentacao/ICVM356.pdf>.

5. See THE BRAZILIAN SECURITIZATION MARKET: A PRIMER 7 (Special ed. 2007), available at <http://www.uqbar.com.br/site/Home.html#primer>.

6. See *Has the Time Come for RMBS in Brazil*, STANDARD & POOR'S RATINGS DIRECT (2007), available at <http://www.standardandpoors.com>.

7. Mexico has the largest RMBS market in the region. Much of this development is due to a strong political effort directed at offsetting a very large housing shortage and to a number of legislative reforms.

8. See Scatigna & Tovar, *supra* note 1, at 78.

9. See *Has the Time Come for RMBS in Brazil*, *supra* note 6.

II. TAX REFORM AND FEDERALISM

At the end of 2007, the Brazilian Executive Power was to present a constitutional amendment to reform the Brazilian tax system. The presentation of amendment was delayed to 2008 due to a critical political dispute in the Federal Senate which struck down the prorogation of the CPMF (a social contribution levied on money circulation through the banking system),¹⁰ which had an impact of roughly 20 billion (U.S. \$) in the 2008 budget.¹¹ The text for the proposed amendment deals basically with indirect and consumption taxes. Indirect taxes play the main role in the Brazilian tax system, unlike the United States where income taxes are the most important taxes. The proposed reform intends to simplify the Brazilian tax system by promoting neutrality and exempting exports from indirect taxes. The initial proposal adopted a new approach to Value Added Tax (VAT) in a federal system. There would be two VATs, which would be levied on all transactions (goods and services); one would be levied by the federal government and the other by states and the federal district, by adopting common legislation through the twenty-seven units of the Brazilian Federation. Five federal taxes would be transformed into one federal value added tax—the federal VAT: tax on industrialized products (IPI), social contributions to PIS and PASEP, contribution to social security (COFINS), and the contribution on fuels.¹² The social contribution on profits (social contribution on net profit—CSLL),¹³ which works as an additional tax to the income tax levied on juridical persons will also disappear. After a round of discussions that included the federal government, with states, municipalities, and civil society (taxpayers), three basic changes in the original project were made. First, the state ICMS,¹⁴ that would be replaced by a state broad tax base IVA, would remain as ICMS, but there will be changes in its legal structure in order to

10. See Marcos Valadão & Nara Galeb Porto, *Mercosur, NAFTA, FTAA and Its Effects in Federal Taxation of International Transactions Between the United States and Brazil: A Comparative Study*, 10 L. & BUS. REV. AM. 726-27, and note 99 (2004).

11. See Roberto Maltchik & Alexandro Martello, *Senado derruba prorrogação da CPMF*, GLOBO.COM, Dec. 14, 2007, http://g1.globo.com/Noticias/Economia_Negocios/0,,MUL215356-9356,00-SENADO%ERRUBA+PROR-ROGACAO+A+CPMF.html (noting that the Senate struck down CPMF prorogation).

12. Federal taxes on consumption would be directly affected by the tax reform. There are three social contributions (which are also taxes): social contribution for the financing of social security (COFINS), contribution to the social integration program (PIS), and the promotion of the welfare of the public servant (PASEP) that can be levied as non-cumulative taxes depending on the income tax regime (i.e., there are two levying regimes: the cumulative and the non-cumulative—which brings more complexity to the tax system). The tax on industrialized products (*Imposto sobre Produtos Industrializados*—IPI) is a value-added tax that is levied only within the production chain, so it does not reach the wholesalers and retailers, e.g., the distribution chain, and the Federal contribution of intervention in the economic domain (named CIDE) on fuels. The CIDE on fuels is a cumulative tax. See Marcos Valadão & Nara Galeb Porto, *supra* note 10, at 705, 716-18, 726.

13. *Id.* at 79 n.61.

14. *Id.* at 99 n.100.

avoid fiscal competition between the states, to harmonize state tax legislation, and to make it less cumulative. Second, the ISS,¹⁵ a municipal tax on services would be preserved (in the original project it was supposed to be absorbed by the new state IVA). Third, the IPI, a federal tax on consumption of industrialized products, would also remain untouched by the reform.

The VAT model to be adopted in Brazil is very similar to the VAT adopted by the European Union. The new tax changes are scheduled to enter into force in 2010 for the new federal VAT and changes in federal tax structure, and in 2016 for the changes in state ICMS. Along with changes in the tax structure some changes will be also favorably impact the resources available by states and municipalities that are budget resources to be distributed by the federal government, to be granted in the Constitution. In addition, bigger apportionments will be allocated to a new regional development fund to help poorer states (it will replace tax incentives to investments currently granted through tax competition mechanisms).

