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ESTABLISHING A BUSINESS ENTITY IN COLOMBIA

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ESTABLISHING A BUSINESS ENTITY IN COLOMBIA

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1. Preliminary Considerations:

In Colombia, a foreign company is able to act and do business by itself, for example, by contracting with local entities or investing foreign currencies. Entering contracts, such as joint ventures, with local corporations or persons, depends on commercial negotiations, more than on legal requirements. Foreign investment, on the other hand, is subject to different regulations and the Central Bank supervises the activities (more information below). However, when a foreign company not only has investments in Colombia, but also desires to perform "Permanent Activities" in its territory, legal provisions require it to establish a branch or a subsidiary in Colombia (Article 471 of the Commercial Code). Colombian legal provisions do not provide general criteria for what should be understood as "Permanente Activities", however article 474 of the Commercial Code contemplates a list of activities that are considered as permanent, which are:

1. "Opening commercial establishments or business offices, even if they only provide technical or consulting services.
2. Intervene as a Contractor in the execution of works such as a construction, or rendering of services.

3. Participate in any way in activities of management, use or investment of funds from private savings.
4. Engaging in the resources extraction industry and/or any of its areas or services.
5. Obtain from the Colombian Government a concession, being assigned a concession or participate in the exploitation of one.
6. The conduction of shareholders' meetings, boards of directors, management or administration in the national territory”.

The performance of any of the above activities usually implies the execution of other related activities such as hiring employees, owning or renting physical premises and other services, which suggests that there is an intention of conducting permanent activities in Colombia. This will result in the obligation to constitute a branch or a subsidiary company in Colombia. In both of these scenarios the local vehicle will necessarily have to observe Colombian provisions, which include compliance with capital contributions and dividend distributions. A capital contribution or the designation of an amount of assigned capital is simply a contribution of capital, in the form of money or property. A dividend distribution refers to the distribution to the parent company or shareholders of the local vehicle, of its net profits earned in the last financial year, after deducting any reserves or deficit carried forward from earlier years.

2. Elements of a Branch Office:

First, we would like to establish that a branch office is not considered an independent legal entity, but an extension or commercial establishment of its home office. The branch is considered as a legal entity, which for purposes of its activity has to comply with all Colombian regulations. Taking this into consideration, under Colombian provisions, the establishment of a branch office will require the assignment of the following elements: (i) the purpose of the company, which in Colombia is known as “objeto social;” (ii) the domicile of the company; (iii) the term of duration of the branch office and the causes for termination; (iv) an initial Capital Contribution to the branch office, which must be paid in full when it is first established; (v) designation of a general agent with one or more alternates, whom will represent the company in all of the business deals to be celebrated in Colombia; (vi) designation of an auditor, whom must reside permanently in Colombia.

The capital contribution will not be understood as the payment of equity as in an ordinary subsidiary, but it will enter the branch assigned capital for the development of its operations. The designation of the amount of assigned capital must be paid in full when it is first established and since its source is a foreign company it will be considered as a foreign investment and as such it must comply with the obligatory registration in the Bank of the Republic within the next three months, since the reimbursement of the assets is effectuated. There is no minimum capital required for the incorporation of an Office branch in Colombia, however any increase of the assigned capital of a branch requires an amendment of the incorporation document by the pertinent corporate body abroad. The amended document must be formalized by a public deed in Colombia. However, the branch may alternatively receive supplementary investment to its assigned capital from its home office abroad. In this case, the supplementary investment does not alter the assigned capital of the branch and therefore does not require an amendment to the incorporation document. The funds will be registered in the branch's "supplementary investment to assigned capital" account, which is managed as a current account between the branch and its home office. The only formality required is the registration of all supplementary investments received from the home office in the preceding financial year, which in conclusion results in a very easy method to finance the office branch. Please note that Article 490 of the Commercial Code establishes that in no case the effective capital of the branch may decrease to an amount inferior to 50% of its assigned capital.

For the distribution of dividends, since the branch office is not an entity with independent judicial capacity but an extension of the foreign company, there is not a dividend distribution as such, but a distribution of its net profits at the end of the corresponding financial year, prior approval of the applicable superintendence (Article 496 of the Commercial Code). These net profits may only be disbursed if the branch has complied with the legal reserve provision established in article 452 of the Commercial Code.

3. Elements of a Subsidiary Company

For the establishment of a subsidiary company, the investor must choose the appropriate corporate form. Colombian provisions establish several forms of association. However, it is common for foreign investors to take the form of a limited liability company, a simplified shareholding company or a corporation as a mechanism for their activities in Colombia. Nonetheless, for tax purposes abroad, sometimes investors prefer to adopt corporate forms that relate to collective associations, such as the "company limited by shares" (Sociedad encomandita por acciones). The main characteristics of all these entities are described below.

