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Current Notes and Comments

Colombia's Tax Reform and Its Effect on Foreign Businesses

The Republic of Colombia has recently undertaken a fairly substantial overhaul of its income and complementary tax system. The purpose of the reform has been to inject a more equitable distribution of the tax burden among the various economic strata, which has been translated into not only increasing the burden on upper-bracket taxpayers but also improving the collection process. In some ways the system has been rendered more simple by, among other things, eliminating such minor taxes as the Special Housing Tax and Electrical Development tax as well as the once-dreaded excess profits tax. But the system has also picked up what will at least for the short run be a bit of complexity. This is mainly due to the introduction of some new concepts and the resultant first stage uncertainties as to the consequences of the interaction of these with the more traditional rules. Among the new concepts are taxes on "occasional income" (capital gains) tax discounts (credits), a new presumptive tax and operating loss carryovers.

Not untouched by the reform are the various aspects of the income tax law which are of prime concern to foreign business enterprises which do business with or in Colombia, as well as to both resident and non-resident aliens. In this article we propose to take a brief look at some of these areas of the new tax laws.

I. Scope of Foreigner's Liability

The new tax law has carried over the distinction between individual foreigners and foreign legal entities. Aliens are taxable only on their Colombian source income.[1] However, an alien who resides in Colombia will find his worldwide

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[1]Art. 11, Decree 2053, September 30, 1974.

income subjected to Colombian taxes commencing with the fifth year or tax period of continuous or discontinuous residence in the country. However since "residence" is defined to mean continued stay in the country for six or more months, then exposure of an alien's worldwide income to Colombian taxes does not materialize until 5½ years of residence.[2]

Legal entities which are foreign to Colombia are taxed only on their Colombian source income.[3] To be considered foreign an entity must have been set up under the laws of a foreign country and also have its principal place of business outside Colombia.[4]

The source of income rules are for the most part unaltered in substance, from the pre-reform rules. There is one salient exception to this. Any payments for services performed in connection with a technical assistance agreement are considered Colombian sourced irrespective of whether the services are performed within or outside the country.[5]

II. Withholding Taxes

This is an area in which the reform has introduced major innovations. Foreign legal entities which have neither a domicile in the country nor an appointed agent will have a 40 percent withholding applied to a taxable income paid to them.[6] Normally, foreign entities would be subject to a 40 percent tax on Colombian source income; however, it would not be retained by the payor hence would benefit from the various allowable deductions. A withholding tax does not allow for deductions, it is a flat rate. When the type of income being received by the foreign entity is dividends, the withholding tax can be halved, *i.e.*, it becomes 20 percent, if the foreign entity proves one of two facts:[7]

a. That the dividends received are taxed at a rate of 30 percent or more in its jurisdiction of incorporation, or,
b. That 75 percent or more of its shares are held by non-resident foreign aliens.

Individuals who are foreigners who do not have a domicile nor are required to have an agent in Colombia must pay a 40 percent withholding tax.[8] If an agent is appointed, the individual becomes subject to a tax at the normal graduated tax rates which in many cases would be lower than a flat 40 percent. The idea

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[2]Art. 12, Decree 2053.
[3]Art. 13, Decree 2053.
[4]Art. 6, Decree 2053.
[5]Art. 14(7), Decree 2053, Art. 16, Decree 187, February 8, 1975.
[6]Art. 134, Decree 2053: according to this rule the remittance of branch profits to the home office would not be subject to withholding taxes.
[7]Art. 69, Decree 2247, October 21, 1974.
[8]Art. 83, Decree 2053.

supporting this rule is that the presence of an agent in the country is a guarantee of payment of taxes since the agent is jointly liable with the taxpayer for both the filing of a return and payment of the tax.[9]

Some initial confusion was caused by this provision, which permits both foreign entities and individuals to avoid the 40 percent flat withholding tax by naming an agent in the country. Questions arose as to whether any such person or entity could name an agent, the scope of power with which the agent had to be entrusted, and other possible consequences of naming an agent. Under recently issued regulations, many of these questions have been answered at least with respect to non-resident aliens.[10]

According to the regulations only those non-resident aliens who, pursuant to Article 477 of the Commercial Code, are required to appoint an agent in Colombia may do so for the purposes of avoiding the 40 percent withholding tax.[11] Commercial Code Article 477 states that non-resident aliens who intend to carry on permanent business in Colombia must appoint an agent or attorney-in-fact. In order that the appointment be sufficient to eliminate the 40 percent withholding tax the following complementary requisites must be met:

a) the agent must be granted general powers to represent the taxpayer in all of his planned business activities in the country including the power to answer for all of the taxpayer's tax obligations.

b) the agent must be permanently resident in Colombia, though there is no requirement as to nationality.

c) the appointment of the agent must be accomplished prior to the time the Colombian source income against which the withholding tax is to be applied is actually paid or credited to the non-resident alien.

d) due notice of the appointment of the agent must be given to the party responsible for withholding the taxpayer's tax before the withholding is to be effectuated.