Changes in the Brazilian tax system are necessary to ease development and improve the Brazilian business environment, where the tax system is deemed to be complex and not neutral. One of the main problems of the current system is the so-called tax wars between states (fiscal competition)—a problem derived from the Brazilian federal system.¹⁶ Due to a lack of centrally coordinated development policies, states have been conceding tax subsidies to attract new business to their territories. But, the Constitution only allows these subsidies if states convene to grant them through an interstate chamber called CONFAZ (National Council of Fiscal Policy—a federative-nature chamber) which is constitutionally empowered to decide such issues.¹⁷ In the last four to five years, the Brazilian Supreme Federal Tribunal (STF) (similar to the U.S. Supreme Court) has been striking down state laws, statutes, regulations, and special agreements that had granted unilateral subsidies (without CONFAZ validation). Thus, all the investments based on those statutes and agreements are now at risk because they are no longer allowed to benefit from that kind of tax break. And the worst scenario is that states are required to assess unpaid taxes due to unconstitutional subsidies (the assessment would cover the last five years, the elapse period established by the statute of limitations). The tax reform is also designed to fix this situation, putting things on track again.

III. INTERNATIONAL TRADE—CHANGING THE APPROACH

Brazil will move on to cross-retaliation regarding the case for upland cotton subsidies adopted by the U.S. Government, which is deemed to be illegal and affecting Brazilian cotton exports, according to a WTO deci-

15. *Id.* at 99.

16. Actually, the 2004 tax reform did not properly address this problem. *Id.* at 718-19.

17. CONSTITUIÇÃO FEDERAL art. 155, § 2º, XII, g (Braz.).

sion. Now Brazil will request WTO authorization to apply cross-retaliation to U.S. exports to Brazil, if the United States does not accomplish a WTO ruling on its cotton subsidy program.¹⁸

In 2005, after Brazil won the cotton case against the United States,¹⁹ it formally requested the right to retaliate against U.S. patents, copyrights, and services providers, and further suspended cross-retaliation request against the United States.²⁰ Now, there are rumors that WTO authorization will be applied to U.S. property rights and patents by anticipating the expiration of patent rights, among other strategies. Indeed, there is a bill in the Brazilian Congress that will allow widening of the scope of breaking patents of drugs for AIDS treatment—which has been a paradigmatic issue since the beginning of the Doha Round.

The bill, introduced by Representative Paulo Teixeira, states in its first clause that the law will establish procedures for adoption of measures related to suspension, weakening, and extinction of property rights in the Brazilian territory, when a foreign country does not accomplish multilateral obligations according to the WTO.²¹

18. See LEANDRO FORTES, *Um Teste Inédito, Para Além da Rodada Doha [An Unprecedented Test: Beyond the Doha Round]*, Carta Capital, SEPT. 12, 2007, AT 26-27 (BRAZ.), available at http://www.sindag.com.br/noticia.php?News_ID=402.

19. See Julien Chaisse & Debashis Chakraborty, *Implementing WTO Rules Through Negotiations and Sanctions: The Role of Trade Policy Review Mechanism and Dispute Settlement System*, 28 U. PA. J. INT'L ECON. L. 153, 176 (2007) (referring to the Panel Report, *United States - Subsidies on Upland Cotton*, WT/DS267/R (Sept. 8, 2004); and the Appellate Body Report, *United States - Subsidies on Upland Cotton*, WT/DS267/AB/R (Mar. 3, 2005)).

20. See *Brazil Asks for Cross-Retaliation Under TRIPS, GATS in Cotton Dispute with U.S.*, 9 BRIDGES WKLY. TRADE NEWS DIG. (Issue no. 34), Oct. 12, 2005, at 5-6, available at <http://www.ictsd.org/weekly/05-10-12/story3.htm>; see also *Brazil Suspends Cross-Retaliation Request Against U.S. in Cotton Case*, 9 BRIDGES WKLY. TRADE NEWS DIG. (Issue no. 40), Nov. 23, 2005, <http://www.ictsd.org/weekly/05-11-23/WTOinbrief.htm>.

21. Law Bill No. 1893/2007 (introduced by Representative Paulo Teixeira), <http://www.camara.gov.br/sileg/integras/497234.pdf>.

