

**RESTRUCTURING
BRAZILIAN
COMPANIES
IN THE USA**

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/ Sérgio Cury Meirelles

INTRODUCTION

After building your operations in Brazil with loans from friends, relatives and local seed investors, you are then ready to enter a Series A Venture Round, involving amounts between USD 1-3 million.

The USA continued as the world's most active venture funding market, known as "venture capital" or "VC", for technology and Internet companies. However, the US-venture capital funds, in general, will not directly invest in companies operating in Brazil due to concerns with tax issues, law standards and contractual and labor interpretation.

To conclude a venture round, it is prudent, and even required by some investors, to reorganize companies in order to create an international holding in which the Series A investors will invest.

Here is our article on the subject.

Options to reorganize your Brazilian company in the United States

After building your operations in Brazil, using loans from friends, relatives and local seed investors, you are ready to enter a Series A Venture Round, involving amounts between USD 1-3 million.

Congratulations! To have survived as a new company in a country highly regulated and with an unstable economy is a



success. Your company is successful in an environment full of barriers that your competitor will have to go through.

The USA continued to be the world's most active venture funding market, known as "venture capital" or "VC", for technology and Internet companies. However, the US-venture capital funds, in general, will not directly invest in companies which operate in Brazil due to concerns with tax issues, law standards and contractual and labor interpretation.

To conclude a venture round, it is prudent, and even required by some investors, to reorganize companies in order to create an international holding in which the Series A investors will invest. These holdings are usually structured as corporations or limited liability companies in the United States ("LLC")¹, which own the local operating companies. Another option is to create a holding in the Cayman Islands owning an LLC in the United States which, in turn, owns local operating companies².

Find below a cost/benefit analysis of the reorganization which may become necessary prior to creating the new structure, as well as the three legal structures, as described in the prior paragraph, which work for startups located in Brazil,³

Reorganizing companies from Latin America

¹ The venture capitals funded in the USA are virtually always domiciled in the State of Delaware, therefore, the terms Corporation and Limited Liability Company from the United States or Delaware are alternately used herein.

² The conventional understanding is that the companies seeking investment of US-venture funds should be organized as a US-company, because these funds require their portfolio companies to be corporations. Usually, that is the case for venture funds of at least USD 1 million and, in case of investments, conversion into corporation may be required. However, once become a corporation, too often it is too expensive or unbearable to convert into a Limited Liability Company (LLC). While many companies expect increasing cash in the future of US-funds, often what happens, first, is that a strategic purchaser not interested in owning a taxable US-company acquires the business, funds are set-up by seed investors, high-income individuals or funds based in Brazil, or a lower funding process occurs under which the US-funds are willing to invest in an LLC. In such case, organizing a corporation may be counterproductive, since it is usually quite simple and cheap to convert into a corporation, there is good reason to consider the use of one or two other structures described herein.

³ This article assumes that your company has no "effectively related income", i.e., operations (such as employees and sales) in the USA. Usually, the mere existence of a company in the USA to operate as a holding, existence of a bank account, etc., is not effectively related income. If your company has "effectively related income" (e.g., founders are US-citizens/residents and/or the company operations are based in the USA), the analysis changes, the company from Cayman Islands is required to provide a US-statement and the structure will not be probably a useful option anymore. Shall there only be limited liability operations in the USA, the structure in the Cayman Islands can still be useful if the income source from USA is added to a C-Corp, which would be a wholly-owned subsidiary under the LLC.



A VC fund or investor will require that the holding, in which it will invest, hold 100% of the capital stock of the local operating companies (or 99% for jurisdictions requiring two shareholders) and 100% of the assets and intellectual property of the operating companies.

Organizing several companies in Brazil is, oftentimes, difficult and expensive. In addition, it is common for startups operating in the country to have to maintain low costs. Maybe their legal structure is a little informal. For example, the intellectual property belongs to the own founders and the many companies do not have the same interest shares.

As a rule, reorganizing the many operating companies into an international holding structure is quite easy. Reorganization of the ownership of many companies is usually done by means of a simple exchange agreement, whereby shareholders of each company agree to transfer their shares in the local operating company to the new holding in exchange for shares in the new holding. The local attorney reviews, based on the local requirements, and would provide all documents required by the local law. The exchange agreement may be used jointly with either structure described below.

Three Types of Holding

Delaware C-Corp

The Delaware C-Corp would own all group companies. That is the classical, most popularly used structure.

Pros:

- The VC funds and US-investors are comfortable with the Delaware C-Corps. Unlike a Limited Liability Company (LLC), there is no "ghost income" on the earnings of the corporation for the shareholders, i.e., until the corporation makes a distribution, submits to a triggering fact (as a merger or put option) or the shareholder sells its shares, there is no tax to the shareholder.

