

Real estate investment funds: a proposal for dividend distribution in Brazil

Fundos de investimento imobiliário: uma proposta de distribuição de dividendos no Brasil

Fondos de inversión inmobiliaria: una propuesta para la distribución de dividendos en Brasil

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ABSTRACT

This article discusses the current challenges faced by Real Estate Investment Funds (REITs) in Brazil, particularly regarding the mandatory dividend distribution based on the "cash" result, which can pose financial risks for managers, especially when future obligations exist. While this practice benefits passive income for investors, it may jeopardize the financial health of the funds. The Brazilian Securities and Exchange Commission (CVM) is keen on revising the current model but will have to overcome resistance from parts of the market. This article suggests a technological solution inspired by models used in developed countries such as the United States, the United Kingdom, and Spain, where dividends are distributed according to accounting profits with the option for dividend reinvestment. Implementing this model in Brazil would necessitate changes in market regulation and investors adapting to the investment platforms' modus operandi—proper accounting of distributions. This model would enhance transparency in resource management and financial stability for REITs. The article emphasizes the role of technological innovation in evolving Brazil's REIT market.

Keywords: real estate investment funds, dividend distribution, technological innovation, financial regulation, transparency and management.



RESUMO

Este artigo discute os atuais desafios enfrentados pelos Fundos de Investimento Imobiliário (FIIs) no Brasil, principalmente no que diz respeito à distribuição obrigatória de dividendos com base no resultado “caixa”, o que pode representar riscos financeiros para os gestores, especialmente quando existem obrigações futuras. Embora esta prática beneficie a renda passiva dos investidores, pode comprometer a saúde financeira dos fundos. A Comissão de Valores Mobiliários (CVM) está empenhada em revisar o modelo atual, mas terá que superar a resistência de partes do mercado. Este artigo sugere uma solução tecnológica inspirada em modelos utilizados em países desenvolvidos como Estados Unidos, Reino Unido e Espanha, onde os dividendos são distribuídos de acordo com os lucros contábeis com opção de reinvestimento de dividendos. A implementação deste modelo no Brasil exigiria mudanças na regulamentação do mercado e a adaptação dos investidores ao modus operandi das plataformas de investimento – contabilização adequada das distribuições. Este modelo aumentaria a transparência na gestão de recursos e a estabilidade financeira dos REIT. O artigo enfatiza o papel da inovação tecnológica na evolução do mercado de REIT no Brasil.

Palavras-chave: fundos de investimento imobiliário, distribuição de dividendos, inovação tecnológica, regulação financeira, transparência e gestão.

RESUMEN

Este artículo analiza los desafíos actuales que enfrentan los Fondos de Inversión Inmobiliaria (REIT) en Brasil, particularmente en lo que respecta a la distribución obligatoria de dividendos basada en el resultado "en efectivo", que puede plantear riesgos financieros para los administradores, especialmente cuando existen obligaciones futuras. Si bien esta práctica beneficia los ingresos pasivos de los inversores, puede poner en peligro la salud financiera de los fondos. La Comisión de Valores Mobiliarios (CVM) de Brasil está interesada en revisar el modelo actual, pero tendrá que superar la resistencia de partes del mercado. Este artículo sugiere una solución tecnológica inspirada en modelos utilizados en países desarrollados como Estados Unidos, Reino Unido y España, donde los dividendos se distribuyen de acuerdo con las ganancias contables con la opción de reinversión de dividendos. Implementar este modelo en Brasil requeriría cambios en la regulación del mercado y que los inversionistas se adaptaran al modus operandi de las plataformas de inversión: una contabilidad adecuada de las distribuciones. Este modelo mejoraría la transparencia en la gestión de recursos y la estabilidad financiera de los REIT. El artículo enfatiza el papel de la innovación tecnológica en la evolución del mercado REIT de Brasil.

Palabras clave: fondos de inversión inmobiliarios, distribución de dividendos, innovación tecnológica, regulación financiera, transparencia y gestión.



1 INTRODUCTION

The Brazilian Real Estate Investment Trust (REIT) market has experienced significant growth, driven by investors seeking passive income opportunities with tax advantages. Despite this growth, complexities have emerged regarding dividend distributions, a key draw for investors. The current law mandates REITs to disburse most of their "cash" earnings, potentially misrepresenting the actual financial state of the funds and posing challenges for both managers and investors.

