Foreign Tax Problems of U.S. Companies Doing Business in Latin America

Peter D. Byrne

Foreign Tax Problems of U.S. Companies Doing Business in Latin America

PETER D. BYRNE*

Local tax problems faced by U.S. companies operating in Latin America vary considerably from one country to another, because each country has its own tax system and legal history. Nevertheless, common culture, similar levels of economic development, and technical tax cooperation and advice orchestrated by organizations such as the International Monetary Fund, Inter-American Center of Tax Administrators, and Inter-American Development Bank have resulted in many similarities. Regionwide trends are clearly discernible.

This Paper focuses on some of the more salient tax features of a cross-section of Latin American countries.[1] Because tax rules directly related to foreign investors are of primary concern, this Paper will examine income tax rates, assets and capital taxes, special sector taxes, special incentives, and employer-charged payroll taxes. Other important tax issues affecting the general business climate also will be explored.

I. REGIONWIDE TRENDS

The tax news from Latin America for U.S. investors is mostly

* Former Deputy Director, Harvard University International Tax Program. This paper is truly a joint effort—it would not have been possible without the contributions of the following colleagues, who ensured that the information contained herein is up to date and accurate (both legally and as a practical matter): Argentina—Cristian E. Rosso Alba of Hope, Duggan & Silva, Buenos Aires; Brazil—Paulo Messina of Lilla, Huck e Malheiros, Sao Paulo; Chile—Jorge Espinosa of Ernst & Young, Santiago; Colombia—Alfredo Lewin of Lewin & Wills, Bogota, and Alvaro Leyva, Attorney at Law, Bogota; Costa Rica—Alonso Arroyo, Bufete Arroyo y Asociados, San Jose; Peru—Humberto Medrano of Estudio Rodrigo, Elias & Medrano, Lima, and Cesar Luna-Victoria of Muniz, Forsyth, Ramirez & Luna-Victoria, Lima; Venezuela—Francisco Garcia Arjona, Attorney at Law, Caracas, and Cristina Tovar of the Harvard International Tax Program.

1. Countries were selected for discussion on the basis of investment levels and information available to the author. Space limitations do not permit discussion of every country.

good. In general terms, the tax culture in Latin America has matured over the past ten years.[2] The level of brazen tax evasion has declined substantially in almost all countries. This has been achieved through greater enforcement and more severe penalties, as well as the introduction of taxes that are structurally more difficult to evade, such as the value added tax ("VAT") and the business assets tax. This is good news for foreign investors. While opportunities for tax avoidance have diminished, the new tax systems feature lower tax rates and have contributed to a more stable economic environment (including dramatically lower inflation rates) and improved infrastructure. The flood of investment into Latin America confirms that investors are not discouraged by the comprehensive tax reforms.

The most significant tax reform in Latin America over the past two decades has been the introduction of the VAT in nearly every country.[3] This has contributed to the region's economic stability and has direct consequences for the foreign investor. The VAT is favorable for companies engaged in manufacture and export, because exports are "zero-rated," meaning that all VAT paid on inputs, be they services or materials, will be refunded to the extent the VAT is attributable to exports.[4] This favorable treatment, however, could be compromised if the local tax administration's refund department is inefficient, and many are. Revenue produced by VAT has enabled governments to reduce the tax burden on business.

Although the introduction of VAT is a worldwide phenomenon, the introduction of a business assets tax is an almost exclusively Latin American trend. The business assets tax has spread incredibly quickly throughout the region.[5] It has been introduced, in various permutations, as an alternative minimum tax for businesses. Although the tax is about 2% of assets, it is payable only to the extent such calculation exceeds the income tax calculation. The exact nature of the assets tax in each country should be examined. Differences in the details may make the tax truly burdensome (as in Peru)[6] or so avoidable as to make it meaningless

2. *See* Parthasarathi Shome, *Tax Reform in Latin America*, *in* FIN. & DEV., Mar. 1995, at 14 (discussing Latin American tax reforms during the past decade that have caused structural changes in the region's economies).

3. *Id.* at 15.

4. *See* ALAN A. TAIT, VALUE ADDED TAX: INTERNATIONAL PRACTICES AND PROBLEMS 53 (1988) (discussing a similar VAT system that zero-rated exports and allowed businesses to claim as credits the taxes paid on inputs). On this or any other basic VAT issue, the Tait book continues to be the most lucid and authoritative source.

5. *See, e.g.*, Peter D. Byrne, *The Business Assets Tax in Latin America—No Credit Where It Is Due*, 9 Tax Notes Int'l 533 (1994).