Cons:

- A Delaware C-Corp is a taxable company, resulting into "double taxation", i.e., the company's total revenue shall be subject to the US-corporate income tax and tax on dividends withheld at source. If the company is profitable, such earnings are taxed (the highest corporate rate in effect is 35%) and, then, the shareholders are taxed again upon sale. For a



profitable company, such fiscal treatment will lead to a significant tax burden upon company's sale.

- Delaware C-Corps are subject to the Delaware franchise fee, which may have a lower value, such as \$175 or higher, which is unusual, \$180,000. Usually, the value is lower than \$1,000, and is related to the face value of the corporation's shares. This explains the required issuance of shares with a very low face value.
- Potential purchasers may insist in purchasing from local operating companies to prevent acquisition of a US-taxable company and, in such case, the holding's shareholders could be forced to pay taxes on sale of the operating companies or when the money is distributed.

Delaware Limited Liability Company – LLC

The Delaware Limited Liability Company (LLC) would own all other group companies.

Pros:

- An LLC is not a taxable company and earnings are only taxable at the partner level.
- An LLC could operate less formally than a corporation and is subject to less formal documentation. For example, there is no requirement of annual meeting and greater flexibility on governance and how to define the rights of its partners).
- Usually, the venture round documentation is simpler – traditionally, the investment documents for a corporation are divided into purchase and sale agreement and other four major documents governing the relationship between shareholders, while an LLC requires only the purchase and sale agreement and Articles of Incorporation.
- The US-partners are authorized to deduct their interest in proportion to the losses generated by the LLC against their US-actual income, subject to limitations, such as passive activity loss rules.
- The LLC holding may sell operating subsidiaries to partners other than US-citizens free from any capital gains. Furthermore, to the benefit of the purchaser, the LLC holding can, in the future, change its domicile outside the USA with no additional taxes, except in unusual situations.

Cons

- The LLC is subject to the so-called "ghost income", i.e., income is taxable to their partners in a certain year, either revenues are distributed to such partners or not.



- Many US-VC funds require that the company be a Delaware C-Corp. However, conversion into a corporation is usually a simple and inexpensive process.
- Non-American partners shall obtain a US fiscal identification number (analogous to CPF/CNPJ) to enable the LLC to comply with its obligations as to US income tax return.

Cayman Islands Company⁴ above a Delaware LLC.

A Cayman Islands Company would own a Limited Liability Company (LLC) from Delaware and the Delaware Limited Liability Company (LLC) would own all other group companies⁵.

Pros:

- No federal income tax return in the United States would be required by the shareholders of the Cayman Islands company.
- The Delaware LLC, entirely-owned by the Cayman Islands company, is not seen as a US company for fiscal purposes. The LCC shall only pay an annual franchise fee to Delaware (currently around \$300).
- Institutional investors are highly comfortable with Cayman Islands companies. Many venture funds are domiciled in Cayman Islands or keep a raising fund abroad.
- C-Corps and LLCs are subject to the US-requirements of reports and statements, which could be avoided by investors in a Cayman Islands company. Annually, in the United States, C-Corps and LLCs are required to present annual income statement. Furthermore, a report from the Foreign Bank and Financial Accounts (FBAR) may be required as to the bank accounts other than those from the United States, as well as the bank accounts of their subsidiaries not from the United States. In such structure, the Delaware Limited Liability company may be required to register the FBAR report and Form 5471, but no annual fiscal statement is required.

Cons:

- Additional expenses will be incurred due to the inclusion of an additional company into the structure.

⁴ The Jurisdiction of the Cayman Islands can be replaced with the jurisdiction of the British Virgin Islands, with lower costs for organization and maintenance of the companies. However, the Cayman Islands are better accepted among VC funds, since these are better acquainted with the local laws.

⁵ The Delaware Limited Liability Company is included into the structure, because (i) investors from the United States are more comfortable with a US-company with a bank account and employer identification number from United States included into the structure and (ii) many Latin-American jurisdictions consider the Cayman Islands a tax haven and precisely a Delaware Limited Liability company below the Cayman Islands company prevents fiscal issues to companies operating in Brazil in certain jurisdictions. Certain Latin-American jurisdictions have discussed to enact the fiscal act which considers the structure for the final beneficiary owner as regards tax havens, but it was not put into practice yet.



- Cayman Islands companies have more corporate formalities to comply with than the Delaware C-Corps and more expensive organization and maintenance.
- Certain funds located in the USA may object a structure located in Cayman Islands, for being more comfortable with a Delaware C-Corp.

In summary, startups located in Brazil have alternatives beyond the creation of a Delaware C-Corp for their Series A venture round. A Cayman or Delaware holding through an LLC could be acceptable to institutional investors while providing the startup located in Brazil with fiscal efficiency and operationality.