

Global Tax Briefing

Vol. 8, Issue No. 2 March 30, 2006

INSIDE

- 1 Costa Rica
- 4 Argentina
- 7 Bolivia
- 9 Brazil
- 11 Chile
- 13 Columbia
- 15 Ecuador
- 18 Mexico
- 19 Peru
- 21 Uruguay

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Tax Reform in Costa Rica: An isolated move or the beginning of a Central American trend?

By Eric Thompson Chacón, Managing Partner, Faycatax, Tax Department Facio & Cañas, San José, Costa Rica.

Introduction

Costa Rica is the oldest uninterrupted democracy in Latin America, and its political stability has been a major asset for attraction of foreign direct investment. The consolidation of a welfare state in the second half of the 20th century and a dynamic economy have served to achieve high social development indicators--health, education, infrastructure, etc.--even compared to some so-called "First World Countries" standards, but the historical cost has been the growth of a complex bureaucracy, which represents a heavy burden to the economy. Our country has accumulated high levels of Government debt due to recurrent fiscal deficits, and the interest payments on governmental debt reaches approximately 30 cents out of every monetary unit ("Colón") of revenue. The tax burden on GDP, by comparison to similar countries

in terms of state of development and per capita income, is arguably low, moving in recent years towards the 13% figure. This delicate financial scenario clearly leads to tax reform, especially in the absence of a privatization program and strong measures that erode the inflexible public expenditures structure. Since 2002, the slow advancement of the Tax Reform Bill has been a constant issue in the relationship between the Costa Rican government and the international financial community, and its recent approval in the Congress¹ is an important sign of macroeconomic stability for the upcoming new Administration, beginning on May 8, 2006.

Tax Reform History and Process

The Bill is based on the recommendations given by a committee of former ministers of finance appointed by the Rodriguez ad-

ministration. This report was supported by the subsequent Pacheco Administration, and it included an Annex with the original text of the Bill. A special legislative commission was later formed to oversee this project. Two main technical attacks have been made to the Tax Bill throughout these four years:

- The drafting decision to take Spanish legislation as a model, both for the Income Tax Law and the Value Added Tax Law. Keep in mind that the Costa Rican tax legislation drafting style has been a blend of South American tax drafting style (going back to the 1970's) and local drafting. The new law would bring European-style terminology that would require an intense retraining for tax officials and taxpayers.
- The use of sophisticated international standards with no clear revenue impact but higher compliance costs. This area of criticism is clearly referring to the proposed change to a worldwide income taxation system in a country that is a net importer of capital. In the VAT area, some new mechanisms cause concern over increased complexity for taxpayers.

However, the Ministry of Finance prevailed with the argument of the need to update domestic law with international best practices, achieving a reinforced structure of

cross-controls that helps to minimize non-compliance and tax evasion, and eliminating any residual categorization of Costa Rica as a tax-haven jurisdiction.²

The New Income Tax Law

Structure of Taxes. There will be three categories of income taxes: (1) Corporate Income Tax (Residents); (2) Personal Income Tax (Residents); and (3) Non Residents Income Tax.

Tax Rates. (a) The corporate income tax rate is 30%, with a gradual reduction up to 2010 leading to a 25% rate. There is a special treatment for small business entities, having an income bracket up to approximately US\$16000 with a 10% rate, and a Simplified Regime with a 12% tax rate. There is a new "Pioneer Status Regime" that would allow a preferential 15% rate for companies characterized as having technological value or providing substantial employment generation, and was conceived to attract foreign direct investment.

(b) In the case of individuals, the personal income tax has a progressive schedule that ends with a top marginal rate of 30%, not subject to a future reduction.³

(c) The nonresidents income tax is composed of a permanent establishment tax of 30% that includes restrictions on deductibility of expenses related

to Headquarters, and a set of withholding taxes having a top rate of 25%.

Corporate Income Tax Exemptions. Nonprofit organizations, a myriad of public entities, and the preferential treatment of cooperatives—full exemption for strictly "cooperative transactions", taxable income for transactions with third parties—are the main exemptions.

Worldwide Income Taxation. Costa Rica adopts the resident principle and allows the exemption method for resident companies with substantial activities abroad through permanent establishments. For companies that accumulate capital of foreign origin, the corresponding income is tax-

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Senior Editor

Jerome Nestor

Designer

Craig Arritola

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able upon effective repatriation. For any non-territorial taxable income, the foreign tax credit method is generally available.

Corporate Income Tax Base. In terms of gross income, the tax base is enlarged with the inclusion of isolated capital gains and financial investment income. The deductible expenses structure is essentially maintained with some specific adjustments.

Tax Compliance. The main change is the adoption of the calendar year as the ordinary tax year, beginning January 1, 2007, and the generalization of a withholding system that generates advanced payments of the corporate income tax.

New Value Added Tax Law

Taxpayers. The new law covers business entities and professionals, and any frequent or isolated importer of goods.

Taxation of Goods and Services. The most important reform in the tax bill is the wider coverage of the VAT. Accordingly, the law mandates the taxation of every good and service, with a list of exempted goods and services, mainly composed of merit items to prevent impact on poor people, and goods and services produced or performed by public entities. For the first time, independent professional services, construction services, intangible assets use and rents of different goods or assets will be taxed, including services paid to nonresidents that are performed in Costa Rica.

Tax Rates. The general rate is 13%, but there is a preferential rate of 6% for the following list of goods and services: water and residential energy, rents, health, construction, private security and professional services. The zero-rating system for exporters of goods and services applies.

Tax Base. The general system of comparing tax paid and tax collected for the monthly VAT accounting is followed with additional technical fine print. The main and important innovation is the application of the “financial deduc-

tion criteria” to accept most of the VAT paid in purchases, in contrast with the traditional restrictive approach that insisted in “physical incorporation” of raw materials or other inputs to the production of goods and services in order to allow the deduction of VAT paid. In this respect, this adjustment really helps to assure the value-added methodology.

Tax Compliance. The traditional system of a monthly tax return continues. A sensitive issue is the need for keeping track of proportions of tax credits in the case of depreciable assets that are sold before the end of its useful life or assets that are not fully used in business activities, which represents a specific accounting and the prospect of producing some number of amendments of tax returns over time to pay VAT differences.

Repercussions in the Central American Region

It would be fair to say that upon entry-into-force of this new law, Costa Rica would have the most sophisticated and far-reaching income and VAT in the Central American region, and such taxes would require a very efficient tax administration, whose legal powers have been reinforced through the introduction of an administrative collection system that reduces the participation of the courts. There are some variables that should determine if this updated model could be a role model for the rest of Central America:

- The pending confirmation of the Costa Rican tax policy to attract foreign direct investment upon the dismantling of tax exemptions by 2010 due to the WTO policy of progressive elimination of subsidies to exports. It is foreseeable that this WTO policy would include free zone regimes throughout Central America.
- The consolidation of a Customs Union in Central America, which currently shows a more advanced process in Guatemala, Honduras and El Salvador.
- The gradual movement towards tax harmonization in Central America that could lead to a harmonized VAT, and a potential tax treaty

with the USA in the aftermath of the CAFTA-DR implementation.

- The aggressive regional strategies of corporations, both of Central American capital or foreign capital, that would welcome initiatives to harmonize and simplify the current tax systems.
- The strategic position of Panama as an important international trade and financial center, with a strict territorial system that is considered frequently abroad as a cornerstone of a tax-haven jurisdiction. One of the direct consequences of the enactment of new tax legislation in Costa Rica is the imminent categorization of Panama as a tax haven, and the application of restrictive measures against tax-planning strategies.

Conclusions

In the context of globalization and the need of reinforcement of regional blocs of trade, I believe that the Costa Rican tax reform would have a direct influence in the trend towards harmonization in Central America. However, it is probable that the Spanish-European recipe that was used will be seasoned in the future with USA and Mexican technical ingredients, due to the connections of both countries with the Central American

economies. Also, we could not discount some technical influence from recent South American tax reforms. In any case, the short-term dilemma is to implement a new technical model, and for us as tax advisers to alleviate a difficult transition for the private sector. ♦

Endnotes

- 1 The legislative approval requires two votes, the first was done on February 19, 2006, and the second and definitive vote is currently postponed due to a pending consultation to the Constitutional Court. Assuming that the Court would validate the legislative procedure used for this Bill, is highly likely that the second affirmative vote would be done during April and the current President Pacheco will sign the new Law before leaving office.
- 2 By OECD standards, Costa Rica has not been included in tax havens lists due to the existence of an ordinary income tax with a general set of withholding taxes for foreign remittances, the existence of a sound penalties system and the subscription in 1990 of an Exchange of Information Agreement with USA, the only tax treaty currently in force apart from Central American Customs Treaties.
- 3 For individuals, it is estimated that everyone that has monthly income below US\$ 2400 would be paying less than current tax. Obviously, the tax burden will be felt through the increased coverage of VAT. In contrast, professionals and executives earning more than such figure will be experiencing a direct impact, because the top marginal rate will be raised up to 30%.