6. Peru's assets tax is so burdensome because no carryback or carryforward of tax paid is

(as in Venezuela).[7] The assets tax has foreign tax credit consequences in the United States[8] and serious international implications: it limits use of thin capitalization and transfer pricing as tax-avoidance techniques. Without an alternative minimum tax that establishes a floor, these techniques potentially can reduce tax liability to zero.

While the majority of Latin American countries have introduced the business assets tax, it has been eliminated in Argentina and Bolivia.[9] It is too early to say whether the momentum of the assets tax is diminishing.

There is a clear trend in Latin America toward lower business and individual income tax rates, and toward corporate integration. The rate reduction follows a worldwide pattern. However, the downward trend in Latin America has been more pronounced: the 30-35% rates found in most of Latin America are favorable by world standards.

The movement toward elimination of the double tax on income earned by corporations, or corporate integration, demonstrates the prominent role talented economists have played in Latin American tax reform. Brazil, Mexico, Argentina, Chile, and Venezuela have all moved toward tax neutrality, making tax considerations less important in choosing the capital structure and business vehicle of an investment. Chile has reduced the corporate level tax to just 15% while leaving the shareholder-level tax intact. Though successful, this approach presents clear problems for tax treaty negotiations. Other countries have achieved integration simply by exempting dividends from tax. This form of integration is easily administered but does not permit progressive taxation of high-income shareholders.

On the subject of tax treaties, there is a nascent trend toward expansion of treaty networks. Mexico is at the forefront of this drive, Venezuela is negotiating, and other countries are starting to view tax treaties as a sensible step. Some want to negotiate in order to appear more attractive to foreign investors; others view treaties as a prerequisite for free trade. This new attitude toward treaties is logical in light of another significant trend: There has been a steady shift away from Latin America's traditional territorial view of taxation. Argentina, Brazil,

allowed for refund; and at 2% of gross assets, it is double Argentina's rate, even though the two countries share an ordinary business income tax rate of 30%. *Id.* at 536.

7. Venezuela's assets tax is meaningless because the tax of 1% is on net assets and may be carried forward to reduce income tax liability in excess of assets tax liability. *See id.* at 535.

8. "[T]he tax will never be creditable in the United States to the extent it increases liability above the amount attributable to the ordinary income tax." *Id.* at 538.

9. The tax was implemented this past year in Colombia, Guatemala, Honduras, and Costa Rica, to name four countries. The tax has also received serious consideration outside Latin America.

Chile, Colombia, and Mexico, for example, all tax resident companies on worldwide income.

Another reason for improved treaty prospects is the reduced emphasis on tax sparing, or "phantom" credit for taxes forgiven, or spared, pursuant to a tax holiday. This follows logically from the fact that many Latin American countries have eliminated or reduced the availability of tax holidays. Therefore, countries unwilling to negotiate tax treaties with a tax-sparing provision, such as the United States, have one less impediment to a treaty. Although foreign investors may mourn the passing of such tax holidays, most experts view tax holidays as bad tax policy.[10] In addition, the other attractive tax reforms discussed here have been made possible in part by the elimination of tax holidays.

A mini-trend worthy of mention is the reduction of the withholding rate on interest paid to the exterior to just under 5% in Mexico, Venezuela, and Argentina. Anyone with doubts about the extraterritorial impact of domestic U.S. tax policy should take note.[11]

Finally, certain Latin American countries have made an effort to become more competitive by cutting payroll taxes imposed on employers.[12] Around the world, payroll taxes are a politically popular means of transferring government and individual responsibilities to the business community. Increasingly, however, they are recognized as a significant obstacle to investment, both foreign and domestic. The effort to reduce these taxes is advantageous for U.S. investors.

Let us turn now to the situation in some of the countries in Latin America.

A. *Argentina*

Argentina, with a 30% tax rate on company profits and tax-exempt dividends, has an extremely competitive profit tax environment. Surprisingly, Minister Domingo Cavallo's team has been able to cut rates dramatically while simultaneously increasing revenue. Argentina's fiscal situation is vastly improved notwithstanding a severe recession. This has been possible because improvements in enforcement have changed the tax psychology of the people, and compliance has increased dramatically.[13]

Argentina was one of the early subscribers to the business assets

10. Indeed the United States' position reflects disapproval of tax holidays. The one exception to this is Puerto Rico. *See* I.R.C. § 936 (1994).

11. I refer, of course, to these countries' effort to keep their withholding tax out of the high withholding tax interest basket. *See id.* § 904(d).

12. Because payroll taxes are not creditable and are a function of wage levels rather than of income, I will limit my discussion to general observations on levels and trends.

