

International Holding Company Considerations

Peru Startup Ecosystem | June 2018



Disclaimer

This presentation is meant to provide preliminary information and an overview of options for startups considering legal structures outside of Peru. No legal, tax, or accounting advice is provided in this presentation. Founders and investors should seek direct counsel from experts prior to making decisions. A list of potential resources is provided at the end of this presentation

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Why this is important

Planning poorly and making uninformed decisions early on can create friction when speaking to investors, lead to unforeseen transaction costs and result in significant tax consequences both at intermediate valuation events and at exit

- Each founder, startup and investor base is different and there is no one-size fits all approach
- Exits may lead to tax consequences down the road for founders and local angel investors that can vary depending on the nature of the exit including any future sale to a strategic acquirer
- Sophisticated international investors want to invest in structures with which they are familiar and that may limit future capital gains taxes
- Even at a very early stage for small rounds (\$50k-\$100k) some leading U.S.-based accelerators and seed investors (500Startups, IndiBio, Y Combinator) have a preference or requirement to invest in U.S.-based companies
- Founders may want to seek capital from angel investors outside of Peru
- Adverse tax implications locally for Peru-based employees with stock options in the local entity

When this is important

- As early as possible, but only after outlining future strategy and financing options
- After startup has enough money to pay for set-up costs for an international holding company structure
- Before accepting capital from local sources who might be affected adversely by future rounds and restructuring due to local tax rules
- Prior to a round of financing from a foreign accelerator or venture capital fund

Start by asking six key questions

Questions

- How much are you seeking to raise?
- Where do you expect to raise?
- What is the profile of investors?
- Where do you foresee future growth and operations?
- Where do you see yourself getting sold and who do you see as likely buyers?
- What is likely exit path?



Options

\$250k-\$500k vs. >\$1.5M

US, UK, Mexico, Brazil

**Venture Capital, Angel Investors,
Accelerators, Corporate Venture**

**U.S., Latin America, Non-U.S.
International, Peru-only**

US, UK, Spain, Mexico, other

IPO vs. Strategic Sale

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Considerations

Setup and maintenance costs

Capital gains taxes

Capital gains taxes, Annual filing requirements

Potential exit scenario, Income taxes

Capital gains taxes

Capital gains taxes, Transaction costs

We will look at a typical fact pattern

Startup Profile

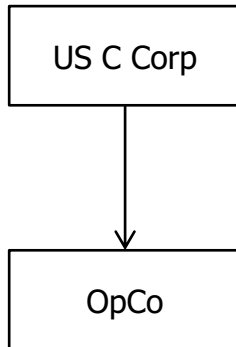
- Already raised equivalent of US\$500k to US\$1M locally from angel investors
- Seeking future financing from international venture fund with regional focus
- Latin America expansion strategy
- Potential exit to international tech company



Considerations for setting up a holding company

Structure Options

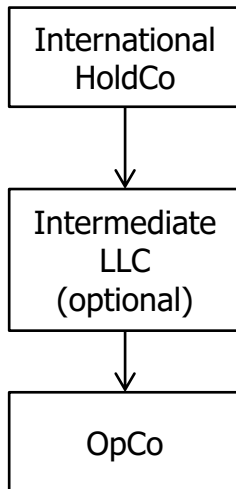
1.



Considerations

- + Preferred by some U.S.-based venture capital funds, angel investors, and required by Y Combinator
- + Ideal for U.S. IPO or sale to U.S. strategic acquirer
- Restructuring to a U.S. C Corp triggers a taxable event locally
- Exit at local OpCo level will lead to double taxation
- May prevent subsequent investment by venture capital funds with experience investing outside U.S.

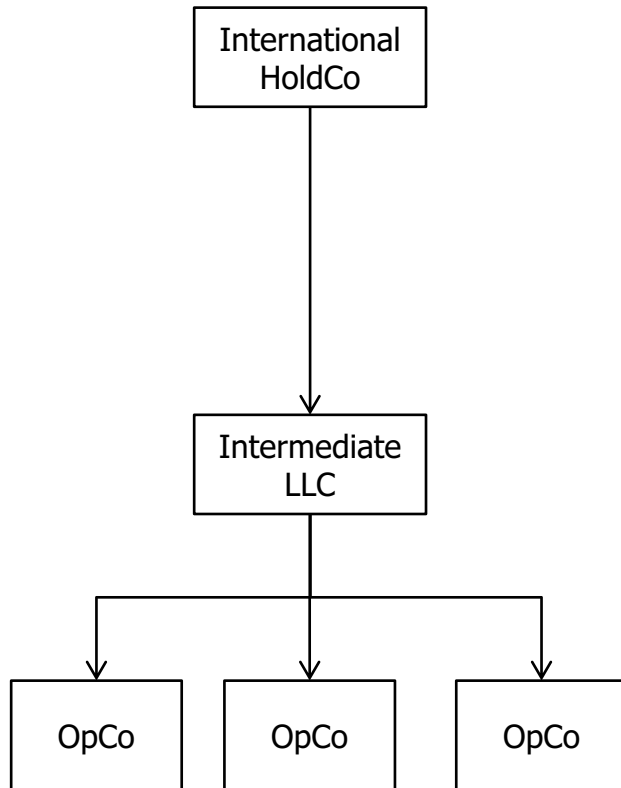
2.