Argentina

By Cristian E. Rosso Alba and Florencia Ortiz Rosso Alba, Francia & Ruiz Moreno, Buenos Aires, Argentina

Final Withholding Foreign Partnership, Trust and Qualified Intermediary Agreements Modified

The second half of 2005 has been an active one, at least from the point of view of the fiscal authorities, especially in areas such as: (1) tax-free reorganizations, where numerous rulings have defined the legal scope of these transactions, (2) transfer of technology contracts, and (3) tax exemptions on negotiable bonds, where a discussion held last year nationally is now being held locally regarding the gross turnover tax. Finally,

there has been no reinstatement of inflationary adjustments or amendments of income tax brackets or categories, despite increasing inflation rates. These and other issues set the trend for 2006.

Reorganizations. Rulings issued by the legal and technical divisions of the IRS have stated that a capital reduction is not a tax-free reorganization since there is no ongoing concern transferred to shareholders. They have also stated that the conversion of entity types is not a tax-free reorganization but does imply an irregular fiscal pe-

riod (for the purpose of computing the five-year statute of limitations for use of NOL's). Another ruling stated that the purchase of assets in and of itself does not constitute a tax-free reorganization, and that the authorization granted by the Central Bank does not obviate the need for the registration before the Superintendence of Corporations. Finally, reference must be made to certain rulings favorable to the taxpayer. The Tax Court ruling in *International Engines South America S.A* held that tax-free reorganizations of economic groups do not have to comply with the requirement of "having maintained the same activity in the twelve months prior to the reorganization".

Tax Exemptions on Negotiable Bonds. Another heated debate concerned the tax exemption on negotiable bonds. Last year, following a joint resolution on public offerings of tax-exempt, debt securities published by the local SEC and the local IRS, a debate arose on national grounds as to the exemption. This resolution redefined the concept of public offerings of tax-exempt debt securities and settled a number of open issues which have been the subject of countless disputes between AFIP and the tax-exempt beneficiaries during the 1990's. In 2005, the debate arose again, but this time concerning local, provincial taxes, such as the gross turnover tax.

Transfer of Technology Contracts. On another matter, the National Institute of Intellectual Property ("INPI") issued an amendment with significant implications. In effect, a recently issued resolution has amended the definition of transfer of technology contracts. Although the resolution supposedly clarifies certain doubtful concepts, in fact, it imposes new requirements and delimits the scope of the contracts which may be registered as transfer of technology contracts. In fact, pursuant to the Income Tax Law ("ITL"), payments to non-resident beneficiaries are subject to withholding at the source. In order to benefit from the reduced withholding rates set forth in ITL Section 93, subsection (a), the contract must be registered before the INPI. The recently

issued INPI Resolution P-328/2005 limits the application of the reduced withholding rate by restricting the scope of the term "technology". In this sense, the new resolution states that the acquisition of products, technical assistance, know-how for preparatory purposes, software user or update licenses and activities implying outsourcing of day-to-day activities of the local company do not imply "technology" and may, therefore, not be registered.

Inflationary Adjustments. Another significant yet unresolved issue centers around inflationary adjustments. As of December 2001, Argentina abandoned the convertibility regime, and inflation has reappeared. Since the indexes that account for inflation were never updated, the adjustment is impossible to apply. Taxpayers have been demanding the re-installment of the inflationary adjustment rules since 2002. Lower courts were not consistent and thus, while some decreed the unconstitutionality of the norms which impede application of the inflationary adjustment, others rejected the claims. In 2005, the Supreme Court in *Santiago Duggan Trocello* rejected the claim based upon certain admissibility matters of the *amparo* and postponed the analysis of the constitutionality of the inflationary adjustment norms. The Court expressly stated that comparing the tax with inflationary adjustments and without those adjustments does not clearly prove clear and patent illegality. However, the Court refrained from stating what would be considered sufficient proof. In the end, the Supreme Court ruling did not provide clear guidance in the future.

Tax Administration. Binding rulings have been incorporated into the Argentine tax system as a way for taxpayers to present their inquiries before the local tax administration. The construction of the whole process, as set forth by Resolution 1948, makes it doubtful whether any taxpayer will submit an inquiry under this process. In fact, the process (which is to last no more than 3 months) begins with a presentation (considered a sworn statement) made by a taxpayer regarding his/her

own opinion as to the proper interpretation of the issues involved. The ruling binds both the tax administration and the taxpayer involved; however, it is not binding for third parties. The party involved must, however, comply with the terms of the resolution, and noncompliance is considered to aggravate the situation of the taxpayer. In any case, an adverse ruling may be appealed before the Ministry of Economy within ten days from the day the taxpayer is notified of the ruling. Certain issues cannot be subject to rulings, e.g., rulings related to double tax treaties signed by Argentina, withholding regimes, or issues involving audits that are already in process and in which notice has been given to the taxpayer.

Stamp Tax. The courts of the Province of Buenos Aires have issued two controversial rulings in which contracts signed outside the jurisdiction of the province and having no legal effects within the province were considered subject to stamp tax on the basis of the alleged economic implications of the contract in the provincial jurisdiction.

The newly issued rulings deeply contradict the traditional interpretation held by the provincial tax authorities. In *Unilever de Argentina S.A.* (TFiscal de Apelación de Buenos Aires, Courtroom III, 08/30/2005, “*Unilever de Argentina S.A.*), a multinational company signed contracts with several foreign-incorporated companies that referred to “know how”, “business group services” and “brand licensing agreements”. The contracts were signed outside the provincial jurisdiction, but the contract was considered to be subject to stamp tax in the Province of Buenos Aires. The court decision was based on an analysis of both the static and dynamic elements involved, from which the Tax Court considered that the economic consequences of the contract were not immediate but rather extended over time and throughout the Argentine territory. Another controversial decision adopted in the same ruling referred to the statute of limitations. The court determined that the statute of limitation (5 years in Argentina), had not ended, despite the fact that the contract had been signed in 1993. To arrive to this conclusion, the court analyzed Section

133 of the Fiscal Code, which sets forth that the statute of limitations period does not include the period in which the fiscal authorities do not know of the existence of the agreement on account of some acts or deeds in the Province.

In another holding by the Appellate Court of the Province of Buenos Aires in *Mary Kay Cosméticos S.A.* (TFiscal de Apelación de Buenos Aires, Courtroom II, 14/12/2004, *Mary Kay Cosméticos S.A.*), the court also determined that the stamp tax was due despite the fact that the contract was signed in Texas between Mary Kay Cosméticos S.A. and its parent company, Mary Kay Cosmetics, Inc. In arriving at this conclusion, the court determined that the contract terms not only applied to the US but throughout the country, including the Province of Buenos Aires. The court concluded this because the parties had agreed on the development of a sales program, a commercialization contract and the transfer of certain privileged information, and that the contract was to be read as a whole (a complex instrument assembling license agreements, know-how, technical information, technical assistance and consulting services, some of which had economic consequences within the provincial jurisdiction).

Tax Procedure. Law 26,044, effective July 14, 2005, amended the Tax Procedure Law as follows:

- (a) Two new types of tax domiciles were introduced: (1) the “alternative tax domicile” (an address fixed by AFIP on the basis of the taxpayers verified information and data), and (2) the “electronic tax domicile”, a website address determined by taxpayers and used to establish that notifications made to the alternative tax domicile are valid and binding.
- (b) A new legal framework for issuing binding tax rulings was instituted.
- (c) The supervisory functions of AFIP were extended by allowing for the use of undercover agents, who may simulate purchases and transactions in general to verify fulfillment of tax obligations.

(d) The joint and several liability of partners of non-registered companies was broadened to any tax duties owed by the company.

(e) New penalties were introduced for failure to fulfill the information regime. The penalties are made worse whenever the taxpayer involved is a trust, corporation or any other business entity. The tax authorities may, without a prior judicial order, directly require assistance of the local enforcement agents in order to lien or forfeit goods for which no documentation is available.

(f) The scope of the statute of limitations within which the tax authorities may assess and collect taxes due and apply penalties was extended. A new suspension of 120 days has been granted for notifications summoned 6 months before the deadline.