13. *See* David Pilling, *Tax Amnesty Buoys Argentina*, FIN. TIMES, Dec. 1, 1995.

tax as an alternative minimum tax. While the business assets tax was imposed at a modest 1% rate, it was based on gross assets and had few relief provisions.[14] Argentina now has eliminated this tax. Interestingly, there is little official indication as to why the tax was rescinded.[15] The general increase in revenue may have made the tax unnecessary. In any event, the rescission will provide necessary relief to Argentine businesses. Because the tax was payable without regard to net income, it could have been devastating during the current recession.

Certain aspects of Argentina's tax system are extremely favorable to foreign investors. For example, there are no thin capitalization rules though the exemption on dividends makes excessive debt less tempting than usual. However, opportunities for investors are presented, in that interest paid to the exterior is deductible and subject to only a 4.5% withholding tax.[16] Real estate presents another opportunity. If land is purchased through a foreign corporation, sale of the corporation's shares ordinarily will be tax free.[17] And although Argentina has somewhat curtailed its tax incentive program, ample exemptions remain.[18]

Argentina is not without its tax hazards. Substantial areas of uncertainty exist because rules on the relatively recent switch to worldwide taxation of Argentine companies have not been developed. Perhaps as a holdover from its territorial days, Argentina has been slow to expand its treaty network. Fewer than ten treaties are in force, and a U.S.-Argentina treaty seems unlikely in the near future. Investors, therefore, cannot depend upon the stability offered by tax treaties. In the VAT area, refunds for VAT attributable to exports can be slow in arriving. Payroll taxes amount to a burdensome 33% on employers, though this has been moderated with a recently implemented cap of $4500 per employee.

B. *Brazil*

The tax situation in Brazil has improved considerably over the past decade. The tax picture was horrendous for foreign investors, then it

14. Companies in certain sectors, such as banking, insurance, and primary products, were allowed to exclude 60% of assets from the tax base on the logic that a substantial portion of their assets in fact belonged to third parties.

15. Decree 1684/93 refers to simplification, neutrality, and general economic policy as reasons for the tax reform that included repeal of the assets tax. Decreto 1684/93, Boletin Oficial [B.O.] Aug. 17, 1993.

16. Telephone Interview with Cristian E. Rosso Alba, of law firm of Hope, Duggan & Silva, Buenos Aires, Arg. (Dec. 15, 1995) (relying on Ley No. 24.587, B.O., Nov. 22, 1995). This is the latest in a series of reductions—the rate had most recently been 12%. *Id.*

17. Case law precedents must be followed to ensure the tax-free treatment.

18. See No. Ley 24.196, B.O., May 24, 1996, which sets forth certain incentives available in the mining sector. Anyone considering investment in Argentina should seek advice about what exemptions, if any, might apply.

became merely unfavorable, and now it is competitive with other Latin American tax systems. Of particular note, Brazil has not tried the business assets tax.

In late 1995, Brazil reduced its top tax rate on corporate income to 25%.[19] Following the example of other Latin American countries, Brazil has achieved corporate integration by exempting both resident and nonresident shareholders from tax on distributions. Brazil, therefore, now has the lowest total tax rate on corporate income in the region, and among the most favorable in the world.[20] For investors, numerous incentives and exemptions remain available. There is considerable competition among states and municipalities to attract investment, and tax holidays for taxes under local control are always negotiable. Investments in some remote areas in the Amazon are tax exempt by federal law for a period of ten years. Remittances to the exterior (other than dividends) are subject to a 15% withholding tax. Therefore, use of a high debt-equity ratio may offer some advantages. In the few cases where a lower treaty rate on interest is available, a business still must worry about special rules regarding the deductibility of related-party interest.

Brazil has a limited treaty network, although the recent reductions in withholding rates alleviate some of the need for treaties, Brazil has now moved to worldwide taxation of resident enterprises.[21] This may motivate Brazil to seek treaties with more enthusiasm. There is a general rule for transfer pricing that requires use of the arm's-length standard. The issue comes up occasionally on audit, but there is no detailed regulatory guidance.

Brazil still is not a tax haven. For example, the new tax reform calls for strict monthly payments of estimated income tax. The amount of estimated tax is based on gross sales, and establishing that a business is losing money (and therefore not liable for estimated tax) will not be simple.[22] Significant compliance costs are expected. Furthermore,

19. The 25% rate comprises a base of 15%, with a 10% additional tax on income above $240,000. Telephone Interview with Paolo Messina, of Lilla, Huck e Malheiros, Sao Paulo, Braz. (Jan. 5, 1996); *see also* Lei No. 9249, Regulamento do Imposto de Renda, Dec. 27, 1995, for this and all other references to the recent tax reform.

20. Longtime Brazil watchers will appreciate this dramatic turn of events. Brazil's corporate tax rate used to be among the highest in the region. Even worse, Brazil imposed a withholding tax on "excess" dividend payments so confiscatory that repatriation of profits was often impossible. The policy was defended as promoting reinvestment in Brazil but, of course, it discouraged many investors from going into Brazil at all.