- + Avoids potential double taxation at exit
- + Option for startups not planning to enter U.S. market or with minimal U.S. expansion strategy
- + Path of least resistance is to setup the U.S.-based LLC as the intermediate entity first as a "halfway house"
- Unfamiliar for some angel and seed who typically invest in U.S. C Corps
- Additional expense of hiring international accounting firm for filing requirements
- Additional time needed to help angel and seed investors with annual paperwork and filings

Potential holding company structure for local Peru startup

Structure



Domicile

- Cayman Islands, BVI, UK
- Delaware, Ireland
- Peru, Colombia
- Mexico, Chile, etc.

Considerations

- International HoldCo that issues shares and options
- Treated as partnership (LLC) for U.S.-based investors if a tax election is made
- Can issue preferred shares to venture capital investors
- Not always necessary
- Intermediate LLC is seen as HoldCo for Peruvian tax purposes
- Separate subsidiaries "ring fence" liabilities (ex. labor) in each jurisdiction

Options for international holding company

Caribbean:

- Cayman Islands and BVI are tax neutral, politically and economically stable, and have flexible and modern corporate regimes
- Treated similar to Delaware LLC if appropriate U.S. tax elections are made
- Cayman Islands counsel typically work alongside U.S. lawyers who take the lead in drafting financing documents
- Majority of offshore investment funds are domiciled in the Cayman Islands
- Venture capital investors investing in Latin America (including U.S.-based investors) are familiar and comfortable with these structures
- Some European and Mexican investors cannot invest in Cayman Islands or BVI HoldCos

United Kingdom:

- UK is tax neutral, politically and economically stable, and has a flexible and modern corporate regime¹
- Fewer examples leads to less efficiency and potentially higher operating costs
- Can be more cumbersome for stock options
- Peru has tax treaty in discussion with United Kingdom
- Local UK investors have tax incentives to invest in early stage businesses
- UK avoids “tax haven” issues

1. Due to the Substantial Shareholder Exemption, an exit at the OpCo level is not subject to tax in the UK. The Participation Exemption results in no withholding tax on a dividend paid out after an exit at the OpCo level.

Consider costs of setup and operations

One-time legal set-up costs:

Cayman Islands
HoldCo:

US\$15k - US\$30k +

- Cost varies widely depending on cap table and complexity of financing documents
- Process takes up to one month and includes Know your Customer (KYC) requirements

Annual legal operating costs for tax advisors:

Cayman Islands
HoldCo:

US\$5k

Delaware LLC:

US\$1k - US\$2k



Rebaza, Alcázar & De Las Casas



K&L GATES



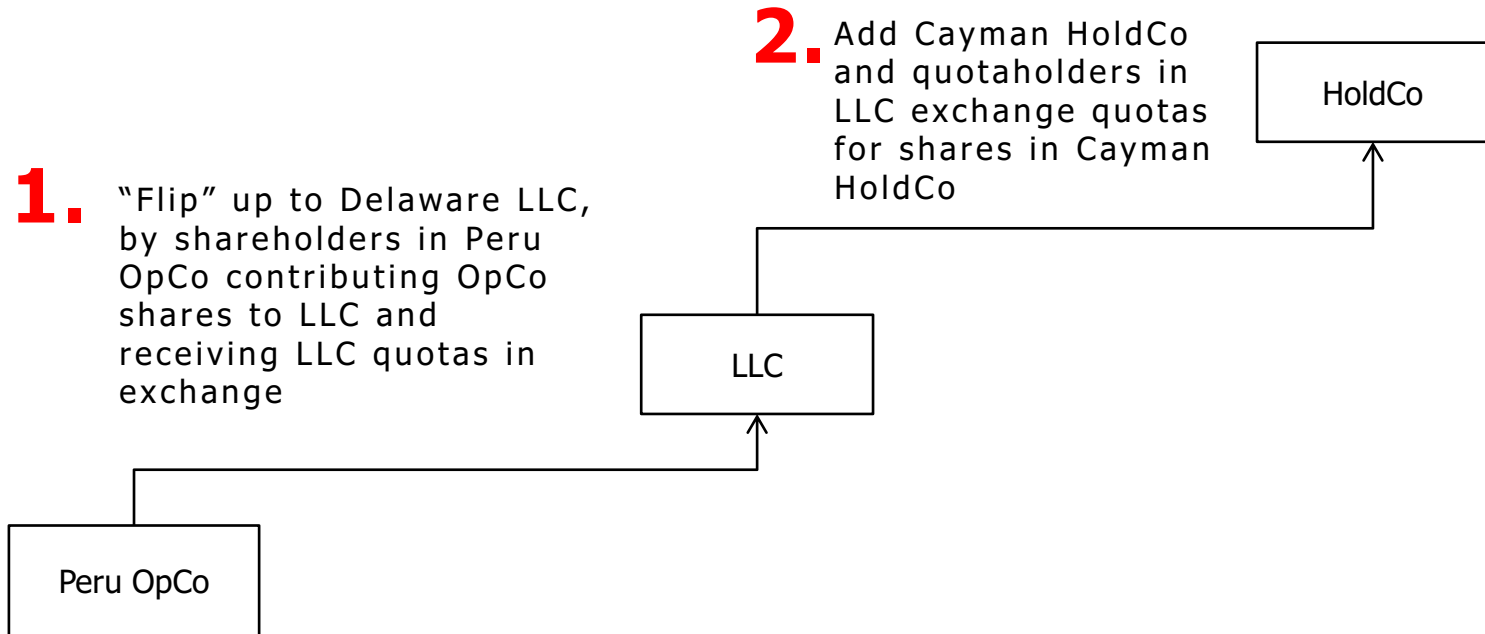
International venture capital firms are familiar with Cayman Islands HoldCo structure

Venture capital funds with portfolio companies that use Cayman Islands holding company structures:



Peru OpCo will go through a process to “flip” entity up to international structure

Delayed flip process



- Flip at a lower value than the acquisition cost to avoid taxable event for local investors

- Set-up prior to international investment
- Add share options at HoldCo level

Peru OpCo will go through a process to “flip” entity up to international structure

One-step flip process

1a. Setup Cayman HoldCo

HoldCo

1b. HoldCo forms LLC and LLC subscribes for shares in Peru OpCo

LLC

Peru OpCo

- High setup and maintenance costs

- Tax considerations may determine how Peru OpCo contributes shares
- Intermediate LLC is seen as HoldCo for Peru tax purposes

Applicable tax rate depends on investor profile and domicile of startup at time of transaction

Startups Domiciled in Peru

International HoldCos

Shareholder Profile

Tax rate on Sale or Flip

Individual Domiciled in Peru

- Founder
- Angel investor

• 5%

- 30%
- 5% for indirect transfer of Peruvian shares²

Company Domiciled in Peru

- Company

• 29.5%

• 29.5%

Foreign Investor

- Angel investor
- Fund
- Company

- 30%
- 5% if for listings on local stock market

• 0%

Tax considerations for founders and local Peruvian investors

- Timing is key and the decision when to flip is often a local tax question
- Exchanging shares in Peru OpCo for interests in a Delaware LLC (the “flip”) could be considered taxable if the “flip” value is higher than the acquisition cost
- The flip creates a local tax event for shareholders domiciled in Peru considered as a capital gain and will be calculated based on the difference between valuation at time of investment and at time of flip
- The applicable valuation method as well as the stage and historical performance of the startup impact whether taxes will be paid at the time of the flip
- For tax purposes, valuation at time of flip is calculated based on market value, which could be based on transfer value (valuation of previous rounds) or net book value
- Peruvian founders and angel investors investing in a Peru OpCo pay 5% capital gains tax on sale or flip of startup
- The flip value is the cost of the Delaware quotas, which is the new tax cost of the investment and will be the tax cost in a future exit
- Flips are complicated when there are existing convertible debt or stock options, so it could be better to convert and then flip or replace the current structure and create another one

Tax considerations for founders and local Peruvian investors

- The exit from the Delaware LLC for Peruvian founders or Peruvian investors could be taxed in two ways:
 - i. Foreign income as direct transfer of foreign shares (30%)
 - ii. Peruvian income as an indirect transfer of Peruvian shares (5%) if both:
 - a. In the last twelve months, the market value of the shares of Peru OpCo shall be equivalent to 50% or more of the market value of all shares or participations that represent the social capital of Delaware LLC (50% criteria), and;
 - b. In any period of 12 months shares that represent 10% or more of the social capital of Delaware LLC are acquired (10% criteria).
- The Peruvian indirect transfer regime will most likely apply to Peruvian founders
- Peru OpCo is taxed at the Peruvian corporate income tax rate (29.5%)
- Transfers of income from a Peru OpCo to a Delaware LLC will be considered dividends and taxed a dividend tax (5%), subsequently the Peruvian shareholders who repatriate the funds will be taxed at the foreign income rate (30%), essentially a double taxation
- Various pending Peru tax treaty proposals exist, including discussions with the United Kingdom, which could affect local tax treatment

Intellectual Property considerations

Subsequent to the International HoldCo “flip” process, it is important to take steps to establish an intellectual property (IP) structure aligned with the business plan and future exit strategy. Most investor rights agreements have provisions that restrict transfers of IP to HoldCo.