The core issue of this study centers on the question: How could adopting a dividend distribution model based on accounting profits, akin to practices in developed nations, affect the financial sustainability of Brazilian REITs? This inquiry stems from concerns that the prevailing model might undermine the funds' financial stability by neglecting future obligations in its dividend distributions.

This research aims to explore the viability of introducing a new dividend distribution framework for Brazilian REITs, centered on accounting profits and incorporating a dividend reinvestment option. Its specific goals are to (1) scrutinize the existing dividend distribution mechanism and its fiscal effects on REITs; (2) explore dividend distribution methods in developed countries like the USA, the UK, and Spain; and (3) evaluate the advantages and obstacles of applying the new model within Brazil.

The methodology involves a literature review, analyzing documents, academic papers, pertinent legislation, and other secondary sources related to REIT management and regulation in Brazil and abroad. This method provides a comprehensive understanding of the current practices and potential innovations in the REIT sector.

The research anticipates that a dividend distribution model based on accounting profits could enhance transparency in REIT resource management and ensure greater financial stability. Aligning investor expectations with the funds' financial realities could also bolster confidence in Brazil's REIT market.

In conclusion, this article contributes to the discussion on the financial sustainability of Brazilian REITs by suggesting a shift in dividend distribution



strategies. By examining alternatives that consider accounting profits and permit dividend reinvestment, the study aims to offer valuable insights for regulators, fund managers, and investors, fostering more effective and transparent REIT management in the nation.

2 THE REAL ESTATE FUND INDUSTRY

Real Estate Investment Trusts (REITs) in Brazil are recognized for their dividend distributions, which come with a tax advantage: exemption from Income Tax (IR) on earnings derived from the distribution of results. However, this exemption is contingent upon the fund's commitment to distribute the majority of its 'cash' result, distinct from the accounting result as it does not account for all the financial obligations associated with these transactions. It's important to note that this IR exemption applies solely to dividends and does not cover capital gains—the increase in the fund's share value in the market. When investors sell their shares at a higher price than the purchase price, the profit (capital gain) is taxable.

This practice poses a risk for Fund Managers because distributing the "cash" result leaves future obligations unpaid, potentially necessitating new capital contributions after dividends have been distributed. The Securities and Exchange Commission (CVM) acknowledges the need to reassess the current distribution model for real estate funds but encounters resistance from a segment of the market that has invested in REITs seeking passive income and benefiting from the existing model.

The purpose of this article is to suggest an alternative to the present dividend distribution model for REITs, inspired by models utilized by similar funds in other countries, including the United States, the United Kingdom, and Spain. This proposition aims to contribute to market discussions and literature by addressing the temporal misalignment in dividend distributions, offering an alternative that could benefit managers and various shareholder types—a feasible option in harmony with the necessity of reevaluating the CVM's stance on the matter.



3 HISTORY OF THE LEGISLATION GOVERNING REAL ESTATE INVESTMENT FUNDS (FII) IN BRAZIL

Despite stark differences from American and European legal frameworks, the regulations surrounding tax matters and the management of Real Estate Investment Funds (REITs) in Brazil have seen significant development since their inception in 1993 (Schoueri & Cardin, 2022). Law 9.532/97, through its Article 19, laid down requirements for REIT shareholders to receive dividends. Subsequently, Law 9.779/99, in Article 10, mandated the distribution of at least 95% of cash-based profits to shareholders, with these distributions being taxed at 20% at the time of distribution.

Article 10 of Law 9.779/99 instituted a crucial regulation for REITs, aiming to ensure the prompt collection of Income Tax—REITs are required to disburse their profits to shareholders at the end of each semester. This legal stipulation seeks to avert delays in the payment of Income Tax on these profits. Regardless of any pre-existing financial commitments, REITs must give precedence to the semi-annual profit distribution, thereby facilitating more immediate tax revenue for the government.

The introduction of this new tax regime necessitated a clear methodology for determining the distributable amount. Yet, the term "profits earned, calculated on a cash basis" introduced ambiguity, lacking a "precise" legal interpretation for Profits Earned on a Cash Basis (França & Longo, 2021).