(i) Corporation (Sociedad Anónima – S.A)

Under Colombian provisions, the establishment of a Corporation will require the assignment of the following elements: (i) the purpose of the company which in Colombia is known as "objeto social;" (ii) the domicile of the company; (iii) the term of duration and the causes for termination; (iv) Capital Contributions (v) Corporate bodies: Board of Director and Legal Representative; (vi) designation of an auditor.

Corporations "S.A." must be created with at least five (5) shareholders, none of which may own ninety-five percent (95%) or more of the share capital at one time. The liability of shareholders is limited to the amount of their capital contributions, which are represented by shares.

The capital of the corporation is divided into shares of equal value and is classified in three categories: (i) authorized or stated capital, which represents the total number of subscribed shares plus the number of shares that are in reserve, if any; (ii) subscribed capital, which represents the shares that have been issued to the shareholders, and may never exceed the corporation's authorized capital. Any issuance of shares over and above the authorized capital requires a prior increase in authorized capital by an amendment to the bylaws; (ii) paid-in capital, which represents the shares paid by the shareholders. Upon incorporation of a corporation, at least 50% of the authorized capital must be subscribed for, and at least one-third of the value of the issued shares must be paid. The remainder must be paid within a one-year period. Further increases of authorized capital do not require subscription of any particular percentage of capital.

At the ordinary annual general meeting, the board of directors submits the financial statements of the corporation for the previous fiscal year to the shareholders for approval. Once they have approved the financial statements, the shareholders determine the allocation of the corporation's distributable profits, if any, for the preceding year. Ten percent (10%) of the corporation's net profits must be allocated to a legal reserve until such reserve reaches an amount equal to at least 50% of the subscribed capital of the corporation. The remainder of the net profits if any, is allocated as determined in the bylaws or by the shareholders and may be distributed as dividends. The corporation must distribute as dividend at least 50% of its annual profits, unless 78% of the shareholders vote otherwise. If the total amount of all the reserves of the corporation exceeds the corporation's outstanding capital, it must distribute 70% of its annual profits. No dividends shall be distributed if previous losses that affect the capital have not been met. The dividend payment will be in cash, however, the dividend may be paid in the form of bonus shares of the same company, if so provided by decision of the general assembly by a vote of eighty percent of the shares represented.

(ii) Company Limited by Shares (Sociedad en comandita por acciones)

Under Colombian provisions, the establishment of a Company Limited by Shares will require the assignment of the following elements: (i) the purpose of the company which in Colombia is known as "objeto social;" (ii) the domicile of the company; (iii) The term of duration and the causes for termination; (iv) Capital Contributions (v) Corporate bodies: Legal Representative; (vi) designate an auditor.

This type of structure has two groups of partners: managers and limited partners. Managers are responsible for the administration of the entity, while the limited partners make capital contributions in order to finance the needs of the entity. The managing partners are jointly responsible for the operations of the company, while the liability of limited partners is limited to the sum of its corporate contributions. The capital once again, is divided into the same three categories mentioned above. The capital will be conformed with the contributions of the limited partners or with those of these joined simultaneously with those from the managing partners. Upon incorporation of a corporation, at least 50% of the authorized capital must be subscribed for, and at least one-third of the value of the issued shares must be paid. The remainder must be paid within a one-year period.

Regarding the profits and distribution of dividends, the same process mentioned above applies. Specifically, corporate profits are distributed among the managing partners and limited liability partners in the manner stipulated in the contract. Where not specified, profits are distributed among the limited partners in proportion to their shares, but the benefit of the managing partners must be met first.

(iii) Limited Liability Company

Under Colombian provisions, the establishment of a Limited Liability Company will require the assignment of the following elements: (i) the purpose of the company which in Colombia is known as "objeto social;" (ii) the domicile of the company; (iii) the term of duration and the causes for termination; (iv)

Capital Contributions (v) Corporate bodies: Legal Representative and Board of Directors (not mandatory) (vi) designation of an auditor, if the assets or income of the company exceed certain limits established by law (i.e., if the gross assets of the company at the end of the preceding year exceed or are equal to 5,000 minimum legal wages, or if its gross income in the preceding year exceeds or is equal to 3,000 minimum legal wages.) The capital, once again, is divided into the same three categories mentioned above. The capital of the company is divided into shares of equal value. The capital of the company must be entirely paid-in on incorporation and every time a capitalization takes place the corresponding article of the bylaws must be amended. Such an amendment must be formalized by means of a public deed and the amount of capitalization must be paid upon the formalization of the decision. Partners are entitled to transfer their shares, but all other partners have a statutory right of first refusal, proportional to their existing participation, unless the bylaws provide otherwise. In other words, the partners shall have the preferential right to acquire the outstanding shares of the company on a first basis, whenever the other partners decide to sell its stake. As a general rule, the liability of the partners is limited to the amount of their capital contribution, however Colombian labor provisions establish that, the partners will be jointly liable for the employment obligations towards the company's employees; and tax laws provide that partners of a limited liability company are jointly liable for all the income tax obligations of the company.

