Colombia in the International Tax Competition for Foreign Direct Investment (FDI): The Interest Deduction's Case*

Luis Orlando Sánchez-Neira**

Abstract

This article first discusses the Colombian tax measures implemented over the last years and analyzes them as factors in increasing the foreign direct investment (FDI). The second part argues that Colombia's longstanding foreign indebtedness exchange and tax regime fosters tax free income repatriation from Colombia by Multinational Enterprises which may have produced the Inward FDI. The third part discusses alternatives to address the extraction of rents through interest payments. The fourth and final part argues if these practices should be changed or not.

Keywords: International Taxation, Tax Competition, Thin Capitalization, Interest Payment, Foreign Direct Investment (FDI).

Key word plus: Colombia - Public Finance, Economic Competition, Economic Forecast, Foreign Investment.

JEL Classification: E420, E24, E27, F3.

Fecha de recepción: 10 de junio de 2009
Fecha de aceptación: 27 de julio de 2009

---

* Review article written by the author on tax law and foreign investment as result of the guidelines established at the International Tax Policy seminar within the framework of the International Tax Law Master's program of New York University (NYU).

** Pontificia Universidad Javeriana JD; New York University (NYU) Master (LLM) in International Taxation; Universidad de los Andes, graduate studies (Specializations) in Commerce Law and in Tax Law. Sanchez Neira is currently working in the Tax Department of Ernst & Young LLP, New York, NY. Contacto: los216@nyu.edu

Colombia en la competencia fiscal internacional por Inversión Extranjera Directa (IED): el caso de la deduccion por intereses

Resumen

Este artículo, en primer lugar, discute las medidas tributarias implementadas por Colombia en los últimos años y analiza éstas como factores por incrementar la Inversión Extranjera Directa (IED). La segunda parte discute como la normatividad cambiaria y tributaria respecto de endeudamiento externo permite la repatriación de ingresos desde Colombia por parte de las empresas multinacionales que han llevado a cabo IED en el país. La tercera parte aborda las alternativas para abordar la extracción de rentas mediante el pago de intereses. La cuarta parte discute si la práctica de extracción de rentas mediante el pago de intereses producidos por endeudamiento externo debe ser objeto de cambio.

Palabras clave autor: tributación internacional, competencia tributario, capitalización delgada, pago de intereses, Inversión Extranjera Directa (IED).

Palabras clave descriptor: Colombia – Hacienda Pública, competencia económica, pronóstico de la economía, inversiones extranjeras.

Clasificación JEL: E420, E24, E27, F3.

La Colombie dans la concurrence tributaire internationale par "Investissement Etranger Direct" (IED): Le cas de la déduction par intérêt

Resumé

Dans cet article une introduction est faite de quelques unes des dispositions en matière fiscale que la Colombie a adopté, ainsi que ses effets économiques face a l'augmentation de l'Investissement Étranger Direct (IED). On analyse principalement la structure des normes fiscales et de change en relation avec l'endettement externe, et la façon dont celui-ci peut constituer un outil pour le rapatriement des recettes des entreprises multinationales depuis la Colombie. Sous cet angle, on aborde diverses alternatives qui peuvent se considérer pour limiter la pratique d'extraction des rentes grâce aux paiements d'intérêts, en analysant les bénéfices et les désavantages de celles-ci. Finalement on questionne la nécessite et la convenance d'établir, actuellement, dans la législation fiscale colombienne unes de ces alternatives

Mots clés auteur: Fiscalité internationale, compétence fiscale, faible capitalisation, paiement d'intérêts, "Investissement Etranger Direct" (IED).

Mots clés descripteur: Colombie – finances publiques, compétence économique, prévisions de l'économie, investissement étranger.

Classification JEL: E420, E24, E27, F3.

Summary: Introduction. 1. Colombia in the Tax Competition Scenario. 2. Foreign Indebtedness in Colombia: Exchange Control and Tax Treatment. 3. Approach to Deter Income Extraction by means of Interest in Colombia. 4. Is it Advisable to Impose thin Capitalization Rules in Colombia? Conclusion. Bibliography.

Introduction

From 2004-2006, the United Nations Conference on Trade and Development (UNCTAD) ranked Colombia's inward Foreign Direct Investment (FDI) potential 94th out of 141 countries. For the same period, Colombia's inward FDI performance was 44th out of the same number of countries.