In May 2014, the Institutional Investors Board (SIN) and the Accounting and Auditing Standards Board (SNC) issued Circular/CVM/SIN/SNC/No. 1/2014. This circular clarified the Methodology for Calculating "Profits Obtained and Calculated on a Cash Basis," as outlined in the sole paragraph of Article 10 of Law 8.668/93, to specify the distributable amount. In December 2021, following the evaluation of a specific REIT - FII MRXF11 - the CVM decreed that dividend distributions must be tied to accounting profit, compelling the entire REIT sector to adhere to Accounting Profit for dividend distributions. Any excess should be disbursed as amortization, incurring a 20% tax rate.



Facing backlash from Institutional Shareholders—who stood to lose dividends—in May 2022, the CVM revisited its verdict and acknowledged the legitimacy of the accounting treatment applied to Profit distributions calculated on a cash basis; even if the amount exceeded the Accounting Profit for the year (Fernandes, 2022; CVM, 2022). Voguel (2022) noted that for certain categories of REITs in the Brazilian market, the allure of distribution makes them competitive against other fixed-income assets available to Brazilian investors. Consequently, managers are motivated to distribute as generously as possible to maintain the investment's appeal.

4 DISTRIBUTION MODEL IN THE USA, UK AND SPAIN

Historically, the United States, the United Kingdom, and Spain have encountered their own set of challenges within the Real Estate Investment Fund (REIT) sector. In various instances, these nations have grappled with issues arising from funds that allocated significant dividend payments to investors without retaining sufficient cash reserves to fulfill their financial obligations. This approach led to financial strain for some funds, necessitating managers to contribute personal capital to address deficits and ensure commitments to investors were met. These circumstances underscored the critical importance of cautious and balanced management of both real estate and financial assets, as well as the necessity to harmonize investor return expectations with the fund's genuine capacity for generating sustainable income.

The difficulties faced by these countries illuminated the intrinsic complexities involved in managing REITs, which require balancing income generation through leases with the maintenance of reserves for periods of diminished profitability. Moreover, these situations brought to light the significance of maintaining open and transparent communication between fund managers and investors to ensure that expectations regarding dividend payouts are in line with the financial realities of the fund. In response to these past challenges, these countries have implemented more stringent regulatory measures and management practices aimed at minimizing risks and ensuring the



long-term viability of Real Estate Investment Funds. These measures are designed to provide investors with confidence and establish a stable financial foundation for the sector. Table 1 (not provided here) would detail the specific characteristics of REITs in these countries, illustrating the varied approaches and regulatory frameworks adopted to safeguard the interests of investors and the overall health of the real estate investment fund industry.

Table 1: Characteristics of real estate investment funds.

Features	Real Estate Investment Funds	Real Estate Investment Trusts	REITs - United Kingdom	REITs - Spain
	(REITs) - Brazil	(REITs) - USA		
Type of Investment	Investment in diversified real estate assets, such as commercial and residential properties.	Investment in diversified real estate assets, such as commercial and residential properties.	Investment in diversified real estate assets, such as commercial and residential properties.	Investment in diversified real estate assets, such as commercial and residential properties.
Legal structure	Regulated by the Brazilian Securities and Exchange Commission (CVM).	Governed by the Internal Revenue Code in the USA.	Regulated by the Financial Conduct Authority (FCA) in the UK.	Regulated by the Comisión Nacional del Mercado de Valores (CNMV) in Spain.
Income Distribution	Generally obliged to distribute the majority of income to investors (minimum 95% in Brazil).	Obliged to distribute at least 90% of taxable profits to shareholders.	Requirement to distribute the majority of income (90% or more) to investors.	The need to distribute the majority of earnings (80% or more) to shareholders.
Basis for Distribution	Profits (actually received) from the fund's real estate and financial assets	Profits from the rental, sale or refinancing of real estate properties, limited to the accounting profit.	Profits from the rental, sale or refinancing of real estate properties, limited to the accounting profit.	Profits from the rental, sale or refinancing of real estate properties, limited to the accounting profit.
Regularity of distribution	Usually monthly or quarterly, depending on the fund.	Generally quarterly, but can vary depending on the REIT.	Generally half-yearly or quarterly, depending on the REIT.	Usually annual or biannual, depending on the REIT.
Reinvestment of Dividends	Some FIs allow dividends to be reinvested, but this is not a general rule.	Many REITs offer dividend reinvestment programs (DRIPs) that allow for the automatic reinvestment of dividends.	Many REITs in the UK offer dividend reinvestment plans (DRIPs).	Many REITs in Spain offer dividend reinvestment programs for shareholders.