21. Until the December 1995 reform, Brazil had defended the territorial principle. The new system allows a foreign tax credit for taxes paid abroad. It will be interesting to see whether Brazil's strict territorial source rules (an impediment to treaty negotiations) are now modified.

22. The mechanics of the refund for overpayment of estimated tax may affect the whole tax's creditability for U.S. purposes.

depreciation and inventory valuation regimes are not as favorable as in the United States.[23] An investor also must consider other taxes, such as the payroll tax for pensions and health care (27%), social contribution on income (7.4% of net income, deductible from net income) social security (or COFINS, amounting to 2% of gross sales), and the social integration contribution (or PIS, levied on 0.65% of gross sales). Therefore, savings from the beneficial income tax regime may be offset by these non-creditable taxes.

After negotiating this minefield of payroll taxes, a business must still contend with the VAT. Brazil's fondness for the VAT extends to three separate levies, imposed by the federal, state, and municipal governments.[24] The three differ with regard to base and rate. Exports are not subject to the VAT, but cash refunds on inputs simply are not paid. This will be no problem where the business has adequate domestic sales subject to the VAT, but it will present a significant problem in isolated cases, for example for businesses that have many taxable inputs and export most of their production. Although not within the scope of this Paper, Brazil's customs tariffs pose significant problems. Thus the total burden of customs tariffs, payroll taxes, and the VAT is heavy, and compliance costs cut into return on investment.

C. *Chile*

Chile's vibrant economy is hailed as a success for Chile's economists, including its tax economists. They have devised an integrated system that encourages investment. Chile imposes a 15% rate on corporate earnings and subjects dividends to personal income rates of up to 45%. A withholding tax of 35% is generally imposed on payments to nonresidents. In either case, a credit for tax paid at the corporate level is allowed.[25] The combined rate for nonresident investors, therefore, is just 35%, which is in the same range as the 30-35% combined rate available in competitors such as Argentina and Mexico. Note, however, that Argentina's and Mexico's taxes are payable immediately, whereas the bulk of the Chilean tax is deferred until distribution. Additionally, Mexico's and Argentina's fully integrated systems do little to discourage repatriation. Because that which is not repatriated ordinarily is rein-

23. There is, however, a special accelerated depreciation for machinery that is in effect through 1997.

24. The three levies are the IPI (Imposto sobre Produtos Industrializados); ICMS (Imposto sobre a Circulacao de Mercadorias) and ISS (Imposto sobre Servicos). The ISS is not technically a value added tax because no credit is allowed on inputs.

25. Telephone Interview with Jorge Espinosa, of Ernst & Young, Santiago, Chile (Dec. 10, 1995) (relying on Decreto Ley No. 824, *in* Diario Oficial No. 29.041, Dec. 31, 1974, amended by Decreto Ley No. 910, *in* Diario Oficial No. 29.092, Mar. 1, 1975).

vested, it stands to reason that Chile's unusual system has contributed to that country's robust investment rate and sound economy.

It also should be noted that Chile's integrated system appears to be progressive, in that dividends are taxed according to the recipient's overall income. Mexico and Argentina, by taxing only the business level, do not distinguish between high- and low-income dividend recipients.

Whether other countries should embrace the Chilean approach warrants investigation, yet it must be recognized that this approach does not fit comfortably into the international tax treaty scheme. Chile collects most of its revenue from business activity at the distribution level, whereas the international norm is to collect most revenue at the entity level.[26] Tax treaties forgive most distribution-level tax through a reciprocal reduction of withholding rates.[27] Chile cannot reasonably be expected to reduce its withholding rates reciprocally when its corporate level tax is so modest. This is among the principal reasons why Chile has no tax treaties of significance.[28] It will be interesting to see whether Chile decides to change its system, continues not to have tax treaties, or works out treaties that do not include reciprocal withholding rate reduction.

Chile no longer doles out tax holidays and has apparently not considered the assets tax. The country imposes a 15% tax on capital gains but in some cases imposes the ordinary personal income tax rate.[29] Like Argentina, Chile does not have thin capitalization rules. The withholding rate on interest, like dividends, is 35%, meaning that some benefit can be derived by borrowing from a parent company. A special 4% withholding rate applies to interest paid to foreign banks, and this can generate substantial tax savings.[30]

26. Virtually every country has a business income tax rate of 25% or higher and a dividend withholding rate of less than 25%. Countries with higher withholding rates routinely reduce them by treaty to the 15% range. Tax reform proposals have focused on reducing the tax rate on resident individuals; raising the corporate rate is not under discussion.

