Colombia implements tax reform measures on jurisdiction and thin capitalisation

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Colombia's Ministry of Finance recently issued three decrees[1] implementing tax measures introduced in the 2012 tax reform, including an official definition of permanent establishment, rules governing thin capitalisation, and amendments to the residence criteria for individuals and companies.

Decree 3026: permanent establishment

Decree 3026 introduces and regulates the PE concept, defining the terms "foreign company," "fixed place of business," and "preparatory and auxiliary activities" and establishing rules for the taxation of profits attributed to PEs, as well as branches. The provisions generally follow the OECD model tax treaty and commentary. However, because Colombia is not yet a member of the OECD, the Ministry of Finance is required to provide specific rules to regulate PEs in Colombia. In a nutshell, the main rules are as follows:

Foreign companies are defined as foreign corporations, foreign legal entities, and individuals without residence in Colombia who carry out a business or activity in Colombia. For individuals, the definition applies to personal services, independent personal activities, and professional services.

The definition of "fixed place of business" follows the OECD definition, but Decree 3026 further clarifies that the place can be a space; no premises, facilities, or installations are necessary, nor is a legal title required. The important criterion is that the business of the enterprise is carried on through that space. Colombia's tax treaties use a criterion of six months' presence to determine whether building activities and construction activities are "permanent." Decree 3026, however, provides no additional rules for determining whether mere presence is sufficient to constitute a PE.

Decree 3026 further elaborates on preparatory and auxiliary activities that are excluded from the definition of a PE. Those activities include the use of facilities or maintenance of a stock of goods for storage, display, or delivery, as well as the maintenance of stock for processing by another enterprise.

The definition of "dependent agent" follows the OECD model and includes a person that habitually exercises the authority to conclude contracts. Decree 3026 does not elaborate on the meaning of "habitually."

If a foreign company acts through an agent (other than an independent agent) in Colombia, the domicile of the PE is the domicile of the agent in Colombia. In other cases, the domicile for tax purposes is the place where the foreign entity carries out its activity, wholly or in part, in Colombia.

A foreign company with a PE in Colombia will be taxed on the income and capital gains attributable to that PE (or branch) and on the Colombian-source income the company receives directly. The tax rates are the same rates applicable to Colombian residents. If there is no PE or branch, the foreign company will be taxed only on Colombian-source income and capital gains at the rates applicable to non-resident companies. A Colombian agent making a payment to a foreign company is required to withhold the income tax due on such payments.

Foreign companies with branches or PEs in Colombia are subject to the equality tax (CREE) introduced in 2012.[2]

Foreign companies are required to register each PE with the unified tax registry and must file income tax returns for the income attributed to their PEs or branches and for the Colombian-source income that the foreign companies receive directly.

A functional and factual analysis should be conducted to determine the profit to be attributed to a PE or branch – specifically, the arm's-length profit that it might be expected to make if it were a distinct and separate enterprise dealing wholly independently with the parent company. Criteria that will be taken into account are the functions performed, assets used, risk assumed, and the people involved in obtaining the profit. This approach is in line with the commentary to article 7(2) of the OECD model treaty.[3] The functional and factual analysis should be done separately for each PE or branch. The documents related to the analyses should be kept for five years, starting from 1 January of the year following the tax year for which the study was done.

Foreign companies are required to keep separate accounts to document the income, costs, and expenses of their PEs or branches, as determined in accordance with the Tax Code provisions.

To ensure equal treatment of Colombian and foreign entities, the tax reform and Decree 3026 establish that the transfer of profits from Colombian branches or PEs to their home offices abroad are deemed dividends. A 25% tax is to be withheld at the time of the transfer of untaxed profits abroad. However, the consequences of these deemed dividends should also be analysed in accordance with the provisions of Colombia's existing tax treaties.

Decree 3027: thin capitalisation

Thin capitalisation rules introduced in the 2012 tax reform limit the deductibility of interest expense when the amount of interest-bearing debt exceeds a 3-to-1 debt-to-equity ratio. Decree 3027 establishes that the interest on financing for regulated housing projects carried out by companies, legal entities, or special purpose vehicles can be deducted based on a 4-to-1 debt-to-equity ratio.

While Decree 3027 provides rules for the calculation of the debt-to-equity ratio for the application of the thin capitalisation rules, it does not further clarify the definition of debt, nor does it introduce a definition of equity for tax purposes. The 2012 tax reform provided a general, broad definition of debt as anything that generates interest. The word "loan" is not included in that definition, so it could possibly cover finance leases, factoring arrangements, and other arrangements that aren't specifically mentioned.