Tax exemption	Exempt from income tax on distributed income.	Exempt from corporate income tax if they meet the distribution and diversification requirements. Shareholders pay income tax.	Exempt from corporate income tax, provided they distribute the majority of profits and meet other requirements. Shareholders pay income tax.	Exempt from corporate income tax if they distribute most of the profits and meet the requirements. Shareholders are taxed on dividends
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Source: Prepared by the author with research data

In the United States, the recognition of the significance of optional dividend reinvestment emerged notably during periods when Real Estate Investment Funds were undergoing construction or redevelopment phases. Often, the obligation to disburse dividends, without the guarantee of a stable future cash flow, placed a strain on available financial resources, thereby jeopardizing the Fund's capacity to meet its obligations and continue with development initiatives. Introducing the option for dividend reinvestment permitted these Funds to allocate resources towards construction and enhancements when necessary, instead of locking up their cash in obligatory payouts. This shift improved financial flexibility and strategic investment capacity in their assets.

In the United Kingdom, similar insights were gained, particularly when real estate investment funds were in phases of transition or renovation. The sporadic availability of cash during restructuring periods compelled funds to proceed with distributions without adequately considering their future income-generating potential. The adoption of optional dividend reinvestment facilitated more judicious resource management, allowing Funds to better allocate capital for constructive ends, such as property enhancements or strategic acquisitions, thus preserving financial stability. This alternative proved more logical and efficient for the Funds during times of transformation.

Similarly, in Spain, these circumstances underscored the value of adept dividend distribution management, especially for funds engaged in construction or restructuring efforts. The market's embrace of optional dividend reinvestment presented a beneficial option for Funds focusing their resources on upgrades or expansion, ensuring that their liquidity was not unduly affected by compulsory distributions during periods of financial ambiguity. This strategy enabled funds to



retain the financial agility necessary to navigate unforeseen challenges and seize opportunities, illustrating the importance of maintaining a balance for sustained financial health.

5 APPLICATION IN BRAZIL

Adopting an optional dividend reinvestment model and limiting distributions to cash profits, as seen in other countries, would mark a significant advancement for the Real Estate Investment Funds (REITs) market in Brazil. From a control perspective, such a change would enhance transparency and align investor expectations with the funds' financial realities. Allowing investors the choice to reinvest their dividends would enable REITs to build stronger financial reserves, reducing the necessity to allocate excessive cash to mandatory distributions and permitting strategic management of real estate assets. This approach would afford the funds greater financial stability and diminish the risks linked to unsustainable distributions.

The adoption of this model would also serve to safeguard the interests of REIT administrators and managers. By restricting distributions to cash profits, it would motivate directors to pursue a more prudent asset management strategy, thereby avoiding financial obligations that could adversely impact the fund's fiscal health. It offers additional protection to directors against the pressures to distribute beyond what the available cash would permit, ensuring the fund's financial viability over the long term. Consequently, this could bolster investor confidence in REITs, as they would recognize that distribution decisions are based on realistic and judicious criteria.

Funds that conserve and reinvest their earnings are likely to attract investors with a long-term outlook, who prioritize capital growth over immediate returns. Such investors can contribute to the fund's stability and enable managers to concentrate on long-term investment strategies.

To successfully adapt the Brazilian REIT model in line with practices from other countries would necessitate a series of coordinated steps, as outlined in Table 2 (not provided here). This comprehensive approach would involve



regulatory changes, educating stakeholders about the benefits of the new model, and possibly adjusting the legal framework to accommodate these innovations, ensuring a smooth transition to a system that promotes sustainable growth and investor confidence in the Brazilian REIT sector.