27. The Organization for Economic Cooperation and Development and U.S. Model tax treaties call for reciprocal dividend withholding rates of 5%-15%, depending on degree of ownership. Organization for Economic Co-Operation and Development Model Tax Convention on Income and Capital, art. 10 (1992), *in* 1 Tax Treaties (CCH) ¶ 191; U.S. Model Convention on Income and Capital, art. 10, *in* 12 INTERNATIONAL TAX TREATIES OF ALL NATIONS 496 (1982). The United Nations model does not specify a rate, but reciprocity is assumed. U.N. Model Double Taxation Convention Between Developed and Developing Countries, art. 10 (1979), *in* 25 INTERNATIONAL TAX TREATIES OF ALL NATIONS 553 (1992).

28. Chile has only one income tax treaty, that with Argentina. This treaty, like the Andean Pact Model, simply reiterates the territorial principles included in domestic law.

29. Decreto Ley No. 824, art. 17, ¶ 8, *in* Diario Oficial No. 29.041, Dec. 31, 1974, amended by Decreto Ley No. 910, *in* Diario Oficial No. 29.092, Mar. 1, 1975.

30. Non-tax rules make this strategy less attractive: 30% of any loan from abroad must be deposited with the Central Bank for one year. After one year this amount is released, but no

The VAT is set at 18%.[31] No problems are reported in recovering export-related VAT refunds. Payroll taxes imposed on employers are limited to a 0.9% charge for an accident fund.[32] The most significant "tax" in the labor-and-employment area is a variable profit-sharing requirement.[33]

D. *Colombia*

Colombia recently implemented a major tax reform, and though the tax burden there is increasing, it should not be significant enough to deter investment in a country that has experienced uninterrupted economic growth for the past thirty years.

Under the new tax law, the tax rate on corporations will be 35%.[34] A new alternative minimum tax, which imputes income equal to 1.5% of gross assets, has been introduced, with the 35% rate applied to the imputed figure after certain adjustments.[35] This new alternative minimum tax supplements, rather than supersedes, the previous alternative minimum tax. So taxpayers must make a third calculation based on net assets, imputing income of 5% to such net assets. The figure derived is subject to certain adjustments, and then the 35% tax rate is applied.[36] In cases where alternative minimum tax is due, a mechanism exists to carry forward excess alternative minimum tax to reduce income tax liability in subsequent years.[37] This exceedingly complex system appears to be the result of insufficient compromise.

Although investors may be intimidated by this complexity, Colom-

---

interest is paid. Alternatively, an amount equal to LIBOR plus 4% on the 30% may be paid over to the Central Bank. This rule is to stem the flow of "hot" money into and out of Chile.

31. The rate will fall to 17% at the end of 1997.

32. The rate may be higher for high-risk activities.

33. The business may choose between the following as a minimum: 30% of taxable corporate income, less 10% of the net worth of the business; or 25% of each employee's annual salary, limited to a maximum of 4.75 minimum monthly salaries (approximately $675).

34. The previous nominal rate was 30%, but with various adjustments amounted to about 35%. Before the recent reform, Colombia had *one* alternative minimum tax (based on imputed income from net assets). The new law also features "stabilization," which gives an investor the guarantee that its tax rate will never be increased.

35. Telephone Interview with Alfredo Lewin, of Lewin & Wills, Bogota, Colom. (Jan. 7, 1996). Colombia differs from other Latin American countries in that the alternative minimum taxes use the assets (net or gross) of a business to calculate a level of "presumed" income, which then is multiplied by the 35% tax rate to derive a tentative liability. Calculation of presumed income adds an extra step, but certain adjustments may be made to the presumed income before the tax rate is applied. Accordingly, the first alternative minimum tax normally will be just over 0.5% (35% of 1.5%) of gross assets. This is much lower than the rate imposed by other Latin American countries. *Id.*

36. *Id.* Thus, the tax will be about 1.67% (35% of 5%) of net assets. *Id.*

37. *Id.* Alternative minimum tax is not charged in the start-up phase of a business. This follows the general pattern of other countries with regard to the business assets tax. *Id.*

bia's two alternative minimum taxes should not significantly increase the total tax payable by foreign investors.[38] The alternative minimum taxes' low rates, plus the carryforward mechanism, should minimize any impact on honest taxpayers.