Regarding the profits and distribution of dividends the same rules mentioned for Corporations will apply.

(iv) Simplified Shareholding Company (S.A.S: Sociedad por Acciones Simplificadas):

Under Colombian provisions, the establishment of a Simplified Shareholding Company will require the assignment of the following elements: (i) the purpose of the company which in Colombia is known as "objeto social;" (ii) the domicile of the company; (iii) the term of duration which in this case may be indefinite, and the causes for termination; (iv) Capital Contributions (v) Corporate bodies: at least a Legal Representative (vi) designation of an auditor, only if the assets or income of the company exceed the limits established by law, which were mentioned above. In this case there is no minimum or maximum of shareholders required. This corporate structure foresees the possibility of having only one (1) shareholder. The liability of shareholders is limited to the amount of their capital contributions, which is represented by shares.

The capital, once again, is divided into the same three categories mentioned above. It will be divided into shares of equal value. In this particular case, there are no limits imposed on capital ratios in order for shareholders to subscribe and pay it. However, a deadline is imposed regarding the payment of subscribed shares, for which they must be fully payed in the term of two (2) years following the incorporation. This is an advantage offered by this type of corporation, as it provides a generous window for the payment of capital contributions. Regarding the dividend distribution, in this type of corporation, freedom is the general rule. It is permitted to establish in the bylaws of the corporation the rules that you consider should apply for dividend distributions. For example, you might stipulate that there will be no dividend distributions. In these types of corporations there is no legal obligation to create legal reserves. Finally, Colombian provisions have established that in the event of absence of regulation regarding any subject for this type of corporations, one must apply the regulations set forward for Corporations (Sociedad Anonima.)

If the subsidiary requires additional funding for the development of its operations in Colombian, it can always issue new shares, and/or receive funds from the parent company through an intercompany loan. Every year, at the compulsory ordinary shareholders meeting, the board of directors or the legal representative, as applicable, shall submit the financial statements of the subsidiary for the previous fiscal year for approval. Once approved, the shareholders determine the allocation of the corporation's distributable profits, if any, for the preceding year. Without prejudice of the before, 10% of the corporation's net profits must be allocated to a legal reserve until such reserve reaches an amount equal to at least 50% of the subscribed capital of the corporation. The remainder of the net profits if any, is allocated as determined in the by-laws or by the shareholders, and thereafter it may be distributed as dividends. The corporation must distribute as dividends at least 50% of its annual profits, unless 78% of the shareholders vote otherwise. If the total amount of all the reserves of the corporation exceeds the corporation's outstanding capital, it must distribute 70% of its annual profits. No dividends shall be distributed if previous losses that affect the capital have not been covered. The payment of dividends shall be in cash, except stated otherwise by the shareholders in the corresponding meeting. In the event of a sole shareholder the above stated majorities would not be relevant.

4. Exchange regime compliance:

All payments for capital contributions, for both the assigned capital of the branch and the subscribed and paid capital of the subsidiary, are considered a foreign direct investment and as such must be registered before the Central Bank under Form No. 4. In the event funds are brought as debt they must also be registered before the Central Bank, but in this case under Forms No. 3 and 6. Form No. 6 is particularly used when the funds are brought as Contributions for future capitalizations.

The profits and dividends to be distributed and thereafter paid to the parent company also need to be registered before the Central Bank, under Form No. 4 as a disbursement.

Additionally, every year before the 15th of July or August, relying on the last number of the Tax Identification Number (NIT, as in Spanish), both the branch and the subsidiary need to present Form No. 15 before the Central Bank informing of their current foreign investment status. Companies must not comply the aforementioned requirement in the following cases: (i) Companies required to present their financial statements to the Superintendence, (ii) whenever there are no modifications in the foreign investment, (iii) companies in a winding-up process, (iv) companies with no foreign investment registered before the Central Bank.

5. Conclusions and Recommendations:

In order to determine which mechanism is the best for doing business in Colombia, the first consideration that shall be made is if the activities that will be executed are permanent or not. If they are, the foreign company should evaluate whether a branch or a subsidiary best suits the company's purposes and structure.

The most common entities for commercial purposes are the Simplified Shareholding

Company (S.A.S). This entity has a clear division between capital and responsibility, limiting, as a general rule, the liability of the investor to the amount of its participation.

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This memorandum is for information purposes only and reflects the law on September 2018. Under no account can it be considered as either a legal opinion or advice on how to proceed in particular cases or on how to assess them.

If you need any further information on the issues covered by this memorandum, please contact Mr. Daniel Garcia Piñeros (dgarcia@vgcd.co).