Table 2 – Stages for Implementing a New Model

Stage	Description
1. legislation and regulations	Review and adjust current legislation and regulations governing FII in Brazil. Introduce new rules allowing optional reinvestment of dividends and limiting distributions to cash profits. This involves approvals from regulatory and legislative bodies such as the CVM and the National Congress.
2. Changes to FII Regulations	Updating the internal regulations of each FII to reflect the changes in distribution policies. Define the terms and conditions for reinvesting dividends and limiting distributions to cash profits. Approvals at shareholder meetings.
3. Communication and Education	Inform and educate investors about the new distribution policies and their implications. Disclose dividend reinvestment options and cash profit distribution criteria in a clear and transparent manner.
4. Investor approval	Obtain the approval of the shareholders of each FII to implement the proposed changes. Hold general meetings where investors can vote and express their opinions.
5. Adapting Investment Platforms	Update the investment platforms and brokers that offer FIIs to investors. Enable the reinvestment of dividends and proper accounting of distributions to cash profits.
6. Monitoring and Inspection	Strict monitoring by regulatory bodies to ensure compliance with the new distribution rules. Avoid inappropriate practices that could harm investors or the integrity of the market.

Source: Research data. Prepared by the author

Each phase of transitioning to the new Real Estate Investment Fund (FII) distribution model in Brazil would require the active involvement and cooperation of regulators, fund managers, investors, and financial market professionals to ensure a smooth and effective changeover. In this context, the Brazilian



Securities and Exchange Commission (CVM) might contemplate revising CVM Normative Instruction 472 to introduce more flexibility in the profit distribution process and in how expenses are recognized by FII managers.

Such modifications to the Normative Instruction could authorize Real Estate Investment Funds to make provisions for known expenses prior to distributing profits to shareholders. Additionally, it might allow for adjustments in the frequency of semi-annual profit distributions to better suit the fund management's strategy. For instance, changing the distribution frequency could be made possible, as determined by the Fund's Management. Moreover, managers might be given the option to capitalize dividends distributed, rather than paying them out directly to shareholders. These adjustments would not incur additional taxes for shareholders and could serve as an invaluable mechanism for managers to more efficiently oversee the funds entrusted to their care - ANNEX A - Draft Normative Instruction.

Implementing these changes would not only provide FII managers with enhanced tools for financial management but also align the Brazilian FII sector more closely with international best practices, potentially increasing its attractiveness to both domestic and international investors. It would represent a significant step forward in the evolution of Brazil's real estate investment framework, offering greater operational flexibility and contributing to the long-term sustainability and growth of the sector.

6 CONCLUSION

The investigation into reformulating the dividend distribution model for Real Estate Investment Trusts (REITs) in Brazil uncovers a complex landscape where existing practices face challenges in financial sustainability and transparency. A comparative analysis with models from developed countries suggests that adopting an accounting profit-based system could significantly enhance financial stability for funds and provide clearer insights for investors.

This study accomplished its specific objectives, offering an in-depth understanding of the current state and potential reforms. The shift towards an



accounting profit-based dividend distribution model necessitates a united effort among regulators, fund managers, and the investment community. This transition will involve educating the market on the long-term advantages of such a shift and modifying legal and operational frameworks accordingly.

The literature review laid a strong foundation for this analysis, underlining the necessity for future empirical studies to further examine the impacts of this change on the Brazilian REIT market. Detailed case studies, financial impact assessments, and investor surveys could offer more concrete evidence on the feasibility and market reception of a new dividend distribution model.

The primary recommendation from this article is for regulators to earnestly consider enacting legislative changes that facilitate the adoption of an accounting profit-based dividend distribution model. Implementing such a modification would necessitate a well-orchestrated transition phase, inclusive of extensive stakeholder consultations to ensure the consideration and protection of all interests.

In summary, revising the FII dividend distribution approach in Brazil presents a substantial opportunity to enhance the sustainability and appeal of these investment vehicles. By aligning practices with the actual financial state of the funds and investor expectations, Brazilian REITs could achieve a more competitive stance in the international arena, attracting more interest and investment. The successful enactment of this reform hinges on the collective will and collaboration of regulators, fund managers, and investors, marking a crucial phase in the evolution of Brazil's real estate investment market.



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