One pitfall of the Colombian tax system has been changed somewhat. Under prior law, the deduction for expenses paid abroad could not exceed 10% of the business's net income calculated without regard to such expenses. This limit has been increased to 15%, but many costs that were deductible without limitation until 1995 will now be subject to this 15% limitation.[39] Royalties paid to a parent by a subsidiary are deductible, subject to the foregoing limitation.[40] Royalties also will be subject to 35% withholding, plus a 7% remittance tax. This makes royalties an unattractive option for international investors. A special regime for leasing activity has also been introduced.[41]

Dividend withholding is set at a reasonable 7%. To approximate parallel taxation, a 7% branch tax is imposed on unincorporated entities. Capital gains realized by nonresidents on the sale of stock are taxed at the ordinary 35% rate.[42]

Colombia's general rule addressing transfer pricing establishes a permissible range of prices that can be charged.[43] In general terms, a price will not be challenged if it is within 25% of the market price. It appears that Colombia has decided to limit its efforts to cases of serious abuse. Colombia does not have tax rules regarding thin capitalization. Complex rules govern the withholding rate on interest, but the withholding rate for related-party debt will ordinarily be 35%, so planning opportunities are limited. Colombia's Commercial Code also imposes capital requirements.

The new tax law increases the VAT from 14% to 16%, but there is no problem obtaining VAT refunds related to exports. Where heavy machinery is imported, part of the VAT due may be deferred for two years. Colombia does not require employee profit sharing, and payroll taxes imposed on employers amount to a reasonable 9% of basic monthly payroll.

---

38. *Id.* The business is simply required to pay the greatest of the three taxes—the regular corporate tax and the two alternative minimum taxes. This system could cause foreign tax credit problems in the United States.

39. *Id.* (referring to COLOM. TAX CODE art. 122). Items considered "gastos," or general expenses, were previously subject to the limitation; the deductibility of "costos," related to production of goods, was not limited, but will be in 1996. This change is likely to hurt most taxpayers. *Id.*

40. *Id.* (referring to COLOM. TAX CODE art. 124).

41. *Id.* This new system regulating leasing is outside the scope of this paper.

42. *Id.*

43. *Id.* (referring to COLOM. TAX CODE art. 90).

E. *Costa Rica*

Costa Rica, long recognized as a delightful place to live, is making efforts to also become a nice place to invest. The tax code was amended twice in 1995, with several changes intended to benefit foreign investors. The corporate tax rate has been cut to 30%[44]; the withholding rate on dividends paid to the exterior are now subject to a maximum 15% withholding rate;[45] and royalties are subject to 25% withholding.

Even though these rates are not overly burdensome, there are strategies for reducing tax liability. Transfer pricing and thin capitalization, for example, are not regulated. The capital structure is especially tempting, because interest paid out of Costa Rica to international banks is tax exempt if the bank is recognized by Costa Rica's Central Bank. There is little control of back-to-back loans. Even related-party loans are subject to only 15% withholding on interest.[46]

To help curb abuses, Costa Rica has introduced for 1996 a business assets tax of 1% on gross assets.[47] This assets tax should make it difficult to reduce tax liability below a certain level. The assets tax may help control transfer pricing and thin capitalization. At a 1% rate, however, the "floor" will be low, allowing a fair amount of manipulation.

A range of tax incentives, including accelerated depreciation and possibly exemption from income, excise, and other taxes, are available for certain economic sectors, such as exporters, hotels, and agriculture. A different sort of tax holiday has been offered for the timber and forestry industries: Costa Rica allows this sector to reinvest its tax liability instead of paying the liability over to the state.[48]

Historically, Costa Rica has attempted to be a welfare state. To support this system, businesses are required to pay a hefty 18.75% payroll tax for Social Security, and an additional 5% is levied on total payroll for "family allowances." A VAT is imposed at a 15% rate,[49] with exports zero-rated. Although VAT refunds are technically available, as a practical matter, a business cannot expect a VAT refund. To alleviate this situation, a business has two options: If the company derives 100% of its income from exports, it may apply for a permit to buy capital

44. Telephone Interview with Alonso Arroyo, of Bufete, Arroyo y Asociados of San Jose, Costa Rica (Dec. 2, 1995) (relying on COSTA RICA INCOME TAX LAW art. 15). Lower rates apply where the company's gross sales amount to less than $60,000. *Id.*

45. *Id.* (relying on COSTA RICA INCOME TAX LAW art. 23). However, a 5% rate may be available if the company's shares are traded on the national stock exchange. *Id.*

46. *Id.* The rate can be reduced to 8% if the debt is listed on the national stock exchange. *Id.*

47. *Id.* The assets tax is not imposed on the first $150,000 of assets, and then is phased in. *Id.*

48. *Id.* This incentive is being phased out. *Id.*

49. *Id.* The VAT rate supposedly will be reduced to 13% in early 1997. *Id.*

goods without tax;[50] or it may sell the credits to a third party.[51]

Anecdotal evidence indicates that one of Costa Rica's significant problems is the weakness of its tax administration. This may make tax avoidance easier and planning more difficult. In light of Costa Rica's territorial system and its weak tax administration, it is unlikely that a tax treaty network will be initiated any time soon.