(g) New presumptions have been built into the law, such as those resulting from unjustified changes in a taxpayer's bank account, or agricultural inventories scrutinized by satellite image, among others; and

(h) Finally, the new law authorizes the local IRS to offset tax credits and debits in connection with specially appointed collecting agents. ♦

Bolivia

Guevara & Gutiérrez S.C. – Servicios Legales

Comments On Potential Taxation Issues Related To A Recently Issued Regulation On Air Transportation

On November 25, 2005, the Board of Directors of Bolivia's Tax Administration (*Servicio de Impuestos Nacionales*) issued *Administrative Resolution No. 10.0039.05* (hereinafter the "Resolution"), for the purpose of regulating and clarifying general aspects of the taxation of air transportation. The regulations contained in the resolution were intended to regulate those operations carried out by the *Travel Agencies affiliated with the International Air Transportation Agency ("IATA"), Airlines and General Authorized Agents* (hereinafter the "Subjects"). Among other matters, the Resolution specified the tax treatment applicable to those documents (manual, automatic and electronic tickets) issued by the Subjects in Bolivia or abroad for air transportation and other complementary services. Hence, the Resolution sets forth that those documents "paid" or "originated" in the Bolivian territory are subject to the following local taxes: (1) *Value Added Tax ("IVA", by its acronym in Spanish)*, (2) *Transactions Tax ("IT", by its acronym in Spanish)* and (3) *Corporate Income Tax ("IUE", by its acronym*

in Spanish). These taxes (hereinafter the "Taxes") would also apply to those prepaid transportation documents paid overseas and originating in Bolivia. Based on the guidelines set forth by the Tax Administration in the Resolution, a chart was created that details how "Taxes" would apply to every particular operation, taking into account the location where the airplane tickets are purchased and where the services are rendered:

Type of Airline	Location where the ticket is paid	Origin of the transportation service	TAXES (IVA - IT - IUE)
Domestic	Bolivia	Bolivia	Taxed
Domestic	Overseas	Overseas	Not Taxed
Domestic	Overseas	Bolivia	Taxed
*1 Domestic	Bolivia	Overseas	Taxed
International	Bolivia	Bolivia	Taxed
International	Overseas	Overseas	Not Taxed
International	Overseas	Bolivia	Taxed
*2 International	Bolivia	Overseas	Taxed

In principle, the chart detailed above, the operations described therein and the applicable tax treatment, are all consistent with the country's current tax law (Law N° 843, as amended and restated) and its regulations. Those operations marked with a (*), however, could create a

number of issues since they may conflict with the current tax system. In order to understand these possible adverse consequences, an outline details how those specific operations and the applicable tax treatment set forth in the Resolution may affect the general equilibrium incidence of these taxes on consumers.

For a better understanding of the consequences arising from those scenarios deemed to be in conflict with current tax rules and why they should be reviewed by the Tax Administration, each of the following scenarios is analyzed in relation to the applicable Taxes: (1) the airline is Bolivian and the ticket is purchased in Bolivia; however, the flight originates abroad and therefore the flight as such (the service) never enters Bolivian air space; and (2) the airline is foreign, and although the ticket is purchased in Bolivia, the flight originates overseas and, therefore, the flight as such (the service) never enters Bolivian air space.

Before discussing whether Taxes apply to the scenarios above, a summary of the nature, scope and taxable events of the Taxes is detailed below:

- In Bolivia, **IVA** taxes the sale of movable goods and the rendering of services carried out in Bolivian territory. Bolivia has implemented the IVA under the destination principle, meaning it is imposed on the value added of all taxable products that are produced domestically; hence, the tax should be applied wherever the consumption is verified.
- Likewise, **IT** taxes the gross income resulting from carrying out any commercial activity, industry, profession or any other service, profitable or not, in the Bolivian territory.
- Finally, **IUE** taxes the Bolivian-sourced income: (1) arising from goods situated, placed or economically utilized in Bolivia; (2) the carrying out of any act or activity capable of producing income in Bolivian territory; or (3) any other circumstance taking place in the territory, notwithstanding the nationality, domicile or residence of the parties involved or where the contracts are executed.

Without entering into a detailed analysis of

the nature and characteristics of each tax, as well as how they are linked with every specific situation mentioned above, the following is worth mentioning:

- It somehow contradicts the territoriality aspects of the “Taxes”. In addition, it could also result in a problem of international double taxation, which could eventually affect consumers by way of increase fares.
- It broadens and restates the scope of the taxable events of “Taxes” and, according to Bolivian Law, such may only be achieved by means of a legislative act issued by the Congress pursuant to the Principle of Legality. Consequently, the Resolution may lack constitutional support and might be vulnerable to the filing of unconstitutionality claims.
- The Resolution is not in harmony with Decision 599 of the Andean Community of Nations (an enforceable community regulation setting forth the “*Harmonization of Substantial and Procedural Aspects of the Value Added Type of Taxes*”) which specifies in its Article 14 that: “in case of international transportation services, the tax (VAT) will only be charged in the country of the original departure...”
- Finally, its ambiguous text does not make it clear whether the “Taxes” are intended to tax the service rendered in Bolivia by the Subjects (acting as agents) or if the taxes should apply to the entire transportation service.

In light of the above, as a result of the Resolution’s vague text and poor consideration of applying these “Taxes” to the above scenarios, without taking into account possible legal unconstitutionality claims that could be filed, the Tax Administration has failed to analyze and oversee the effective allocation of the tax burden resulting from applying the “Taxes”, as well as who will ultimately bear them. Therefore, as stated before, consumers may be affected by the burden of these Taxes, as well as the economic balance after taking into consideration who is statutorily required to pay the tax vs. who actually bears the actual burden. ♦

Brazil

By Luís Rogério Farinelli and Renato Bertozzo Duarte Machado Associados, Brazil

1. Law 11,196. Several tax law rules and amendments were introduced by Law No. 11,196, issued on November 21, 2005. One of the changes brought about by Law No. 11,196 provides for some tax benefits previously granted by Provisional Measure (PM) 252, which expired before its conversion into law at the term provided by law (120 days): (i) the Special Tax Regime for IT Services Export Platform (REPES), (ii) the Special Regime for the Acquisition of Capital Assets for Exporters (RECAP) and (iii) the Technological Innovation Incentives. (See, *Global Tax Briefing*, Vol. 8, Issue No. 1.) Other relevant provisions brought about by Law 11,196 include the following changes.

1.1—Transfer Pricing Adjustment For Export Transactions. Based on an Article 36 authorization, Ordinance No. 436 and Normative Instruction No. 602, both effective December 29, 2005, authorize (optional) for the fiscal year 2005 only, a transfer pricing adjustment calculation on export transactions carried out by Brazilian entities with foreign-related enterprises. Such provisions aim to prevent distortions in transfer pricing calculations arising from (i) the limited transfer pricing adjustments authorized by Brazilian law, which do not specifically include currency exchange variations and (ii) the appreciation of the Brazilian currency (Reais) against the US Dollar during the years of 2004 and 2005. Such adjustment is made by multiplying the following items by 1.35:

(1) Export revenues, for the purpose of determining whether the average export price is below 90% of the average price adopted for the sale of the same goods, services or rights, in the Brazilian market (during the same period, under similar payment conditions). If the export revenues adjusted by the factor is

higher than 90% of the domestic sales price, the company will not be subject to Brazilian transfer pricing rules on export transactions carried out with related parties (as provided by Brazilian law);

(2) The price adopted by the Brazilian entity on sales to foreign-related enterprises for the purpose of comparison with the parameter price computed under the cost-plus method; and

(3) Export revenues derived from sales to related enterprises for the application of a safe harbor which establishes that, if the net export income derived from sales to associated enterprises (in the same calendar year or in the average of such year plus the two precedent years) is at least 5% of the total revenue in the same period, they may not be subject to transfer pricing calculations.

1.2—Capital Gains of Individuals. Articles 38, 39 and 40 grant benefits to the capital gain of individuals in some specific transactions that are regulated by Normative Instruction No. 599, effective December 28, 2005, as follows:

(1) Capital gain from the sale of residential real estate will be exempt from income tax as long as the value of the sale is applied to the acquisition of another residential real estate in Brazil within 180 days from the transaction. The exemption applies only in proportion to the reinvested amount. Taxpayers can enjoy such an exemption once every five years. However, if more than one residential real property is sold within the period of 180 days from the first sale, and the proceeds of the sale are duly reinvested in this period, the exemption is applicable to the capital gains derived from all the sales previously carried out.

(2) Capital gain from the sale of real estate is reduced by the application of a formula which provides individual taxpayers with a kind of adjustment for inflation as of January 1996.

(3) Capital gain from the sale of assets and rights of a value not exceeding a monthly R\$ 20,000, in the case of sale of stocks negotiated in over-the-counter markets, or R\$ 35,000, in all other cases.