III. Remittance Taxes

Upon the transfer of income or profits abroad a complementary transfer tax is payable on the face amount being transferred. The normal rate is 12 percent.[12] Branch remittances of profits are taxed at the higher rate of 20 percent.[13] On

[9]Art. 1, Decree 2821, December 23, 1974.

[10]It is assumed the regulation rules also apply to foreign nondomiciled legal entities although specific reference is made only to aliens. Article 14 of Decree 187 suggests the correctness of this assumption.

[11]Art. 12, Decree 187/75.

[12]Art. 130, Decree 2053.

[13]Art. 71, Decree 2247.

the other hand remittances of dividends are not subjected to any such tax.[14] Since the branch operation is subject to the same 40 percent tax rate as is a locally incorporated subsidiary, clearly the subsidiary form enjoys the overall advantage because of the tax-free remittance rule on dividends.

The same tax free remittance treatment is afforded to interest on loans registered with the central bank.[15]

IV. Some Innovative Source of Income Rules

The new reform legislation rules on source of income for the most part remain substantially unchanged from the rules under prior law. In general if the income in question derives in some way from an occurence emanating territorially (work performed, products manufactured in Colombia) or a *res* (land, personal property) located in the country, the income is labeled Colombian. There are three sizeable exceptions to these fairly orthodox rules. They are exceptions in the sense that the income involved is treated as Colombian though neither an activity nor *res* is located in the country.

For those doing business with Colombia the most important and most disquieting rule concerns the performance of technical assistance services outside Colombian territory. Payments for these are deemed Colombian sourced and hence taxable even though the supplier has no residence or other presence in the country.[16] This exceptional rule is based solely on the nature of the income producing activity without regard to the person who conducts it or the place where it transpires.

The other two innovative rules are based on the fact that the recipient is located in Colombia or on the identity of the payor. In the first case, income from an annuity is considered Colombian if the recipient is resident in the country.[17] This would seem to cover alien retirees who receive pension payments from outside Colombia. The second situation concerns all compensation paid by the Colombian government for services,[18] irrespective of where the services are performed, the nature of the services, or the identity of the payee.

V. New Tax Rates

Important changes introduced into the law involve the new tax rates themselves. Company rates have been simplified down to a flat percentage.

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[14]*Ibid.*
[15]*Ibid.*
[16]Art. 14(7), Decree 2053. This is probably one of the several effects growing out of Colombia's efforts to harmonize, support and complement the Andean Pact foreign investment rules which have spawned an array of restrictive and selective rules on the transfers of technology.
[17]Art. 14(10), Decree 2053.
[18]Art. 14(6), Decree 2053.

Individual rates continue to be based on a graduated scale, with higher rates being introduced for the upper brackets.

Tax Rates

40%	20%	10-56%
• Corporations • Share issuing limited liability partnerships • De facto corporations • State owned enterprises • Foreign companies of all types • Non-resident aliens who have not appointed an agent in Colombia • Dividends, interest and other payments from bearer instruments.	• Limited liability companies • General partnerships • Ordinary mining companies • Private foundations and profit-seeking associations	• Colombian citizens • Resident aliens • Non-resident aliens who have named an agent in Colombia • Successions of resident aliens

VI. Deductibility of Expenses Incurred Abroad

Under prior tax laws expenses incurred outside Colombia were generally deductible by the taxpayer, provided the relationship between the expense and Colombian taxable income were shown. An all-important exception was expenses incurred by a branch subsidiary or agency with its parent or home office.