Location of IP

Where?	Why?
U.S.	<ul style="list-style-type: none">• U.S.-based costumers• Biggest revenue growth opportunities in U.S.• Revenue taxed in U.S.³
Peru	<ul style="list-style-type: none">• Development team in Peru• Revenue generated in Peru or generally outside U.S.• Biggest commercial opportunities in Latin America or outside U.S.

Legal Documentation

- i. Research and development agreement between OpCos/HoldCos in different countries:
 - Teams in both companies work on the IP and product of the business
 - One company must own the IP, the other assigns its IP over
- ii. IP license agreement for customers
 - One company owns the IP and then licenses the rights to it to the other company for local contracts/revenue
- iii. Transfer pricing rules
 - Necessary for accounting purposes
- iv. Shared administrative services agreement so that the teams functioning in each company can share the costs of accounting, human resources and other company-wide services

3. Important changes in U.S. corporate tax rates should be taken into account.

Next steps

- Present report to groups of entrepreneurs in Peru
- Present report to angel investor networks in Peru
- Share with broadly with startup ecosystem in Peru
- Facilitate introductions with local and foreign counsel
- Talk to Peru government (PRODUCE, Innovate)
- Make policy recommendations to tax authorities

Additional questions and answers

- Why is Cayman HoldCo necessary why not just Delaware LLC? *Paraíso fiscal* issues for Peru tax scrutiny? New share issuance? Stock options? Preferred shares? *Paríaso fiscal and stock options. For a Delaware LLC, all investors receive K-1's and must file U.S. tax returns. Most fund will not invest directly into a Delaware LLC for tax reasons.*
- Are Peru investors taxed at liquidity event or intermediary events like the “flip”? *Potentially, yes.*
- What is the tax event on the “flip” or on a subsequent round for local investors? *5% If the “flip” happens at a higher valuation than the local angel round.* Are investors required to pay 5% tax even when there are no proceeds? *Yes.*
- Tax calculated based on net book value or valuation of latest round? *Both can be justified. Early stage startups may have negative net book value, which can avoid a tax event at time of the “flip”. The flip value has to be at least the book value (on the basis that Peru OpCo is not economically related to LLC and Holdco, for example through 30% of shareholders, managers, among others). The tax is calculated using the difference between the flip value and the acquisition cost.*
- On one hand it would seem better to wait for a higher valuation in order to only pay 5% tax and not 30% foreign, but on the other hand there will be cash taxes for a non-cash transaction. *Yes, entrepreneurs and investors should weigh the benefits of maximizing the capital gains that are charged that 5% rate.*
- What are tax consequences of setting up other local (Mexico, Chile) OpCos below Peru OpCo instead of directly below HoldCo? *For Peruvian tax purposes, the capital contribution to OpCo is a neutral tax event.*
- If significant operations will be in US and sale will be to US Corp, then is C Corp best option? *Likely, yes.*
- How are shares “contributed”? *With two shareholders at each level (ie. 99% and 1%).*
- Intellectual property considerations. At which level are they best protected (Holdco, OpCo)? *Usually OK to start with OpCo and either leave there if there is good protection or move to an IP HoldCo.*

Articles

1. Apuntes y recomendaciones para el desarrollo del financiamiento de las startups. Perspectiva tributario, Andrés Gjurinovic
 - <http://ius360.com/columnas/apuntes-y-recomendaciones-para-el-desarrollo-del-financiamiento-de-las-startups-perspectiva-tributaria/>
2. Three structuring options for reorganizing your Latin America startup in the U.S., Jason Stark
 - <http://pulsosocial.com/2014/10/21/tres-opciones-de-estructuracion-para-reorganizar-tu-startup-en-los-estados-unidos/>
3. How to Structure Your Company for VC Financing, Andy Mattson & Christine Ballard
 - <https://vimeo.com/226964535>

Identified local counsel by jurisdiction

Peru

- Barrios & Fuentes
- Hernandez & Cia
- Lazo, de Romaña & Gagliuffi
- Montezuma & Porto
- Rebaza, Alcázar & De Las Casas

U.S.

- Foley & Lardner
- Gunderson Dettmer
- K&L Gates
- Moss Adams
- Private Advising Group

Cayman Islands

- Campbells
- Carey Olsen
- Maples and Calder
- Walkers

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