Potential Inward FDI index is based on 12 variables that are expected to affect an economy's attractiveness to foreign investors[1]. In contrast, the Inward FDI performance index ranks countries by the Inward FDI they receive relative to their economic size. It is therefore the ratio of a country's share in global FDI inflows to its share in the global GDP.

Based on these numbers, Colombia's performance was above expectations as reflected in the so-called potential FDI index[2]. There is no ranking available for 2007 and 2008, years when Colombia had its highest historic FDI according to the data of Colombian Central Bank (Banco de la República)[3] despite the worldwide economic downturn[4]. For 2009, at the same time this article was being written, the effects of the economic crisis had finally started to generate a reduction of the FDI in Colombia[5].

The increase of the FDI in Colombia, exceeding the expectations of some international agencies, cold have been a consequence of several politic, economic and legal factors, including the tax law applied to foreign investors. Tax regimes that grant incentives such as tax holidays, allowances, tax credits and reduce tax rates (or withholding rates) have been found to be an increasingly important factor in FDI decision-making,

1 Variables include market size, gross domestic product (GDP) per capita, GDP growth in the last 10 years, share of exports in GDP, number of telephone and mobile lines per inhabitants, share of the research and development in the GDP, country risk, world market shares in the export of natural resources, among others.

2 This information is available at http://www.unctad.org/Templates/Page.asp?intItemID=2468&lang=1

3 According to the data from the Central Bank, the FDI for 2007 was of US$9.049 million and for 2008 it was approximately US$ 10.600 million. The total FDI in Colombia was for 2007 was about 32.7% of the country's GDP, slightly higher than the south american and the caribbean percentage (32.4%) and far from the world's average (27,9%). See http://www.banrep.gov.co/series-estadisticas/see_s_externo.htm#flujos and UNCTAD World Investment Report for 2008.

4 The UNCTAD considers that, in average, the FDI in 2008 dropped worldwide about 20%. See UNCTAD, *Global FDI in Decline Due to the Financial Crisis, and a Further Drop Expected*, Investment Brief No 1 (2009). http://www.unctad.org/en/docs/webdiaeia20095_en.pdf

5 The Colombian government has announced that in the first quarter of 2009 the FDI in Colombia dropped 22% in comparison to the first quarter of 2008. See http://www.portafolio.com.co/economia/pais/2009-04-09/ARTICULO-WEB-NOTA_INTERIOR_PORTA-4958739.html

more than it was previously believed[6]. On the flip side, the many benefits of FDI can be prejudicial to the country stability; may generate unfair treatments and sometimes the tax foregone is higher than the benefits they produce[7].

This article first discusses the Colombian tax measures implemented over the last years and analyzes them as factors in increasing FDI. The second part argues that Colombia's longstanding foreign indebtedness exchange and tax regime fosters tax free income repatriation from Colombia by Multinational Enterprises, which may have produced the Inward FDI. The third part discusses alternatives in order to address the extraction of rents through interest payments. The fourth and final part argues if these practices should be changed or not.

1. Colombia in the Tax Competition Scenario

An international tax competition occurs when one country seeks to bring foreign investment within its borders through the reduction of business taxation[8].

Colombia's corporate income tax rate was 35% for much of its recent past.[9] From 2002-2006, it increased to 38.5% with a surcharge of 10% of the income tax rate. In the case of non-residents, a dividends tax (or remittance tax) of 7% on the amount distributed was imposed[10]. All of the combined taxes ended up being an effective tax rate of approximately 42.8% for foreign investors.

These tax rates were coupled with scattered tax incentives which were targeted to certain industries[11] and investors in specific geographical regions[12] that were unlikely to have been approached otherwise, without the tax incentive[13]. It can be argued that these incentives were not designed to attract general FDI, but targeted investments.

6 Clark W.S., *Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options, 48 Canadian Tax Journal 1139* (2000).

7 Avi Yonah R.S. *Globalization Tax Competition and the Fiscal Crisis of the Welfare State*, *Harvard Review,* Vol. 113, (2000), page 1643.

8 Julie Roin, *Competition and Evasion: Another Perspective on International Tax Competition*, *Georgetown Law Journal,* Vol. 89 (2001), page 546.

