# A resilient market

Michelle Abreu, Manuel Troncoso and Victor Livio Enmanuel Cedeño Brea of OMG in the Dominican Republic look at emerging trends and opportunities in the country's investment market

In the midst of a stifling global financial crisis that now threatens to generate another widespread recession, the Dominican economy has displayed robustness and resilience. Economic indicators have shown a favourable outcome for the past five years. According to the Dominican Central Bank, GDP growth for the first semester was around 4% in constant terms. While this represents a sluggish rate compared to the 7.5% growth rate for the same period in the previous year, the most recent performance has been recognised as an impressive feat considering the volatility in commodity and fuel prices that recently raised the 12-month inflation rate to +9.32% in June 2011.

These economic results are likely to attract new investment opportunities for private equity investors and venture capitalists in a world somewhat puzzled by a broken financial system and dismal expectations. Private equity activity has visibly grown in the Dominican Republic during the last decades and has evolved from being invitation-only clubs for local elite capitalists to gaining widespread use amongst different types of investors. Among the latest trends are examples of international organisations that wish to provide funding to private actors and the public sector, relief funds for the reconstruction of Haiti, private equity investments for the takeover or restructuring of distressed and insolvent business, and even as a trendy way for local entrepreneurs to raise capital and organise a new venture. Because private equity investment structures operate on a largely unregulated shadow economy, however, it is difficult to pinpoint how much volume they represent in terms of GDP activity.

### Bad company and lack of trust: legislative changes

The Dominican Republic has recently undertaken important structural reforms, the most important one being the Constitutional reform of January 2010 that strengthened economic rights as well as private economic initiatives. Many of these transformations have been aimed at providing economic stability and catalysing entrepreneurship and investment within an environment of legal and commercial certainty. Among the most important reforms directed towards revolutionising the legal organisation of businesses are Law No 479-08 for Commercial Associations and Limited Liability Sole Proprietorships (the Companies Law) and Law No 189-11 for the Development of the Mortgage Market and Trusts in the Dominican Republic (the Trust Law).

From the onset, policymakers, entrepreneurs and legal practitioners expected that both the Companies Law and the Trust Law would profoundly change the way people invest and organise businesses in the Dominican Republic. One of the main policy goals for both projects was to update existing legal business structures in order to make them more attractive for direct investments.

Before the Companies Law, the reality of Dominican corporate structures was dim: joint-stock companies seemed to be the only recommended and widely-used model and they were lightly but inadequately regulated with 19th-century rules. Moreover, the Dominican legal system is inviting for foreign business corporations. As a result, entrepreneurs have often preferred to set up their businesses through offshore corporate vehicles.

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Some structures that had internationally proven to be ideal for setting up private equity funds were unused and largely unfamiliar. Limited liability partnerships were rarely recommended by consultants or chosen by entrepreneurs for new ventures. These corporate types lacked fiscal incentives (such as pass-through approach, or different income tax rates) and as a result were considered very unattractive for investors. Some of these policies were simply sclerotic and helped and pushed investors into the arms of offshore corporate types, which were deemed as being more versatile and sophisticated.

The Companies Law and its subsequent modifications were intended to update the corporate catalogue in the Dominican Republic. Limited liability companies (LLCs) were created as an alternative to

joint-stock companies (JSCs), which were left for larger ventures and publicly-traded companies. A simplified joint-stock company was also created in order to grant this corporate type more governance flexibility and ease. In addition, a significant step for foreign direct private equity investment was the exemption from registering in the local mercantile registry for foreign corporate investors in equity securities issued by Dominican companies. It is still uncertain if this policy will work from an operational standpoint, however, because, in order to receive dividend payments, it is expected that investors (shareholders) be registered in both the mercantile registry and the taxpayer's registry, which is tantamount to an *ipso-facto* taxable establishment.