F. *Peru*

After years of economic and social chaos, Peru is experiencing explosive economic growth. A radical overhaul of the country's tax administration has resulted in tax revenue nearly tripling as a percentage of Gross Domestic Product in less than five years. This improvement has surely contributed to the economic stability and low inflation that has attracted foreign investment.

Peru has instituted a 30% tax rate on businesses and supplemented this with an alternative minimum tax of 2% of gross assets. The assets tax is applied to a broad base.[52] As in Mexico and Argentina, dividend payments are not taxed. This will limit tax-avoidance strategies such as transfer pricing and thin capitalization. The dividends exemption also makes debt financing less attractive, though debt financing may be advantageous in some cases. Paying interest to a related party is not a good option because the amount paid is subject to 30% withholding. On most other interest paid to the exterior, however, the withholding tax is only 1%. Interest paid to the exterior on a bond-type instrument is fully exempt. There appears to be little control of back-to-back loans. Royalties, formerly subject to a stiff 30% withholding tax, are now subject to 10% withholding. Finally, capital gains realized in stock market transactions are tax exempt.

Overall, Peru provides favorable income tax treatment to the foreign investor. Other than the assets tax, and its potentially serious U.S. tax consequences, there is little of concern in the area of business income taxes. Other taxes, however, can be impediments. Unfavorable aspects of the Peruvian tax system include the 18% "social contribution" payroll tax on employers, further payments for mandatory funds and holiday bonuses, and a profit-sharing requirement of 5-10%. Peru

50. *Id.* (relying on Sales Tax Executive Rulings 27 & 28, and Excise Tax Executive Ruling 22).

51. *Id.* (relying on Tax Procedures and Regulations art. 48).

52. The Peruvian Government has indicated that the assets tax will be eliminated within a few years. When that is considered along with the fact that the assets tax is not imposed during the first two years of an investment, the assets tax poses even less of an impediment to foreign investors.

imposes a high 18% VAT, with few exemptions; however, there is no problem with export-related VAT refunds.

Peru has no tax treaties of significance, though this may soon change. The Superintendent of Peru's tax authority recently indicated that Peru was prepared to begin negotiating tax treaties.[53] Such an effort requires sustained commitment, and it remains to be seen whether Peru has this commitment. In the meantime it is important to note that Peru will enter into "stabilization" agreements,[54] which expressly cap the level of corporate tax and withholding at current levels.

Other tax incentives, which consist of special depreciation and depletion rules, and certain consolidation opportunities, are primarily in the extractive industries.[55] Although most other tax incentives have been eliminated, the Investment Promotion Law should be consulted to ascertain whether any other incentive may apply.[56]

G. *Venezuela*

Venezuela is experiencing a period of economic turmoil. Bright spots exist, however. The country has a reasonable tax environment and a steadily improving tax administration. Further, its tax policies, though not always reasonable in execution, are reasonable in concept.[57] Unfortunately, economic planning in other areas has been unwise, and Venezuela is suffering from inflation in the 50-70% range.

Venezuela has followed the pattern of reducing the tax rate on businesses, broadening the tax base, supplementing the corporate tax with an assets tax, and exempting dividends.[58] The top corporate tax rate is now 34%, and most tax holidays and other incentives have been eliminated. The assets tax, on the other hand, is of little concern to the foreign investor, because it is imposed as an alternative minimum tax at a low rate of 1%, and various liabilities reduce the tax base. To be subject to the assets tax, a taxpayer would have to receive poor tax advice and have a very bad year as well.[59] In sum, Venezuela's corporate-level income tax is favorable to investors. It is worth noting that one significant tax

53. Adrian Revilla, Superintendent of SUNAT, paper presented at International Law Weekend/95 (Nov. 3, 1995) (on file with author).

54. *See* PRICE WATERHOUSE WORLD FIRM LTD., DOING BUSINESS IN PERU 17 (1994).

55. *Id.* at 19-21.

56. Telephone Interview with Humberto Medrano, of Estudio Rodrigo, Elias & Medrano, Lima, Peru (Jan. 7, 1996). Decreto Legislativo No. 662 and regulations thereunder allow certain benefits for investments that exceed $2 million or create more than 20 jobs. *Id.*

57. Venezuela has attempted to change the foolhardy policy of subsidizing gasoline. However, when the Government recently raised the price from US 10 cents per gallon to 20 cents per gallon, riots erupted. So retail sale of gasoline is a revenue loser instead of a revenue source.