Colombia's approach to calculating the maximum amount of debt on which interest can be deducted leans toward total debt, rather than related-party debt. The formula is the number of days within the tax year, multiplied by the amount of debt on which the interest will be calculated. The interest exceeding the maximum amount of debt is not deductible for tax purposes. In order to calculate the debt incurred in a foreign currency, the debt must be converted into US dollars.

The 2012 tax reform clarified that the thin capitalisation rules do not apply to the financing of public infrastructure projects carried out by companies or legal entities or special purposes vehicles. Decree 3027 provides a definition of public infrastructure that applies to projects that are necessary for the rendering of public services and that are regulated by the federal government. These projects should promote the growth, competitiveness, and improvement of the quality of life of Colombian citizens.

Decree 3028: Residence

Individuals

The 2012 tax reform substantially changed the concept of residence for individuals in Colombia. With the reform, individuals (regardless of citizenship) are considered to be resident if they stay in Colombia for more than 183 days within a 365-day period. Furthermore, Colombian citizens are resident if they have close ties in Colombia (family); if 50% of their assets are sourced, administered, or located in Colombia; if they have not proved their residence in another country; or if they are residents of a tax haven.

Decree 3028 also introduces rules for determining the 50% rule for Colombian-source income/assets for a specific year. For this purpose, the value of the assets held by an individual on December 31 of that year will be divided by the total value of the assets that the individual received in that year. It is irrelevant whether the assets are located in Colombia. The value of the assets will be determined in accordance with the provisions of the Tax Code. If there is an increase in the value of the assets, the increase will be included in the income that is subject to income tax and capital gains tax.

Decree 3028 also clarifies the rules for determining whether the assets are being administered in Colombia. For this purpose, the assets can be administered directly by the taxpayer for whom residence is being claimed or by means of an intermediary/agent, if the intermediary/agent acts on behalf of the taxpayer. The administrative activities include the day-to-day activities carried out in Colombia with the aim of preserving the asset. Finally, Decree 3028 states that the assets of individuals (nationals or foreigners) who are tax resident in Colombia include assets that are located outside Colombia.

Companies

For companies, the 2012 tax reform introduced the criterion of place of effective management and the tests for determining its existence. The tests follow, to some extent, the OECD criteria. They are

- the place where the key management and commercial decisions are made;
- the place where the meetings of the board of directors or equivalent body are usually held; and
- the place where the senior day-to-day management of the company is carried on.

Decree 3028 provides that companies that have their place of effective management in Colombia are regarded as residents for tax purposes. The determination of the place of effective management has a declarative effect, which means that the tax obligation will arise at the moment that one of the conditions for a place of effective management is met.

The 2012 tax reform also introduced a limitation on the tests to establish the residency of companies in Colombia, establishing that a company is not a resident for Colombian tax purposes solely because the management board meets in Colombia or its shareholders include individuals or companies resident for tax purposes in Colombia.

Decree 3028 further states that a foreign company with a place of effective management in Colombia will be required to register as a Colombian company with the unified tax registry and to make its financial statements in accordance with Colombian accounting rules.

Application of the OECD Model and Commentary

With the 2012 tax reform and Decrees 3026, 3027, and 3028, Colombia is bringing its tax rules in line with international standards, particularly OECD standards. The government is seeking OECD membership, and if it is granted – and approved by Colombia's Constitutional Court – the OECD model and commentary could be used to interpret Colombia's tax treaties.[4] The question is whether Colombia would adopt a static approach or a dynamic approach to the use of the OECD commentaries. Under the dynamic approach, the commentaries would apply when a tax treaty is invoked, whereas under the static approach, they would apply when a tax treaty is concluded.

Furthermore, the commentary to the OECD model treaty and the current work on the OECD Action Plan on Base Erosion and Profit Shifting – for example, regarding preparatory and auxiliary activities as exemptions to permanent establishment (Action 7) and the transfer pricing documentation (Action 13) that can be useful in determining the income attributable to a PE – could be relevant for implementing the 2012 tax reform and tackling tax avoidance.

Notes

[1] Decrees 3026, 3027, and 3028, issued December 27, 2013.

[2] The equality tax rate is currently 8% but will be 9% from 2015 onward.

[3] Paragraph 21 of the commentary to article 7(2) states that the functional and factual analysis should lead to

- *the attribution to the PE, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the PE is a part, and separate enterprises;*
- *the identification of significant human functions relevant to the assumption of risks, and the attribution of risks to the PE;*
- *the identification of other functions of the PE;*
- *the recognition and determination of the nature of the dealings between the PE and other parts of the same enterprise that can appropriately be recognized; and*
- *the attribution of capital based on the assets and risks attributed to the PE.*

[4] *As of January 2013, Colombia had signed income tax treaties with nine countries: Canada, Chile, Spain, Switzerland, and Mexico (all currently in force) and the Czech Republic, India, Portugal and South Korea (all currently pending review by the Constitutional Court).*