The tax reform provisions have carried forward the general rule of deductibility but have limited the overall amount of foreign incurred expenses regardless of the relationship of the creditor to the taxpayer, to 10 percent of the latter's net taxable income calculated before considering these expenses.[19] There are two important conditions which must be met before the expenses may be deducted. First, the taxpayer must give a detailed account of the expenses, which must be certified by the taxpayer's fiscal auditor or by an accountant, and in which it is stated that the expenses (i) have been duly recorded on the taxpayer's books and (ii) are supported by outside receipts.[20] Secondly, the taxpayer must furnish receipts showing that any income tax payable had been in fact paid, when the payment qualifies as taxable Colombian source income for the recipient.[21]

VII. Accrual of Transfer Prices and Costs

Perhaps one of the most important provisions of the tax reform is the one

[19] Art. 64, Decree 2053.
[20] *Ibid.*
[21] *Ibid.*

which empowers the tax authorities to scrutinize declared prices of transfers in order to uncover deceptive pricing policies. In countries such as Colombia where companies face not only fairly high taxes but also exchange control regulations which require exporters to turn over to the central bank all export-produced foreign exchange, there is a natural temptation to make one's profits outside the country. This is accomplished by exporting the company's products to a related foreign company at an artificially low price. The foreign company would then raise the price on its re-sale and thus remove the bulk of the profit beyond the reach of the exporting country's tax authorities.

In order to exercise better control over these types of practices, the reform laws have granted the tax authorities greater discretionary powers. The law starts with the proposition that the price of any transfer is deemed to be equal to the products' commercial value.[22] The commercial value will be taken to be the price which the transferor and transferee have agreed to. However, if the latter deviates "notoriously" from the real commercial value existing on the day of sale, then the real value will be taken as the contract price. A notorious deviation is presumed *ipso facto* to exist when the commercial value is over 25 percent of the contract price.[23] In order to ascertain the commercial value of the product the law authorizes reference to data furnished by various government agencies. Presumably, the contract price of a product may be up to 25 percent under its commercial value and still be acceptable since it does not by definition "notoriously differ" from the latter. Another way which has been open to taxpayers to understate the profits on a sale or other type of transfer has been to overstate the cost of the product sold. Obviously, the tax effect is similar to that resulting from understating the transfer price. Under the reform laws when the tax authorities find "*indicie*" that the cost reported by the taxpayer is not "real," or when the cost is unknown, the director of income taxes is authorized to fix the real cost.[24] To do this he must first consider any and all direct proof such as the taxpayer's past tax returns, those of a third party, and all accounting receipts. If this type of direct proof is unavoidable or from it is not possible to determine the real cost, then the director is allowed to consider indirect or parallel data. This includes costs incurred by other persons during the same period in the same type of activity. Data from various government agencies may also be taken into account.

If none of these procedures proves possible or do not give the real cost, then the cost will be presumed to amount to 75 percent of the value (price) of the transaction.[25]

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[22]Art. 19, Decree 2053.

[23]Art. 76, Decree 2247: when the item transferred is real property the transfer price acceptable to the tax authorities may not be less than its cost or *catastral* (tax) value.

[24]Article 31, Decree 2053.

[25]In this case the taxpayer may be subject to penalties for filing an inaccurate return or for maintaining incomplete books.

VIII. Deductibility of Royalties on Trademark and Patents and Technology Transfers

We have pointed out earlier that there is a perceivable effort on the part of the drafters of the reform tax laws to employ some of the provisions to reinforce or complement non-tax rules laid down in other laws.[26] This is certainly true in the area of royalties paid for imported technology and foreign trademarks and patents. Article 67 of Decree 187—the first major set of regulations issued on the tax reform laws—states very clearly that in order for royalties to be acceptable as deductions it will be necessary to show more than the fact that they were incurred by necessity, and in proportion to the income-generating activity involved, *i.e.*, the general rule for testing deductibility.[27] Article 67 requires an additional showing that the contract under which the trademark or patent is licensed or the technology is transferred, has been duly authorized by the government's official, competent agency or organ as called for under Article 18 of the Statute for the Common Treatment of Foreign Capital and Trademarks, Patents, Licenses and Royalties. The reference here is to the well-known Decision 24 of the Andean Pact Commission. Furthermore, Article 67 adds that in conformity to the provisions of Article 21 of the Statute on Common Treatment of Foreign Capital no deduction will be allowed when the royalties are paid by a company to its foreign main office or to any company subordinated to that foreign home office.

The question which arises regarding Article 67 is its constitutionality. As pointed out, this Article is part of the first set of regulations issued on the tax reform laws. Nowhere in those laws may reference be found to the restrictions contained in Article 67. It is quite likely that the constitutionality of Article 67 will soon be tested before the Colombian Council of State.

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[26] *See supra*, note 16.
[27] *See* Article 45, Decree 2053.