9 The 35% corporate income tax rate was introduced by the article 99 of Act 223 of 1995.

10 This remittance tax rate was 30% in 1986 and was reduced to 7%.

11 E.g. exemptions for industries as scientific book (Act 98 of 1993), tourism and software (Article 207-2 of the Tax Statute) and mining and oil industries (article 258-1 of the Tax Statute).

12 E.g. laws that were enacted providing incentives to geographical areas that were subject to natural disasters as the so-called Paez Act and Quimbaya Act (Act 128 of 2005 and Act 608 of 2000, respectively).

13 E.g. allowances for investments in scientific projects and in green-friendly machinery (exceeding the authority's requisites), articles 158-1 and 158-2 of the Tax Statute, respectively.

In 2006 the Colombian Congress enacted a tax bill that reduced the income tax rate to 34% in 2007 and to 33% in 2008 while repealing the dividends tax[14]. In 2006, the 10% income tax surcharge was also repealed[15].

These tax reforms reduced the corporate income tax rate for a foreign investor to 33%. This nominal rate is considered high in comparison to the neighbor countries income tax rates[16] but the effective rate could be more favorable if profits are not subject to income tax since some kind of tax benefit, exclusion, special deduction or exemption applied to companies. However, they are taxed when the dividends are distributed to the foreigner investor at a rate of 33%. Therefore, many of the tax benefits are deferral devices rather than a real tax forgone[17], and may only really be a beneficial if the deferral is done for an extended time[18].

Even after all of the tax rate reductions, Colombia may not look very competitive once it is compared to other jurisdictions. In addition, many of the reductions and benefits occurred since 2007, years not covered in the UNCTAD report (2004-2006). However, for the years covered by the study and even today, there is still a big advantage for foreign investors if they fund Colombian companies with debt by means of back-to-back loans or other devices allowed by the Colombian exchange control system. By not using equity, they can extract income from Colombia in the form of interest, deductible for the domestic company, which may be not taxed in their home country if some requirements are fulfilled. This "advantage" is discussed in detail next.

2. FOREIGN INDEBTEDNESS IN COLOMBIA: EXCHANGE CONTROL AND TAX TREATMENT

In its Report on Tax Incentives, the United Nations has qualified reduced withholding taxes in the payment of interest to non residents as a FDI incentive. Nevertheless, when this report analyzes the specific case of Colombia, there is no reference to this

14 Article 12 of Act 1111 of 2006

15 Article 260(11) of the Tax Statute

16 For example, the corporate tax rates in some neighbor countries are: Argentina 35%, Bolivia 21%, Chile 35% (combined corporate and dividends tax), Ecuador 25%, Mexico 28%, Costa Rica 30%, Peru 30%, Venezuela 34%. This means that Colombian corporate tax rate, even after the reduction, in many cases is much higher than that of some neighbors.

17 Some exception to this rule is the special deduction for fixed productive assets introduced by Act 1111 of 2006 but only applicable since 2007. This special deduction allows deducting 40% of the amount paid to acquire such asset in the year of the acquisition, and without reducing the tax basis of the asset. This special deduction, will end in profits not taxed at the corporate level, the distributions of those as dividends, would not be taxed for the shareholder.

18 There are several ways to see this kind of deferral. On one hand, if the deferral is very long, and the amount of taxes deferred is reinvested, it may have the same effect as if the income is exempt from tax (because of the time value of money). On the other hand, deferral can be seen as a free-interest loan for the government to the taxpayer.

kind of incentive. In contrast, the Report lists the applicable withholding as 39.55%[19], which was applicable when that report was made[20].

This could be so because the supposed general rule is that it is a tax on interest paid abroad. However, a huge exception makes taxation the exception. This alternative is not including in reports as the one mentioned, and one might conclude that this may be a "disguise" to extract rents from Colombia, allowed by the exchange and tax rules presented here.

2.1. The Foreign Exchange Controls Perspective

From 1967 to 1991, Colombian had a stringent and comprehensive exchange control system that restricted some transactions and required funneling allowable transactions through the Colombian Central Bank (Banco de la República)[21].

In 1991, the exchange control system was deeply relaxed and established two kinds of markets, the so-called free market, and the regulated exchange market. Some transactions, including the importation and exportation of goods, foreign indebtedness and foreign direct investment, among others, belonged to the regulated market. The regulated market generally does not impose restrictions on these transactions, but requires the fulfillment of some report obligations and usually requires the foreign currency to be funneled through the so-called intermediaries of the exchange market, which are mainly commercial banks[22].