58. Telephone Interview with Francisco Garcia Arjona, of Caracas, Venez. (Dec. 3, 1995).

59. At the 1% rate, the assets tax would be payable only if the business had a return of less

incentive remains. Until 1999, a 20% tax rebate is available for investments in fixed assets made by industrial and agricultural corporations.[60]

On the down side, Venezuela has shifted back and forth between worldwide and territorial taxation of certain types of income. Current tax law follows the territorial principle, but income is deemed to arise within Venezuela if the activity is "economically relevant" to Venezuela.[61] This rule has resulted in significant litigation. Another serious problem is Venezuela's arcane inflation adjustment system, designed to keep inflation from eroding taxpayers' liability. There is speculation that taxpayers are attempting to avoid these rules by moving income offshore.

Venezuela is trying to move forward on tax treaties, but the U.S.-Venezuela treaty appears to have faltered over relatively unimportant issues. Venezuela has nevertheless made a significant gesture to U.S. banks by unilaterally reducing the level of withholding on bank interest to 4.95%. Royalties, by contrast, are taxed at the 34% rate on "net income," with "net" deemed to be 90% of the gross payment.

Venezuela does not have meaningful controls on transfer pricing or thin capitalization. This situation furnishes ample tax-planning opportunities. For export-oriented companies, the 12.5% VAT[62] is unlikely to be recovered, but excess input credits may be sold, at least in theory.

Venezuela also imposes a host of other taxes of interest to the foreign investor: A registration duty of 0.5-1% on a variety of transactions, including sales of property and leases;[63] a payroll tax on employers of 9-11% for social security; and an additional 2% for a housing fund.[64] Large companies are also required to allocate 15% of profits to employee profit-sharing, with a floor and a ceiling on these contributions.

---

than 3% on net assets. Because of the available three-year carryforward mechanism, this poor return would have to be sustained. *Id.*

60. *Id.* (relying on VENEZ. INCOME TAX art. 58).

61. *Id.* (relying on VENEZ. INCOME TAX arts. 1 & 4).

62. *Id.* President Caldera made elimination of the VAT a central theme of his successful election campaign. After his election, however, the VAT was simply replaced by a nearly equivalent tax that is invisible to consumers. The tax, called the "Impuesto al Consumo Suntuario y Ventas a Mayor," is imposed at a 12.5% rate. *Id.* That tax is referred to in this paper as the VAT. Venezuela is about to adopt a tax reform that would narrow the VAT base and raise the rate to 15%. *Id.* A financial transfers tax of around 1% is also under discussion. *Id.* By themselves these populist measures constitute poor tax policy; coupled with the gasoline tax, they should be considered irresponsible.

63. *Id.* (relying on Decreto Ley No. 3.316, *in* GACETA LEGAL, Dec. 30, 1993).

64. *Id.* (relying on Decreto Ley No. 3.270, Ley de la Politica Habitacional, Dec. 15, 1993).

II. THE FUTURE

Ten years ago, a paper focusing exclusively on local tax problems encountered by U.S. investors doing business in Latin America would have been lengthy and discouraging. Things have changed. Latin America has recognized the importance of foreign investment, and most countries have fashioned their tax laws accordingly. The magnitude of progress in virtually every country cannot be exaggerated. Now that Brazil has made important reforms, taxes should not prevent investment in any major country. Taxes generally pose no more of an obstacle than they do in Europe or Asia.

In the short term, the problems are transitional. Recent radical changes in some countries make it unclear how the U.S. investor is to comply, though coordination with local tax advisors will likely be needed. Investors should remember that these difficulties will pass, whereas structural improvements in the tax systems will likely remain to render long-term benefits. One potential threat is that Latin American countries will not continue aggressive measures to improve tax administration. If enforcement slips and the old cycle of tax increases is renewed, the improved tax environment could deteriorate.

The assets tax is a related threat. The assets tax has given Latin American tax authorities some breathing room because it is easy to administer. It probably should not be a permanent measure. It is often not equitable,[65] discourages investment and raises creditability issues in the United States. One challenge for the future will be to phase out the assets tax without severe revenue consequences. This can only be accomplished through improved administration.

Payroll taxes, because they are exceedingly high in some countries, may become the largest impediment to U.S. investment in the region. Such taxes may not be a problem as long as wage levels are low, but wage levels can be expected to rise. Transferring payroll tax responsibility to employees, or reducing such obligations, should be a priority for Latin American countries over the next few years.

The tax treaties issue should be resolved. After a flurry of activity between the United States and Latin America at the beginning of this decade, momentum appears to have waned. The treaty with Mexico could be used as a marketing tool. The time is right for a U.S. push in Latin America: most countries are seeking foreign investment; hemispheric free trade in the next decade is an agreed-upon goal; tax sparing should no longer be a major issue; and many countries are moving away

---

65. The carryforward mechanism makes the assets tax more equitable but also more complicated.

from the territorial principle. In sum, there is great interest in tax treaties with Latin America, and the time seems ripe.