1.3—New Payment Terms For Taxes. Article 70 changed the term for payment of withholding income tax (WHT) and tax on financial transactions. As a general rule, the WHT levied on income/capital gains attributable to non-residents is still subject to payment on the same date of the taxable event, which occurs upon payment, credit, conveyance, remittance or use, whichever occurs first. However, a new payment term was established for the WHT on interest on net equity¹ and income derived from financial investments paid to non-resident beneficiaries. As of January 1, 2006, the WHT levied on these transactions must be paid up to the third working day subsequent to the ten-day period (within a month) in which the taxable event occurred. The new criteria facilitates an appropriate calculation of the interest on net equity to be paid, as compared with the former system (where the payment had to be done on the same day in which the expense was recorded for accounting purposes).

1.4—Tax Administrative Court Proceedings. Article 113 amended Decree No. 70,235, March 6, 1972, which established rules for tax administrative proceedings. One such change permits some court procedures to be carried out electronically or by magnetic media or equivalent media. These new procedures, however, will only be available after the issuance of specific regulations. In addition, the Superior Tax Administrative Court (Câmara Superior de Recursos Fiscais do Ministério da Fazenda - CSRF) will be able to approve *stare decisis* on recurring and uniform cases. *Stare decisis*, after approval of the Minister of Finance and publication in the Official Gazette, will bind both Federal tax

authorities and taxpayers before administrative tax courts. However, it will always be possible for interested parties to bring their cases before judicial courts.

1.5—Rendering of Personal Services Through a Legal Entity. Article 129 provides that companies rendering intellectual services, including those of a scientific, artistic or cultural nature, are subject to the tax and social security rules applicable to legal entities, even if such services are rendered by their partners personally. The use of legal entities to render personal services usually results in a reduction of the income tax and the social security burden as compared to the rendering of such services by an independent contractor or an employee. In some cases, such structures have been disregarded by tax administrative courts, and the partner of the relevant legal entity was taxed as an individual. This provision brings some relief to taxpayers regarding such an outcome.

2. Other issues—decisions on indirect legal transactions. During the past year, some Tax Administrative Court decisions involving indirect legal transactions were published. An indirect legal transaction is a transaction in which a legal form, different from that generally used for achieving a certain objective, is chosen, but such form is not incompatible with the intended objective. In this case, there is no incompatibility between the actual and the declared intention (as happens in the case of sham), but merely the choice of unusual forms to ensure a tax saving. From an analysis of such decisions, together with those published in previous years, it is clear that there is no general rule to identify which acts carried out by taxpayers may be considered abusive for tax purposes. Therefore, Tax Administrative Court decisions are now being made on a case-by-case basis. However, it is possible to conclude from such decisions that the existence of economic, administrative, commercial or other reasons supporting an indirect legal transaction, in addition to tax savings,

strengthens taxpayers' chances of success in tax assessment cases. The passage of reasonable periods of time between the implementation of each step of the structure may also help taxpayers to prove that the procedures taken do not qualify as a sham. ♦

Endnotes

1. Interest on net equity is similar to a dividend, but its payment is deductible from the Corporate Income Tax and the Social Contribution on Net Profits taxable bases while dividend payment is not.

Chile

By Jorge Espinosa, Espinosa, Porte & Canales Abogados y Consultores.

New Government in Chile. Recently and in a second election round, Michelle Bachelet became the first woman to take office with 54% of the votes. Mrs. Bachelet, who took office on March 11, has announced that her government will not raise taxes but will reinforce controls to prevent tax evasion primarily by taxpayers with the highest incomes. Likewise, the new government announced a general review of all tax benefit regimes existing in Chile, particularly those regimes that favor specific sectors of the economy, e.g., the VAT benefit granted on sales of homes and other similar benefits.

Treaties to Avoid Double Taxation. At present, Chile has entered into 14 Conventions to Avoid International Double Taxation with Argentina, Canada, Mexico, Brazil, Norway, South Korea, Ecuador, Peru, Spain, Poland, United Kingdom, Denmark, Croatia and Sweden. The following 7 Conventions to Avoid Double Taxation have been signed but are not yet in force: Russia, Malaysia, France, New Zealand, Ireland, Portugal and Paraguay. Negotiations to enter into a Convention to avoid Double Taxation with South Africa have concluded, but it has not been signed. At present, the following 15 Conventions to Avoid Double Taxation are at the negotiation stage: Australia, Finland, Cuba, Hungary, Netherlands, Switzerland, United States, Venezuela, Italy, Czech Republic, China, Belgium, Kuwait, Thailand and India.

Most Favored Nation Clause with Canada. The Treaties to Avoid Double International Taxation entered

into with Chile, Norway, and Poland provide for a tax exemption applicable to the incomes earned by individuals who provide professional services for less than 183 days. A protocol executed by Chile and Canada contains a most-favored-nation clause. Accordingly, the incomes earned by individuals resident of Chile or Canada who provide independent professional services for less than 183 days in the other country are tax exempt. In the event that an individual stays in the State for a period or periods of 183 day or more in the aggregate within any 12 month period, the incomes earned may be taxed in the latter State, but the tax shall not exceed 10% of the gross amount earned on account of such services or activities. This is so unless such taxpayer has a fixed base in that other State, in which case such incomes may be taxed in that other State and in accordance with its domestic laws, but only to the extent they are attributable to that fixed base (Circular letter No. 33 of June 30, 2005 of the Internal Revenue Service).

Most Favored Nation Clause with Canada (II). The Chile—Canada Treaty established that if Chile executed a treaty with another OECD country, like Mexico, that later agreed on a tax rate on dividends less than 10%, such lower rate would automatically apply to Canadian citizens who are residents of Chile. Such residents will be able to apply the lower rate of 5% of the gross amount of such dividends if the actual beneficiary is a company that directly or indirectly controls not less than 25% of shares with the right to vote in the company that pays such dividends

(Circular letter No. 62 of November 24, 2005 of the Internal Revenue Service).

Most Favored Nation Clause with Denmark.

The Chile—Denmark Protocol provides for an automatic reduction in the special retention rates applied to the payment of interest and royalties if even more reduced rates are agreed to in treaties executed afterwards with countries member of the OECD, like the United Kingdom. Accordingly, the benefits of the Chile-UK treaty apply to the Chile-Denmark Treaty. Therefore, the retention rate on interest derived from loans granted by banks and insurance companies, from bonds and securities that are regularly and substantially traded at a renown stock exchange, or the installments sales granted to the purchaser of machinery and equipment by the actual beneficiary who is the seller of the machinery and equipment, is 5% of the gross amount of such interest. Likewise, the royalties paid in any circumstances other than the use or the right to use industrial, commercial or scientific equipment is 10% of the gross amount of the royalties (Circular letter No. 62 of November 24, 2005, of the Internal Revenue Service).

Simplified Procedures for the Installment of Regional Headquarters of Foreign Companies in Chile.

The Internal Revenue Service has taken measures to make it easier for foreign companies interested in locating their “Regional Headquarters” in Chile. For these purposes, a “Regional Headquarters office” is a group of regional executives and directors who are employed by the overseas company and are based in Chile for the purpose of directing, supervising, and coordinating the commercial, marketing, financial, administrative, production, human resources and other policies of the companies that their employer has in one or more countries in Latin America or other regions. Activities regarding companies, agencies or other permanent establishments domiciled in Chile are not covered by this definition of a regional headquarters office. The Circular letter establishes that since the executives and directors of a regional headquarters office are overseas citizens, who are neither residents nor domiciled

in Chile nor undertake economic activities in Chile, they are only required to obtain a Tax Registration Number (RUT). They should do this through a “legal representative in Chile”, with the necessary powers to act before the IRS and to receive notifications on behalf of the applicant. This representative must be domiciled in Chile and must keep a daily register of all the operations it carries out on behalf of the foreign company and must submit each April a sworn statement to the effect that the foreign company has not received any type of payment of other remuneration for the activities of the Regional Headquarters. The representative or principal shall keep a separate register of all expenses incurred on behalf of the principal relative to the activities of the Regional Headquarters and the fund accruals or expense reimbursements made by the latter. The tax effects associated with this are the following:

- (a) The reimbursement of expenses incurred by the representative has no effect on the income tax since neither profits nor losses arise in Chile;
- (b) The principal shall not charge VAT on reimbursement charged abroad, precisely because they are reimbursable expenses rather than expenses associated to a sales or service subject to VAT;
- (c) The principal will not recover as fiscal credit the VAT on the expenses incurred by the Regional Headquarters;
- (d) The remuneration paid to the representative is not subject to VAT when invoiced overseas, but regular income taxes are imposed in Chile. (Circular letter No. 52 of October 4, 2005 of the Internal Revenue Service).

Decision No. 40 of the Cartagena Convention Not Applicable.