Some critical aspects have remained unchanged in the Companies Law while other tortuous policies were introduced: all corporate types are taxed at the same income tax rate (recently raised to 29%), minimum legal capital requirements were set too high for JSCs and LLCs and the only business structure that was left without a distinct legal personality (pass-through taxation) was the joint venture (*sociedad en participación*).

Before the enactment of the Trust Law, no legislation recognised this institution. Because the Dominican Republic has a strong civil law background (mostly based on a French legal tradition), practitioners and academics often felt both intrigued and perplexed by the intricacies of trust law. Some legislative changes within the last decade purported to emulate fiduciary relationships. For example, Securities Exchange Law No 19-00 and its regulations created investment banking for securities brokers and also promoted mutual and close-ended funds, fund administrators and securitisation companies. The Dominican Social Security Law No 87-01 established pension funds administered by special companies inspired on the Chilean personal retirement account model.

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Nonetheless, without a clear-cut set of rules recognising and governing trusts, legal and judicial risk persisted. As a result, people opted for offshore solutions from other jurisdictions. Taking into account that it has just been recently enacted, the Trust Law will certainly take some time to sink in with entrepreneurs and consultants. A large burden also rests on the regulations that will be issued for trustees by the corresponding administrative oversight bodies.

## Taking your business elsewhere

### Private equity vehicles in the DR

When it comes to the organisational vehicles available in the Dominican Republic for private equity investment, one must refer to the corporate forms established by the Companies Law and the trust patterns customised by the Trust Law. There are several novel ways in which private equity investments can be structured.

*Sociedades anónimas* (SAs) are joint-stock companies with a minimum of two shareholders (individuals or companies) whose liability is limited to the amount of their subscribed capital. SAs must have a minimum registered capital of DOP30 million ($787,400) and at least 10% of this amount must be subscribed in cash or in kind upon incor-

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poration. The capital of the SA must be represented by negotiable shares (which may be publicly traded in securities exchanges or not). SAs are suitable for private equity structures that require a rigorous corporate governance regime and a clear delineation and separation of the functions and responsibilities of the shareholders (investors), the directors and the managers. SAs are required to have a board of directors, consisting of at least three members. The board of directors appoints the managers and executives. These corporations have a standalone legal personality different from that of its shareholders. As a result this entails a taxable personality.

A SA may also adopt the form of a *sociedad anónima simplificada* (SAS), which is a simplified JSC designed for businesses that do not require a rigid corporate governance regime. The SAS is not required to have a board of directors, but has the option of appointing one. The president assumes the administration of the company. The SAS is not allowed to issue securities publicly.

As for *sociedades de responsabilidad limitada* (SRL) – analogous to LLCs – they must have at least two shareholders, which are liable up to the amount of their contributions in the capital. The minimum capital for the SRL is DOP100 Thousand (USD2,600.00) fully paid, either in cash or in kind, upon incorporation. The maximum number of partners is 50, and the consent of three-quarters of the ownership interests of the partners is required to transfer ownership interest to third parties. SRL are rather simple to operate since they are not required to have a board of directors. One or several managers (individuals) can administer the SRL without the need of being partners. The managers are personally liable for their administration.

The *sociedades en comandita por acciones* (SCA) – the Dominican equivalent to a Limited Liability Partnership – are formed by two kinds of partners: general partners (*socios comanditados*) and limited partners (*socios comanditarios*). The former are indefinitely and jointly liable for the debts and obligations of the company as they act as general managers, and the latter (at least three) are shareholders that must support the company's losses in proportion to their contributions. The SCA can be managed by one or several managers (partners or not) appointed for the first time by the bylaws of the company, and subsequently by the annual general meeting, with the consent of all the general partners. The managers have the power to represent and act on behalf of the company. The SCA should have a surveillance committee formed by at least three limited partners, which assume the permanent control of the management of the company. This vehicle is appropriate for investors who are interested in being involved in the management of the company. The members of the surveillance committee are liable for their personal inaccuracies in the exercise of their functions.