In the field of foreign indebtedness, there are two key features:

1. In general, the lender can only be a foreign financial entity recognized by the Colombian Central Bank[23]. The Colombian Central Bank will typically recognize a foreign financial entity if it is considered a financial entity in its home country by

19 This is the 35% withholding tax on the full amount, and 7% of remittance tax on the balance (65% x 7% = 4.55%)

20 United Nations, Conference on Trade and Development (UNCTAD), *Tax Incentives and Foreign Direct Investment – A Global Survey*, (ASIT Advisory Studies No 16, 2000), at pages 21 and 155 et seq.

21 Decree 444 of 1967.

22 Act 7 of 1991 and Decree 1735 of 1993

23 Nevertheless, this is not required when the domestic company issues debt (e.g. bonds). In this case, the rules establish that the debt should be negotiated in an international capital market. Circular DCIN-83 of the Central Bank pages 10-29. Although, it is not common that companies in Colombia issue debentures, bonds or other kind of debt in the international market.

the corresponding authority[24]. Therefore, it is possible to find financial institutions located in tax havens[25], jurisdictions with low taxes and/or bank secrecy law.[26]

Aware that domestic companies by themselves may not have access to foreign credit, the exchange control system does not disallow the use of back-to-back structures, where a foreign related company lends money to a recognized foreign financial entity, which then lends the money to the related company of the first lender, in Colombia.

The exchange control system also allows transactions where, once a loan has been granted, another non-financial foreign entity (can be a related party of the Colombian borrower) buys the debt and becomes the new lender. This structure in some cases can be pre-agreed in order to avoid extra charges from the foreign financial entity which are aimed to recover the net present value of the interest flows expected in the future.

2. The second feature relates to the right of Colombian Central Bank to establish deposits for the amounts disbursed by the foreign banks to Colombian residents and Colombian domestic companies when this is required to assure exchange stability. This device has not been used much, but in the last few years, with the revaluation of the Colombian Peso (Col$), a deposit of 40% of the amounts disbursed for a period of six months was established[27] which did not pay any interest. The deposit was reduced to 0% by the end of 2008[28] with the increased appreciation of the US dollar because of the global economic downturn. This caused many investors to liquidate their investments in Colombia and to invest in some other more “secure” markets, creating a devaluation of the Colombian Peso.

In conclusion, under the exchange control placed in Colombia, domestic corporations can borrow money indirectly from related foreign parties, through back-to-back structures, or agreements to acquire a loan from a financial entity once it is granted, or directly if the related party is a financial entity recognized in its home country which qualifies for recognition by the Colombian Central Bank. This practice of foreign indebtedness may only be deterred in the exchange control field if a deposit on the

24 There are others alternatives for a foreign financial entity to be recognized by the Colombian Central Bank. Detail information can be found in the Circular DCIN-83 of the Central Bank pages 10-31 et seq.

25 A list of the recognized financial institutions can be found in this web site: http://www.banrep.gov.co/reglamentacion/rg_cambiaria3_dcin83.htm#ane

26 At the time this article was written, many financial centers were relinquishing to their bank secrecy because of political pressures generated by the global economic downturn, specially by the G 20 Summit in London. See G20, *Report of the Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets* (2009). http://www.g20.org/Documents/g20_wg2_010409.pdf.

27 Resolution 2 of May 6, 2007 of the Colombian Central Bank.

28 Resolution 10 of October 9, 2008 of the Colombian Central Bank.

money disbursed is established, but this practice in the last years has just been used rarely with a high revaluation of the Colombian peso and currently it is not in place.

2.2. The Tax Perspective

Under Colombian tax law, the payment of interests is sourced as Colombian or foreign income depending on whether the loan is economically tied to Colombia[29]. Colombian source interest payments to foreigners are subject to a withholding rate of 33% on the gross amount[30]. Nevertheless, there is a huge exception for money borrowed for activities that are considered important for the economic and social development of the country[31]. In this case, the interests will be deemed foreign source and not subject to any withholding, as foreigners are only taxed in Colombia on their Colombian source income.

The activities covered are very broad and may include general manufacturing, services and construction activities, among others[32]. It is worth noting that currently there are discussions in Colombia to reduce the applicability of this broad benefit[33].