The Internal Revenue Service announced that since Chile would have failed to comply with the juridical acts that both its local legislation and the regulations set forth in Decision 40 and Decision 102 of the Cartagena Convention Commission required to approve and enforce such conventions, it has decided that both the Treaty to avoid Double Taxation among the country members and other states located outside the sub region are not valid both

at local and international level (Circular letter No. 64 of December 7, 2005 of the Internal Revenue Service).

Scope of the term “United Kingdom” for purposes of Applying the Chile-UK Tax Treaty. In accordance with the conditions established in the Chile-United Kingdom treaty currently in force and the fiscal authorities of that country, the term “United Kingdom” does not cover the so called “Overseas Territories” and “Crown Dependencies”. Overseas Territories are the

following: Anguila, British Antarctic Territory, Bermudas, Indic Ocean British Territory, British Virgin Islands, Cayman Islands, Falkland Islands, Gibraltar, Montserrat, Santa Helena and its Dependencies, Ascensión Island and Tristan da Cunha, Turks and Caicos, Pitcairn Island, South Georgia Island and South sandwich, Sovereign Air Bases in Cyprus. Likewise, the following territories are “Crown Dependencies”: Isle of Man, Bailiwick of Jersey and Bailiwick of Guernsey. (Circular letter No. 63 of November 24, 2005 of the Internal Revenue Service). ♦

Colombia

By Adrian Rodriguez LEWIN & WILLS –attorneys and counsellors at law*

Here are three of the most important developments on the Colombian tax landscape in FY 2005: (1) the enactment of the Investment Stability Act; (2) the enactment of a new Free Trade Zones Act; and (3) the signing of the first OECD-type income tax treaty with Spain.

Investment Stability Act.¹

In an effort to promote an increase in both domestic and foreign investment in 2005, the Colombian Congress enacted the Investment Stability Act. Under this Act, Congress has authorized the Colombian Government to enter into individual investment stability agreements with new and already existing investors, both domestic and foreign. The purpose of these agreements is to guarantee to each individual investor a specific legal framework deemed by the investor as determinative for her new investment or for increasing an already existing investment. The duration of the agreement must be at least 3 years and no longer than 20 years. Portfolio investments do not qualify for this treatment.

Although the scope of these agreements can go beyond tax treatment, this type of investment stability agreement can cover a variety of issues related to national level direct taxation, ranging from ap-

plicable rates to tax incentives, and even positions adopted by the Colombian Tax Service in its rulings. Nevertheless, indirect taxes, the welfare regime, and temporary taxes enacted under States of Economic Emergency (and other extraordinary constitutional states) cannot be subject to these agreements.

With the execution of an investment stability agreement, the Government guarantees to the specific investor a permanent selected legal and tax framework for a specific period of time, even if such framework changes in the future. In exchange, the investor must make or increase an investment by a minimum amount of US\$1.3 million and pay to the Governmental Finance Agency a consideration equal to 1% of the amount of the investment.

The investor must exercise care in drafting an agreement by specifying to the maximum extent possible the rules and regulations that the investor seeks to benefit from during the period of the agreement. Rules and regulations left out will be deemed as not covered by the agreement.

New Free Trade Zones (Ftz) Act²

Anticipating the end of the legal regime of the FTZ currently in place on December 31, 2006, the Colombian Congress has enacted new spe-

cial tax, customs and foreign trade regimes for FTZs, effective on January 1, 2007.

In addition to enacting a new regime for FTZs, effective on January 1, 2006, the new Act also extends to FY2006 the application of two important tax incentives that were available until FY2005 only.

Deductibility of Leasing Payments Extended³

The new Act extended to FY2006 the full deduction treatment for lease payments corresponding to: 5-year (or higher term) real estate leasing; to 3-year (or higher term) M&E leasing; and to 2-year (or higher term) vehicles and computer equipment leasing. This treatment will benefit leasing agreements executed on or before December 31, 2006 by small and mid-size enterprises.

VAT Credit for Industrial M&E Extended⁴

The new Act also extended to FY2006 the special VAT credit created to promote the acquisition and importation of industrial M&E. Pursuant to this incentive, VAT paid in the acquisition and importation of industrial M&E should be creditable towards VAT within the next 3 years following the purchase date. Should the taxpayer use the acquired industrial M&E in the production of VAT exempted goods, the credit will then be applicable towards the taxpayer's income tax in the taxable year in which the M&E was acquired or imported. If the taxpayer is a newly established entity, application of the VAT credit can be deferred to the next 3 years following the date in which the VAT taxable activities begin.

New Regime for FTZs. Changes in the current regime include the adoption of a reduced 15% income tax rate for all operators, and for all entities using FTZs to manufacture or transform goods and to render services. Entities using FTZs for commercialization purposes exclusively will still be subject to the general 35% income tax rate, thus not benefiting from the new reduced income tax rate.

Currently and until December 31, 2006, only income from exports obtained by entities established in industrial FTZs is treated as exempt income. Under the new regime and subject to pending regulations, as of January 1, 2007, all income (i.e., from exports and from sales to the domestic market) should be subject to the reduced 15% income tax rate. Under the new regime, all cross-border payments will also be exempt from remittance tax.

Concerning VAT, under the new regime, the sale of raw materials and other goods to entities in FTZs is treated as zero-rated. This clarifies the confusion in which tax authorities adopted contradictory positions in their rulings, sometimes accepting that these sales were zero-rated but at other times holding that they are subject to VAT. Unfortunately, the issue will continue to affect service providers because the new regime did not clarify this situation for them.

Income Tax Treaty With Spain

In FY2005, Colombia executed its first OECD-type income tax treaty with Spain. This represents a change in Colombian international tax policy because in the past, Colombia had refused to consider entering into this type of agreement.

This treaty will only be applicable upon its ratification by the signatory parties. Colombia's ratification is currently pending, awaiting review and approval by Congress and further constitutional review by the Constitutional Court (in that order), both expected to occur during FY2006. ♦

Endnotes

* The author is a Partner with LEWIN & WILLS member firm of LATA.NET. He is a Colombian attorney licensed to practice in NY and IL (2003) and in Colombia (1995); LL.M in U.S. International Taxation from NYU (U.S.A. 2002) and in Colombian Taxation from Rosario University (Colombia 1995). Contact: a.rodriquez.3@alumni.nyu.edu.

1. Colombian Congress, Act No. 963-2005.
2. Colombian Congress, Act No. 1004-2005.
3. See: **Colombian Tax Code, §127-1.**
4. See: **Colombian Tax Code, §485-2.**

Ecuador

By Cesar R. Holguin. Lawnetworker S.a. Legal Advisors

Summary Proceeding For The Cancellation, Dissolution And Liquidation Of Corporations And Branches

The Superintendence of Companies has issued Resolution No. 05.Q.IJ.001, published in Official Gazette # 77, dated 8 August 2005, creating a new summary proceeding, different from that established in the Company Law, faster and more expeditious, for the cancellation, dissolution and liquidation of corporations and branches. This regulation applies to those companies that: (1) have been unable to start operations, (2) for any reason are unable to carry on their corporate objectives, (3) have settled all their obligations toward third parties, (4) do not have pending contracts to fulfill, and (5) do not have pending lawsuits as plaintiff, defendants or as third party plaintiff. The upside of this resolution is that now there is no need to follow the long and cumbersome process of dissolution, liquidation and cancellation set forth in the Company Law. Now, with the reform, it is feasible to execute the three steps in the same deed.

In order to request the cancellation, dissolution and liquidation to the Superintendence of Companies, it is necessary to have a notarized public deed containing: (1) the respective resolution of the stockholders meeting or the board of directors; (2) the designation of the liquidator of the company and (3) the request for cancellation in the Mercantile Registrar Office. As exhibits to be notarized in the deed, the following are needed: (1) a final balance of operations showing the distribution of remaining equity among shareholders, and (2) certificates showing debt-free status with the Superintendence of Companies, the IRS, the Social Security Institute, City Hall and the Provincial Council. A certificate issued by the Nation's General Controller showing that the

company does not have pending contracts with the Government is also needed.

The whole process of liquidation is complete only with the inclusion these exhibits in the notarized deed. In the approval resolution to be issued by the Superintendence of Companies, three publications of the excerpt of the Resolution in one local newspaper, for purposes of third-party opposition, shall be ordered. In the event that no opposition is filed, in the same approval resolution it shall be ordered that the Mercantile Registrar Office proceed to register the deed, the approval resolution and the cancellation of the company in such registry. In order to proceed, the Mercantile Registrar will have requested a certificate issued by the Superintendence of Companies confirming that no opposition from third parties was filed in the legal term, or that if there was an opposition, it was dismissed. The above rules also apply to the cancellation of the operating license, liquidation and dissolution of branches or permanent establishments of foreign companies settled in Ecuador, whichever is applicable.