The *sociedad en comandita simple* (SCS) – which is a partnership – is also formed by two categories of partners: general partners and limited partners. The former are unlimited and jointly liable for debts and obligations of the company, and the latter are only liable for the amount of their contributions. SCS limit the transfer of ownership interest to third parties, since it requires the consent of all the partners to assign ownership interest to non-partners. This vehicle is mostly interesting for investors searching for an accurate separation of the roles and responsibilities of the partners (investors) and the managers, since it is forbidden to the limited partners to participate in the management of the company. They can only assume surveillance functions and are entitled to appoint or remove the managers of the company. In the Dominican Republic, SCS and SCA are seldom used.

Finally, the Trust Law creates the trust institution (*fideicomiso)* for investment purposes, which has interesting tax incentives. One can cite the (i) tax neutrality principle (with the exception of transfer taxes); (ii) exit taxes (excluding transfer taxes which are paid up front); (iii) fiscal parity for the trust's activities (with regards to capital assets); and (iv) fiscal parity for the trustee and the beneficiary. The Trust Law has just been recently enacted and its regulations have not yet been issued; its implementation may take some time to sink in with entrepreneurs and investors.

## Selection of the vehicle

The selection of a suitable organisational vehicle to invest in private equity depends on the combination of several factors. These factors are essentially associated with: (i) tax matters; (ii) the liability of the investors; (iii) the limited or unlimited number of investors; (iv) the conditions to transfer ownership interest; (v) management flexibility; and (vi) corporate governance.

These factors can easily be analysed by comparing the different types of vehicles described above. Nevertheless, when it comes to taxation matters, the most important aspect to take into account for private equity investment purposes is to guarantee tax transparency. To be precise, an ideal private equity structure supposes that gains generated by the private equity vehicle are not taxed, and that only the distribution of profits to investors is taxed. That is the reason why it is important to highlight the taxation matters applicable to the Dominican private equity vehicles.

Regarding the taxation rules applicable to the existing private equity vehicles described herein, it must be pointed out that the Dominican Tax Code establishes that all Dominican companies must pay income tax for all net income received from Dominican source (including profits, interest, dividends and capital gains) at a 29% rate. A 1% rate in an annual basis is also applicable to the assets located on the Dominican Republic owned by companies, which is creditable against the income tax to be paid.

With respect to the taxation policy applicable to investors, distributions deriving from dividends from the private equity companies are also taxable at the level of the investors at the aforementioned income rate. Furthermore, the capital gains realised when the investors' ownership interest (shares, units, and so on) are sold or redeemed are also taxable. These rules apply whether the investors are individual Dominican citizens or Dominican companies.

With regards to taxation matters for foreign investors non-resident or non-domiciled in the Dominican Republic, according to the Tax Code, non-resident or non-domiciled persons in the Dominican Republic (whether the investors are individual or companies) must pay tax on their incomes of Dominican source (including dividends received from the Dominican corporate vehicles incorporated for private equity investment purposes) at the aforesaid 29% rate. Even when foreign investors have local taxable presence, income tax should be paid for the

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income they receive from Dominican sources. It is important to underline, however, that when investors have tax presence in the Dominican Republic, the income tax is applicable on the basis of their net income and must be paid annually, directly to the Tax Authorities. But, when the investors have no tax presence in the Dominican Republic, the income tax is withheld on a case-by-case basis, every time the investors receive income from a Dominican source, in which case such withholdings are calculated on the basis of their gross income. Individuals are deemed to have tax presence when they have domicile or residence in the Dominican Republic. In the case of companies, a presence is deemed when they have operations in the Dominican Republic, provided that in such case they would be required to obtain and maintain valid a Taxation Identification Number and a Mercantile Registry which would require filing and presentation of annual income statements to the tax authorities.

The management fees of the managers of the investment portfolios are subject to VAT at a 16% rate. When the managers are individuals the VAT (and also an income tax at a 10% rate will be withheld). When the managers are Dominican companies or companies with permanent establishment in the Dominican Republic, VAT is also applicable and must be paid directly to the tax authorities on an annual basis.