For the interest payers, the payment will be proportional deductible, if it is necessary, and has a cause/effect relationship with the economic activity[34]. In addition, the exchange regulations must be fulfilled and the withholding tax, if any, is applied. If the payment is done to a related company, the transfer pricing rules must be met[35]. There are no restrictions for the debt/equity ratio of the related companies. Therefore, it is feasible that companies which have been heavily financed with debt instead of equity can engage in earnings stripping using interest payments. Colombia doesn't have general anti-conduit rules[36] and, in fact, back-to-back loans are even encouraged by the way of the exchange control rules as explained above.

Colombian tax law has established guidelines to enact a list of tax havens. These allow the Colombian government to exclude some countries from the list if external policy constraints require it, even if they meet the criteria. The general effect of transactions with tax havens is that they should be considered transactions with related parties, subject to the transfer pricing rules. Additionally, a 33% tax withholding is

29 Article 24 (4) of the Colombian Tax Statute.

30 Article 408 of the Colombian Tax Statute.

31 Article 25 of the Colombian Tax Statute.

32 Decree 2105 of 2006.

33 Rozo Gutiérrez, Carolina, *Fin a exención por financiación externa?* (End of the foreign indebtedness exemption?), Portfolio (2009), available at http://www.portafolio.com.co/economia/justicia/2009-04-16/ARTICULO-WEB-NOTA_INTERIOR_PORTA-4987452.html.

34 Article 107 of the Colombian Tax Statute.

35 Article 260(1) of the Colombian Tax Statute et seq.

36 Only in tax treaties can a beneficial owner rule be found that may determine some conduit instruments.

applicable to any kind of payment if it is taxable in Colombia (e.g. is a Colombian source income received by a non resident).

Under the current law, even if a tax haven list is released, it may not have much impact in the treatment of back-to-back loans, assuming that they already satisfy transfer pricing principles.

Regarding transactional taxes, the only one that may apply would be the Colombian stamp tax. However, there is an exemption for documents related to foreign indebtedness. The rate of the stamp tax is currently 0.5% and will be reduced to 0% by 2010[37].

Therefore, it is likely that interest payments will be deductible in Colombia, without any withholding tax for the foreign recipient.

2.3. The Outcome of the Exchange Control and Tax Rules in the Foreign Indebtedness of Multinational Enterprises

In conclusion, from the Colombian point of view, the benefits of transferring profits to related foreign companies, by means of interest payments, is undeniable. It is encouraged by a foreign exchange control system that fosters back-to-back loans. These advantages can be summarized as follows:

1. The lender –that may be a related party– receives income that is not taxed in Colombia, and probably not taxed in his residence country if an appropriate jurisdiction is used[38]. This would result in a non taxation of all income.
2. The borrower enjoys a deduction that reduces his taxable income that would otherwise be subject to the 33% income tax rate, assuming that the interest payment is defensible under a transfer pricing perspective. In Colombia, it does not matter if the company is excessively funded with debt.

Therefore, it can be argued that Colombia still has a high tax rate in comparison to the income tax rate of comparable jurisdictions. However, there is the possibility of extracting tax-free rents through companies with high debt ratios that pay interest directly or indirectly to foreign related parties.

37 Article 519 of the Colombian Tax Statute.

38 Edgar, Timothy, Farrar, Jonathan and Mawani, Amin, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis*, *Canadian Tax Journal,* Vol. 56 no. 4 (2008), Available at SSRN: http://ssrn.com/abstract=1297354, state at page 7: *"In a standard third-country financing structure, however, source-country taxation can continue to be eliminated by using tax deductible intra-group debt to route taxable profits to a CFC resident in a country with a low-tax or no-tax regime"*.

3. Approach to Deter Income Extraction by means of Interest in Colombia

Conventional wisdom dictates that tax incentives for investment and in particular FDI are not recommended, and the general advice given by multilateral entities such as the World Bank and the International Monetary Fund (IMF) to developing countries is to refrain from offering tax incentives to foreign investors[39]. Assuming this to be true, we now analyze some alternatives which deter the extraction of rents by this practice:

3.1. Repeal of the Interest Treatment

The first option is to completely repeal the "tax exemption" for interest paid on loans related to the social and economic development of Colombia. Even if the enforcement of this alternative is easy, since it means establishing a tax withholding to any interest payment abroad, it is not a good idea.