Tax Standards For Oil & Gas Consortiums And Associations

The IRS has published in Official Gazette # 110, dated 23 September 2005, Resolution No. DGER2005-0437, enforcing new tax standards for consortiums and associations engaged in the exploration and exploitation of oil & gas. Highlights of the new rules are summarized below.

Oil & gas consortiums or associations are the entrepreneurial groups that form an economic unit, independent from the juridical persons that integrate it, pursuing the goal of carrying on jointly one or several contracts for the exploration and exploitation of hydrocarbons. Consortiums and associations must file external audit and tax compliance reports. For tax purposes, members of a consortium must

appoint a representative who will be responsible for assessing the results of the consortium and informing the tax authorities how these results were distributed among members. Contributions in-kind made to a consortium for exploration and exploitation of oil & gas shall not be subject to VAT or taxes of any kind because these are not regarded as a transfer of assets and liabilities.

Consortiums and associations shall keep books and accounting records exclusively for purposes of the contracts in progress, as an independent economic unit separate from its members. Further, it shall not be allowed to offset the profits obtained in a contract with the losses resulting from another. Accounting records will encompass investments and other assets, accounts payable, income and expenses related to the contracts. Costs and expenses incurred by any of the members shall be reimbursed by the consortium or association in proportion to the contract. Taxes and other levies paid by the members of the consortium or association, as taxpayers, shall be recognized by the consortium or association as a "reimbursement of expenses" scheme and will be considered as deductible expenses for the consortium or association.

Once the fiscal year is closed, the consortium or association will determine its own income tax, taking as a deductible expense a 15% profit-sharing for its workers. The members of the consortium or association shall keep their own financial statements, their own accounting records and other registries in an independent manner, separate from those of the consortium or association. If, in connection with the contract, the members of the consortium or association have paid to the IRS tax advances or taxes withheld that allow a tax credit, they will be allowed to transfer those tax credits to the consortium or association, and the consortium or association can use them on their own tax return, provided they have not been previously used in the member's individual tax return.

Income tax paid by the consortium or association is attributable as a tax credit to their members, when these are branches of foreign companies

or companies incorporated abroad. Dividends distributed by the consortium or association, after the payment of the income tax, will be considered as exempt income for the national members. If the consortium or association has been awarded more than one oil & gas exploration and exploitation contract, they shall remain existing as such entities while any of the contracts is still under execution.

Losses registered and declared on the individual tax returns of the members of the consortium until the fiscal year 2005 and not yet amortized by them can be amortized by the consortium or association, provided documentary proof is shown, demonstrating that the losses arose exclusively from the activity to execute the exploration and exploitation hydrocarbon contract and provided that the items that created such losses are considered deductible according to the tax law. The terms for the amortization of these losses will be the same pursuant the tax law and will commence from the tax year in which the loss was registered and included in the individual tax return of the member of the consortium or association.

Tax Incentives For New Productive Investments, Generation Of Employment And Providing Of Services

After five months, the Nacional Congress and the Government finally passed the *Law of Tax Incentives for New Productive Investments, Generation of Employment and Providing of Services*, which is aimed at attracting substantial amounts of investment for the production of specific goods and services in activities of national interest. This law was published in Official Gazette # 148, dated 18 November 2005. The new law introduces tax benefits for new investments made in Ecuador in the following areas:

- (a) New hydroelectric generation and non-conventional electric generation. Thermo-electric generation based on bunker, diesel, asphalt and other contaminating combustibles are excluded.
- (b) Hydrocarbons refinement and industrialization and the manufacturing of goods to be used in

petrochemical that require state of the art technology. Activities of exploration, exploitation and extraction of oil & gas are excluded.

- (c) Manufacturing of high tech electronic devices and of optical fiber and other devices of digital and electronic communication. Industrial plants for assembling integrated digital electronic circuits, microchips, memories, storages, electronic cards and laptops, scientific sensors, software and hardware.
- (d) Development, implementation, installation and operation of regional distribution centers for aerial traffic and/or cargo interconnecting international flights.
- (e) Construction and operation of deep waters harbors and of international cargo and containers transfer, as well as the construction of dry and fluvial ports.
- (f) Manufacturing of machinery and equipment, currently non-existing in Ecuador, for agricultural or agro industrial usage, as well as the production of non-existing goods commencing from transformation processes as the result of new agro-industrial investments; and,
- (g) Environmental protection via productive investments oriented to the preservation and improvement of the hydraulic potential for hydroelectric generation, and new investments for the production of oxygen additives sourced from removable raw material, such as ethanol anhydride.

Tax benefits of this law will be granted only to the enterprises that settle in Ecuador to develop new projects and investments in the sectors and activities listed above. Tax benefits established under this law shall be granted only to domestic corporations and branches of foreign companies that are incorporated and domiciled in Ecuador, respectively, after the date of enforcement of this law and provided: (1) they have capital stock equivalent to 10% of the investment, they commit to invest in fixed assets a minimum of 7.5 million dollars in the cases of paragraphs (a), (b), (c) and (e) above; and of 2 million dollars in the case of paragraphs (d), (f), and (g) above, during the first two years since the date of issuance of the Presidential Decree granting the tax benefits.

Tax benefits of the law shall also be granted to new investments in hydroelectric projects carried out by existing corporations that start production after the date of enactment of this law, provided they produce and sell at a lesser price than the referential generation price current as of the date of enactment of the law. Companies sheltered under present law shall have the following benefits:

- (a) Exoneration of income tax, provided the investments referred to above have been effected,
- (b) The national Government, through a Presidential Decree, and after the fulfillment of the proceeding set forth in the regulation to this law to be issued in the forthcoming months, will exempt the payment of custom duties on importation of machinery, equipment, new spare parts and raw materials that are not produced in this country, as required for the manufacturing of the goods and services referred to above. A standard procedure applicable to each one of the productive activities shall be issued for purposes of the control of imports.
- (c) Total exoneration of all stamp taxes, duties and other taxes levied on incorporation of companies.

Tax benefits established under this law shall apply to the taxes currently in force and to those taxes that are created in lieu of those taxes. As far as municipal taxes is concerned, these can be reduced up to 95% and regarding transfer of real estate acquired for the exploitation of the project, tax reduction will become effective from the date of issuance of the respective presidential decree granting the benefits. Tax benefits granted under this law shall be maintained for a term of ten years in the provinces of Pichincha and Guayas and for a term of twelve years in the rest of the country, effective from the date of issuance of the presidential decree granting the tax benefits. Goods and assets purchased under this law will not be allowed to be transferred to third parties during the term of duration of the tax benefits. If this rule is breached, the beneficiaries of the exonerations shall be obliged to pay all taxes

that were exempted, including interest on those unpaid taxes. This law supersedes any other equal or similar law that opposes or

contradicts its norms. Rulings from the IRS that attempt to overrule the dispositions of this law will lack juridical efficacy. ♦

Mexico

By Ortiz, Sosa, Ysusi y Cía.

Relevant Issues on the 2006 Tax Reform

Overview of Changes. During the process of legislative debate on the 2006 Tax Reform Bill, intense discussions were held among diverse political and economic groups around the country. The initiatives presented by the Executive Branch were subject to modification by diverse proposals made by the House of Representatives, as well as by the Senate. It is expected that federal revenues will increase by 8.53% in nominal terms for 2006, in comparison to the budget for 2005.

One of the most important issues of this tax reform is the elimination of those provisions that regulated the new procedures for the calculation of income tax of individuals, which would have become effective on January 1, 2006, by reinstating the same procedure of tax calculation that was effective until 2004 and which was maintained in force during the tax year of 2005 by means of a temporary provision.

It is important to note the addition of a new tax incentive aimed at fostering an increase in the investment and growth of small and medium companies. Under these new incentives, Mexican residents or foreign residents are able to invest capital or to grant financing to those entities through a pass-through trust.

Modifications to the tax regime applicable to real estate investment trusts (REITs) were made, but without obtaining the desired effect, because the modifications were complicated in their application and the benefits limited.

On the other hand, certain provisions regarding the deduction of interest under the thin capitalization scheme were made without modifying the general structure of the regime.

A new chapter in the Income Tax Law contains a new fiscal mechanism that purports to contribute to the development of cooperative production companies whose partners are individuals.

It is important to remember that as of fiscal year 2006, employee profit sharing (PTU) paid in a fiscal year can be wholly deducted from such year's taxable profit.

Regarding the special tax on production and services, a new mechanism is established for determining the tax on manufacturing, producing or canning companies that alienate or import beer, which make possible, in certain cases, obtaining a reduction of the tax when recycled packages are used.

Regarding the Federal Income Law for Fiscal Year 2006, the fiscal schemes of subsidies and tax incentives remain, emphasizing the incorporation of legal entities in the assets tax exemption established for individuals, so long as their total income in the previous tax year does not exceed \$4 million.