Dominican vehicles available for private equity investment purposes are all taxable entities that do not grant tax transparency. It can be concluded that, for the moment, the Dominican Republic still struggles to offer suitable and attractive structures for private equity investment. In fact, the legal system is designed to facilitate investments through offshore vehicles. That is the reason why private equity investments in the Dominican Republic generally involve the use of companies from foreign jurisdictions that offer more efficient and flexible tax and legal environments (for example, a tax haven or a country that provides exemptions from tax on capital gains and income).

**"Private equity activity has evolved from the closed investment clubs of wealthy Dominican businessmen to a younger entrepreneur class"**

### Trending now

Although is somewhat complicated to track down private equity activity in the Dominican Republic, it is undeniable that it has evolved from the closed investment clubs of the long-established wealthy Dominican businessmen to a younger and more open entrepreneur class.

Customarily, private equity investments in the Dominican Republic were made through limited liability companies or corporations acting as holding companies. As a result, the same closed clubs kept investing in Dominican operations and repatriating their benefits to offshore reserves. In the last 15 years, these traditional investors have increased their participation in the Dominican market, denoting a change in their investment strategy as well as their trust in a better-looking and much profitable investment environment in the Dominican Republic.

Over the last decade, foreign investors and private equity fund managers have endeavoured in small and large-scale transactions on Dominican soil. Initiatives worth mentioning are the acquisition in 2006 of PROSEGUROS (at such moment the third largest Dominican insurance company by market share) by Palmfund Management; the partnership created in December 2006 by Basic Energy, Citigroup, Seaboard and Soros for the acquisition of CESPM, an energy generation company; the acquisition of the full-service telecommunications provider TRICOM by Amzak Capital Management; and the 2008 acquisition of airport operator AERODOM by Advent International, a deal worth over $700 million.

Notwithstanding, the wide spectrum of new options for doing business in the Dominican Republic provided by the Companies Law, local traditional investors understand that international private equity can be attracted more effectively and efficiently if the vehicle used to invest in the country is set-up in a foreign jurisdiction. Local initiatives have begun to establish private equity funds with the intention of attracting true foreign investments to the industry sector as well as the tourism and real estate sectors. Other initiatives are vying to set up small private equity funds to promote the business ideas of low-income entrepreneurs as well as pro-bono consulting services.

Considering the opportunity that the sluggish construction market represents and the enactment of the Trust Law and its supporting regulation, the inception of formal construction private equity funds and, further down the road, the setting up of the first infrastructure fund in the country with the possibility of using its ventures in the Dominican Republic as a launch pad for the local and foreign reconstruction efforts in Haiti, is not implausible. Initiatives such as Grupo Odinsa's investment in the Boulevard Turístico del Atlántico for the construction of the toll road Nagua-Sanchez-Samana-El Limon-Las Terrenas and the Autopista del Nordeste, a toll road connecting Santo Domingo and Samaná, are cases of investment in infrastructure projects in the Dominican Republic. Additional opportunities are presented under the incentive regimes created under the Tourism Promotion Law and the Renewable Energy Promotion Law. The USD$35 million investment of Portland Private Equity in the Las Olas project of the Metro Group and the conversion of CESPM diesel plant to natural gas by CESPM Holdings are example of the multiple opportunities created under said laws.

Another investment opportunity in the country could be found in the obligation imposed on the government by the Dominican Constitution of investing at least 4% of GDP in the education sector. Although not very attractive for short-term investments, a private equity fund involved in promoting investment in the education sector, with the collaboration of the Dominican government, could potentially raise capital for the construction of schools, the development of advanced educational technology and software for distance teaching and virtual learning, so as to reach the isolated countryside community.

A novel opportunity is the incentive regime created by the recently enacted Cinema Law. Even though the movie industry is considered by many as very risky and volatile and the possibility of developing flops is very high, producing a blockbuster in the Dominican Republic could reap the income tax deductions and transferable tax credit created by the Cinema Law.