From the Colombian point of view, this solution, since it is general, would affect domestic companies paying interest to unrelated foreign entities to which the measure is not targeted.

In fact, it is well know that Colombia, as a developing country, needs capital in-flows to invest in its economy. Therefore, imposing a 33% withholding tax on interest paid for any kind of loans may impede that, as the after tax return expected by the lender (especially when it is a unrelated party), may increase the interest charged (gross up) to an amount that would not be economically attractive to be paid by the borrower.

From the international perspective, we must consider that many countries have established interest tax exemptions for interest payments. For example, the US has a general exemption that does not cover loans from foreign banks but does cover debt/bonds held by foreigners[40]. In the case of Colombian companies in general, they are more likely to obtain funds by means of loans than by issuing of debt (bonds) abroad, considering the size of the economy and of the companies and the interest rate that may be recognized to cover the risk, which can be higher than a loan. This doesn't even consider the compliance of administrative and general transactional costs of bonds issued abroad.

39 Avi Yonah, *Globalization Tax Competition and the Fiscal Crisis of the Welfare State*, *Harvard Law, Vol. 113* (2000), at 1643.

40 Section 1441 (c) and 1442 (b) of the Internal Revenue Code.

In addition, it is noteworthy that all major economies have implemented interest exemptions after the US did so because of the fear of losing investment, in what it is referred to as a rate to the bottom[41].

This policy may end with a lending money monopoly of local banks, something that may raise the interest rates, and that may not have the sufficient capacity to engage in big projects that require a large amount of lending.

An additional flaw of this alternative is that a withholding tax would be impose not only on interest that can be considered a "disguised" dividend, but also on the portion of interest that can be considered fair, according to an appropriate equity / debt ratio.

Colombia has started negotiating many double tax treaties which, in some cases, give a reduced or 0% tax withholding. It is then possible that some of these treaties would be used to extract rents by means of interest payment with a low or zero withholding, even if the general interest exemption is repealed.

One variation on this alternative is that only payments to tax havens would be subject to 33% withholding in all the cases. Considering this possibility could be politically controversial, there is no clear a list of tax havens in Colombia and this could be subject to many economic and international policy considerations; therefore, it is quite problematic.

3.2. DISALLOW THE DEDUCTION OF INTEREST PAYMENTS TO RELATED FOREIGN PARTIES

As it has been suggested but not fully explored in the OECD report on harmful tax competition, an alternative would be to establish a consistent treatment of dividends and interest payments by applying a broad denial of the deductibility of such amounts when they are paid to a nonresident related party, especially if it is located in a tax heaven[42].

The interesting point of this alternative is that it targets related parties. Nevertheless, its enforcement might be difficult considering the exchange regime requires a foreign bank as a lender (at least in the first stage). Therefore, it may not be easy to trace whether the real beneficiary of the debt is a related party by means of a back-to-back loan or other type of transaction. This may heavily depend on the effective exchange

41 Reuven S. Avi-Yonah. Globalization*, Tax Competition, and the Fiscal Crisis of the Welfare State*, *Harvard Law, Vol. 113* (2000), at 1581.

42 Organization for Economic Co-operation and Development (OECD). Committee on Fiscal Affairs, *Harmful Tax Competition an Emerging Global Issue* (1998), at 59.

of information required in the tax treaties, and in taxpayer disclosure requirements for transfer pricing purposes.

In addition, the total denial of debt financing form a related party may be an extreme measure and can effect the attraction of FDI, considering that other competing jurisdictions allow such debt funding in some extent, which is regarded as financially recommendable.

From the tax treaty perspective, establishing a non deductibility of interest paid to non related residents, but not setting the same rule when the payment is received to a domestic related lender, may break the non-discrimination treatment clause established in the double tax treaties. Nevertheless, it can be argued that the different treatment is justified because the lenders are not in the same circumstance, and it is necessary to minimize tax avoidance, something that may not happen if the recipient of the payment is a non-resident[43].

3.3. LIMIT CONDUITS OR BACK-TO-BACK LOANS

Another option is to limit back-to-back loans by disallowing the use of conduit companies that are simple ways to channel the funds and its repatriation between the Colombian subsidiary and the foreign-related company.

This alternative is acceptable because it only affects interest payments between related parties. Nevertheless, its enforcement would be difficult for Colombian authorities, as noted previously.