By virtue of the controversies that have arisen from the proposed modifications to the Federal Tax Code, which seek, among other things, to limit the independence of the public accountant and to deter the use by taxpayers of legal figures for the sole purpose of tax avoidance, such reform has not yet been approved.

It is important to mention that in several tax provisions which took effect in 2006, reference to certain proposed modifications to the Federal Tax Code were made. Therefore, such provisions could have a different tax treatment until such modifications are approved. In the 2006 Tax Reform, the creation of the Federal Law of the Contentious Administrative Procedure was approved which, in general terms, established the

procedure that regulates the legality trial before the Federal Tax and Administrative Court. Therefore, with the entry into force of this new law, which started January 1, 2006, the provisions that regulate the legality trial contained in the Federal Tax Code are left without effect.

Subsequent articles will discuss these changes in more detail. ♦

Peru

Muñíz, Ramírez, César Luna-Victoria León, Pérez-Taiman & Luna-Victoria

Tax Developments: Second Half 2005 and What's New for 2006

Transfer-Pricing. In Peru, the transfer pricing regime has been in force since 2001. In general terms, the OECD guidelines are followed with few differences. Probably, the most important one is that transfer pricing studies are required not only to support the price of operations performed with related companies abroad, but also the price of operations performed between local related companies, “when fiscal damage is caused.”

“Fiscal damage” is understood to mean those cases in which one of the related companies is exempt from the payment of income tax (some companies in the Amazon region) or is subject to a rate lower than the general rate (the general rate is 30% and some companies, like agricultural companies, are subject to an effective rate of 15%), or shows accumulated losses that can be compensated for with the profits of the tax year. According to the 2006 regime, a study will also be required for gratuitous operations but declare presumptive revenues for tax purposes. This requirement also applies to individuals, for the operations they perform with the companies with which they are related (shareholders, for instance).

Another characteristic of this regime in Peru is that it extends the relationship criteria to include not only those companies that are subject to

the same share control or to the same management control, but also those companies that are “economically related” to each other. Relationship exists when one company sells to another company more than 80% of its total sales (valid for goods or services) and these sales account for more than 30% of the total purchases made by such other company.

Although this regime has been in place since 2001, experts disagree with regard to the level of formality that may be required by the Tax Bureau. For the first stage (2001 to 2003), it might not have been necessary to have a “study” because the law just required companies to have enough documents and information to prove the agreed price. For the second stage (2004 and 2005), it still might not have been necessary to have a study because, in view of the fact that the regulations were enacted quite late (in December 2005), companies were not “formally obliged” to have it, but also will be required to have the documents and information. Accordingly, only for the third stage (in 2006) might it be formally necessary to have a study that must meet all the requirements contemplated by this regime.

There are also new tax aspects with respect to the 2006 regime: (i) the regulations have established a series of rules (guidelines) that studies should follow to elect the “best method”, that is, the most appropriate method to determine

the margin of the comparable price by transaction basis; (ii) the minimum information to be included in each study has been specified; (iii) it has been agreed that the methodology to be used to establish price ranges is the “interquartile methodology”, thus eliminating the possibility of using other methodologies; (iv) if the price used is not included within the price margin established according to the interquartile methodology, then it will be adjusted to the median of the results obtained from such methodology, as it is not possible to adjust it towards the margin ends; and (v) the possibility of signing Advance Price Agreements- APAs has been regulated.

Modifications to the Value Added Tax (VAT) Regime

During the last few years, as part of the program undertaken to reduce tax evasion, taxpayers have been entrusted with the task of collecting the tax or paying it in advance. In the case of some buyers (either because of the kind of goods or services involved or because they were good taxpayers or major taxpayers), it was established that they would not pay the full tax to their suppliers, and rather pay a percentage of it, on behalf of their suppliers, to the Tax Bureau. This payment constitutes a tax credit recoverable by the supplier at the moment of paying the tax on their sales. With this mechanism, many suppliers have been obliged to regularize their sales to recover the credit. Otherwise, the credit is lost, and the Tax Bureau gets at least that amount.

In the case of some sellers (in this case, according to the kind of goods involved in the sale), it was established that, besides charging the price of the goods with the accompanying tax, they had to charge part of the tax that its buyers would pay at the time of reselling the goods bought. The goods subject matter of this regime are usually sold outside of the formal market. Through a recent modification to the VAT regime, goods sold under “direct sale” systems are included in this regime as of April 2006. This system resorts to sale forces that visit potential buyers in their office or

home, the gain being the difference between the purchase price and the sales price, without paying VAT or income tax on that added value. Through these mechanisms, tax collections have increased by more than 1% of GDP and, as expected, the Tax Bureau is analyzing the possibility of extending these mechanisms as much as possible.

On October 8, 2001, the Council of the European Union adopted a regulation providing for a new business entity, the European public limited liability company called *Societas Europaea* or SE. The regulation entered into force on October 8, 2004, and has effect in all Member States of the European Economic Area (which includes all Member States of the European Union plus Norway, Iceland and Liechtenstein).

Tax Court Resolutions

It is worth analyzing two Tax Court Resolutions. The first one deals with inflation adjustments. In 2001, after several years of very moderate monetary inflation, there was a currency appreciation. As a result, companies whose inflation adjustments only determined “inflation gains” showed a “deflation loss” in 2001. This loss has been disregarded by the Tax Bureau until the holding of this Tax Court Resolution, in which the Tax Bureau was obliged to recognize it. Recent modifications have repealed the tax effect of inflation adjustment rules, bearing in mind the country’s relative monetary stability.

The second Tax Court Resolution deals with access to a reduced income tax rate benefit (15% instead of the general rate of 30%) by agricultural companies. The Tax Bureau repeatedly denied the benefit to companies that failed to request it within a given period of time by application of a rule contained in the regulations that provided that the time period was “essential” for the exercise of the right. The Tax Court resolved that the benefit had been specifically granted to agricultural

companies under the law, and the regulations had exceeded its scope of authority by placing such conditions on the benefit. The Tax Court ordered the Tax Bureau to acknowledge

the benefit, even in those cases where the request was filed beyond the applicable term, in application of the principle of legality and hierarchy of rules. ♦

Uruguay

By Emilio Tuneu and Ana Laura Ghislandi, CHT AUDITORES Y CONSULTORES

Tax and Legal Update June-December 2005

Certainly, the Bill of Tax Structure Amendment proposed by the current Treasury Secretary, Mr. Danilo Astori CPA, is the most significant news of the second half of 2005. This bill has been supported by the current government and is known as “the distinctive feature of this government”. These changes will affect both physical and legal resident persons; however, the definitive provisions have not been passed yet. The bill will be brought to Parliament to be passed in the first half of 2006, and will take effect in 2007. In any case, it is important to point out that most of the measures will be moderate. Furthermore, this is the first version of the Bill, and there will be opinions and comment from the public that will be considered when bringing the definitive Bill to the Parliament. The Bill was presented by the Treasury, which formed a working board in order to make the proposals and has taken into account economic, provisional and administrative aspects of the structure currently in force.

Among the most significant measures, we note the following:

1. Removal of fourteen taxes.
2. Modification of income tax, adding the IRPF /Physical Persons’ Income Tax/ of dual characteristic, and adjusting the corporate income tax by extending its scope of application and diminishing its rate from 30% to 25 %. The territorial principle is kept.
3. Decrease of the VAT, removing the COFIS and diminishing the VAT basic rate from 23% to 21% and its minimum rate from 14% to 10%.

Furthermore, its taxable scope will be extended to goods and services currently exempt.

4. Modification of the managerial contribution rate for social security; regarding the general collection, there will not be changes in the private sector and a decrease in the public sector.
5. Financial Investment Corporations will be included in the general tax regime. The deadline for such adjustment will be December 31st 2009.

I. Taxes to be removed. When this amendment comes into force, the following taxes will be repealed: (1) Individuals’ Compensation Tax (IRP); (2) Contribution for the Financing of Social Security (COFIS); (3) Banking Institutions’ Assets Tax (IMABA); (4) Financial System Control Tax (ICOSIFI); (5) Health Services Tax (IMESSA); (6) Small Firms Tax (IMPEQUE); (7) Commissions Tax; (8) Telecommunications Tax (ITEL); (9) Credit Cards Tax; (10) Forced Sales Tax; (11) Farming Income Tax (IRA); (12) Sport Assignments and Exchanges Tax; (13) Sell at Auction Tax; and (14) Lots and competitions Tax.

II. Income Taxation. The taxation of income is proposed to be founded on two pillars: (1) taxation upon business and corporate income, which will be levied by the Economic Activities Income Tax (IRAE), and (2) the taxation of the incomes of individuals, which will be levied by the Physical Persons’ Income Tax (IRPF). In both cases, the territorial principle is kept. The only taxable income will be the one arising from activities developed from, assets situated

at or rights economically used within the Republic of Uruguay.

II.1. Economic Activities Income Tax. The Economic Activities Income Tax (IRAE) will be levied on business and corporate income of Uruguayan source. This tax will replace the current Industry and Trade Income Tax (IRIC), Farming Income Tax (IRA), Commissions Tax and Small Firms Tax (IMPEQUE). The general rate of the income tax (IRAE) will change from 30% to 25%, calculated upon the fiscal net rate. Furthermore, its taxable scope will be extended to currently tax-exempt income, mainly to pure capital income and pure work income obtained by partnerships. The term for the constitution of investment reserves will be extended, and an amplest group of fixed assets will be included. Furthermore, it is also proposed that the deduction of losses from previous fiscal years shall be extended from three years currently to five years. The IRAE will be levied upon income from Uruguayan source, whatever the origin of the income may be. This income shall be obtained from corporations constituted in the country, and from permanent commercial establishments of individuals residing abroad. The interpretation of “permanent commercial establishment” will be the definition given by the OECD Model Tax Treaty. This tax will also be levied upon the Uruguayan-source business income obtained from any individuals other than those residing abroad, and from work income only if the taxpayer chooses this tax instead of the IRPF. Regarding the international income tax, it is planned to include those provisions that govern transfer pricing. The transfer prices regime will include the usual international methodologies.

II.2. Income Tax on Individuals. This is the most significant change of the future taxation model. Its introduction will mean a deep change in the tax structure since it includes all income from Uruguayan source, whatever its origin may be, and a relevant group of currently tax-exempt income. According to

recent comments, the incorporation of the IRPF will increase with time, but initially, it must be kept simple since it will require deep changes within the Tax Administration as well as in the society. At present, there exists a partial system of individual income, which includes the individuals’ compensation tax (IRP). IRP is withheld by the employer at the time of paying the duties, and in some cases the commissions tax (CT). As previously explained, one of the main objectives of the proposal is to tax those incomes that currently are tax-exempt, such as pure capital income and the work income arising from non-dependent relationships. This income, as well as the income that is currently taxed by the above-referenced taxes will be included in the taxable scope of the IRPF, removing the IRP and the CT. From a structural point of view, the IRPF will establish a distinctive treatment for capital and labor income. The IRPF applicable to capital incomes includes all the incomes arising from that factor, such as interests, leases, royalties, etc. In the case of appreciation, the tax will be applied at the time of producing the appreciation, i.e., at the time of selling. We have to point out that profits and dividends are not taxable so as to avoid double taxation. The applicable rate on capital income will be 10%, and it will be proportionally applied to the taxable base. Securities of national debt will be tax exempt; the results of retirement saving funds. On the other hand, long-term domestic currency deposits or index-tied deposits will only be taxed at a 3% rate in order to encourage the process of “un-dollarization” and the development of long-term financial instruments.

II.2.2. Work Incomes. A taxable system with progressive rates applicable to each income stage will be structured. There will exist a non-taxable minimum for these incomes. At this stage, the reckoning shall compulsory be made individually. At this stage, a system of deductions related to subjective situations is not in place because of management difficulties and collection matters.

II. 3. Non-residents Taxation. In the case of foreign individuals not residing in the country and not acting through a permanent establishment, their incomes will be taxed at a 10% rate upon the net income, whatever its origin may be. Along the same lines as the IRPF, the interests of securities of national debt as well as the dividends and profits will be tax-exempt. The interests of long-term domestic currency deposits or indexed deposits will be taxed at a 3% rate, similar to residents.

III. Net Worth Tax. It is proposed to keep this tax as a controlling instrument of the net-worth variations suffered by those involved. In this respect, its structure is planned to be maintained while diminishing its rate from 1.5% to 0.1%. In this case, like the income tax, the territorial principle governs. Regarding the net worth tax upon legal persons, it is intended to extend the taxation system of the IRIC to the IRAE since this system comprises up to 50% of the amount of the IRAE. This feature may not be applied to corporations with bearer shares.

IV. Excise Taxes. Currently, the value added taxation system includes two taxes: the value added tax (IVA) and the tax of the contribution for the financing of social security (COFIS). The amendment provides for the repeal of the COFIS, whose rate is 3%, and the decrease of the VAT basic rate from 23% to 21%, and of the minimum rate on goods and services from 14% to 10%. Some taxable goods and services are modified. For instance, the first sale of real property, health services rendered to human beings and passenger transport--within the general taxation regime--will be taxed at the minimum rate. Furthermore, the VAT basic rate will be levied upon cigars and cigarettes, fruits and vegetables, water supply, flavored and long-life milk, financial services of those who do not develop activities included in the IRAE, except for the interests of loans granted by the Mortgage Bank of the Republic of Uruguay and interests of loans destined for housing and that have already been granted and are tax-exempt.

V. Domestic Specific Tax. Regarding the “domestic specific tax” (IMESI), it is proposed to adjust its structure in such a way that the taxable basis of most of its taxable goods will be determined by the sale price of the manufacturer or importer, completing the basis, if necessary, with a specific taxable basis for each unit sold. The alcoholic drinks that are currently not taxable shall be included within the scope of the tax.

VI. Taxation of Financial Operations. The contribution for the financing of social security is among the taxes that will be repealed and replaced with a financial operations tax, with characteristics resembling similar taxes in the rest of Latin America. The introduction of this tax has to be considered in the context of the repeal of the banking institutions’ assets tax, the financial system control tax and the credit cards tax. The new tax will be levied at a low rate (0.2%) upon the activities carried out in the financial mediating system, related to debit and credit operations of current and savings accounts, debit and credit cards and similar operations.

VII. Financial Investment Corporations (SAFI). It is proposed to prohibit the creation of these special corporations as of effective date of the amendment, as well as the adjustment of the already existing corporations to the general taxation regime of corporations before December 31st 2009.

VIII. Bank Secrecy. Regarding bank secrecy, it is deemed proper to maintain the current legal criteria which establish the compulsory disclosure of secrecy just for fiscal purposes. Those criteria are founded on the application of a mechanism related to a jurisdictional decision.

IX. Employers’ Contributions to Social Security. It is planned to establish a sole rate of 7.5% for the industrial, commercial and service sector that develop their activities within the private area, as well as for the non-financial public enterprises. ♦

Latin America Tax and Legal Network

Name	Country	Phone n°	E-mail
Cristian E. Rosso Alba	Argentina	5411 4893 3366	crossoalba@rafya.com.ar
Ramiro Guevara	Bolivia	591 2 277-0808	rguevara@gg-lex.com
Luis Rogério Farinelli	Brasil	5511 3093-4855	lfarinelli@lmachadoassociados.com.br
Jorge Espinosa	Chile	562 263-2803	jespinosa@tie.cl
Alfredo Lewin	Colombia	5713 12 5577	alewin@lewinywills.com
Eric Thompson	Costa Rica	506 256 5555	ethompson@fayca.com
Federico Araujo Medina	Venezuela	58 212 905 0239	faraujo@tpa.com.ve
Walter Tumbaco	Ecuador	593 2 2268 349	wtumbaco@hsecuador.com
Cesar R. Holguin	Ecuador	593 4 2562 908	cholguin@lawnetworker.com
Peter Byrne	United States and Peru	1 703 387 3009	pbyrne_taxlaw@attglobal.net
Mr. Paul Tadros	United States and the Caribbean	1514 697 0901	paul.tadros@sympatico.ca
Miguel Ortiz Aguilar	Mexico	52 55 1084 7008	mortiz@lataxnet.net
Ignacio Sosa Lopez	Mexico	52 55 1084 7014	isosa@losy.com.mx
Julio A. Ysusi Farfan	Mexico	52 55 1084 7006	julioy@osy.com.mx
Jesús Francisco Morales Garcia	Mexico	52 55 1084 7005	jfmorales@osy.com.mx
Miguel Valdés	Latin America, U.S.	US 1 773 867 8629 Brasil 55 11 3093 4855	mvaldes@machadoassociados.com.br
Dayra A. Castaneda	Panama	507 269 1127	dayracl@riveboca.com
Cesar Luna-Victoria	Peru	511 611 7048	cedarl@munizlaw.com
Fernando Goyco-Covas	Puerto Rico	1 787 281 1802	goyco@amgblaw.com
Emilio Tuneu	Uruguay	5982 917 0045	emiliot@cht.com.uy
Luis Hernandez	Uruguay	5982 917 0045	luish@cht.com.uy
Robert B. Jennings	United States	703 847 4660	inhoc_sv@cox.net