The downside of this alternative is its all-or-nothing approach, which does not allow some amount of debt funding from related parties. It can be assumed that subsidiaries or multinational enterprises in Colombia may not have enough creditworthiness to borrow money. A foreign parent company could resolve this by funding the company with enough equity to enter into loans if it is required or to act as an escrow to guarantee the loan.

In the tax treaty context, the anti-conduit rules are designed to find the true residence of the beneficial owner of a stream of income and to deter treaty shopping techniques, rather than to impede rent extraction through interest. Assuming that the related lender is also a resident of the same country of the conduit, tax benefits from the treaty should apply. On the other hand, if back-to-back loan rules are allowed in the domestic context, when the related lender using a conduit (domestic or foreign) is

43 Edgar, Timothy, Farrar, Jonathan and Mawani, Amin, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis*). Canadian Tax Journal v. 56 no. 4 (2008), Available at SSRN: http://ssrn.com/abstract=1297354. at 29 et seq.

also a Colombian company, it can be argued that it is a discriminatory treatment and violates the tax treaty.

3.4. Formulary Apportionment

Another alternative that could also be used is a formulary apportionment which allocates a portion of the total debt of an international group to Colombia in the same ratio as the assets of the Colombian subsidiary to the total assets of the international group (gross world -wide group income and Colombian gross income can also be used). This would only allow a deduction for the amount of interest that can be tied to the amount of debt allocated. This alternative relies on the theory that money is fungible and can be used interchangeably to fund any operation of the group as a whole. Its application is currently recognized in US, but in a reduced scope –and mainly to determine the tax credit limitation.

Implementing a formulary apportionment can be very difficult since some debt should not be considered for these calculations (e.g. intra group debt) and an acceptable methodology has to be established to measure the worldwide assets and the Colombian assets (maybe book value, fair market value, tax basis etc). In addition, information gathering by the Colombian subsidiary and an in-depth review by the Colombian tax authority would add even more layers of complexity and increased auditing costs.

From an international perspective, the fact that only a relatively small country, such as Colombia, adopted these rules could end in a double deduction of the interest or no deduction in any country, which are undesirable effects from a global revenue-raising and efficiency perspective[44]. Furthermore, in tax treaties, a formulary apportionment may introduce conflict with the article related to the taxation of related enterprises (usually article 9), which requires that every related company transaction must be arm's length.

Due these potential problems, this may not be a good solution for Colombia, which is eager for the continuous receipt of FDI, has limited resources to spend on tax audit procedures, and where internationally-owned subsidiaries have limited information on the worldwide activities of the group.

3.5. Thin Capitalization Rules

Thin capitalization rules act to limit the interest deduction paid to foreign related parties in excess of the amount that each country establishes as the desirable debt/

44 Edgar, Timothy, Farrar, Jonathan and Mawani, Amin, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis*). Canadian Tax Journal v. 56 no. 4 (2008), Available at SSRN: http://ssrn.com/abstract=1297354. at 24.

equity ratio. Usually, the interest paid in excess is treated as a disguised dividend payment (dividend stripping), subject to all the tax rules of dividends: no deductibility, withholding etc.

The “thin cap” alternative is important because it recognize that up to some amount of debt is acceptable, and even desirable, within the financial structure of a particular company. Determining the optimal debt/equity ratio is difficult and may vary from country to country. However, once the country has established a ratio, it can be said that this is considered acceptable for all companies residing in that specific country.

In addition, thin capitalization rules usually don’t affect transactions between unrelated parties since they are established to only target loans among related companies, since the goal is deter extraction of rents from Colombia to foreign parents.

From the tax treaty point of view, thin capitalization rules are recognized as an acceptable tool and their implementation is even advised in the commentaries by various tax treaties models such as the OECD. In consequence, the implementation of this measure will not violate the tax treaties negotiated by Colombia.

The downside to this alternative is its enforcement, since it is very difficult to find out if the counterparty in a loan is directly or indirectly a related party (using a back-to-back) especially when there isn’t an exchange of information agreement in place with the relevant jurisdictions. In this case, the tax authorities must rely on the disclosure of the taxpayer (sometimes inaccurate)and information gathered in the transfer pricing field.

Due to the potential for companies to extract rents from Colombia by the way of interest in 2006, the Colombian government proposed a thin capitalization rule[45] as part of an ambitious tax bill to enact a brand new Tax Statute (Tax Code). According to the proposed rule the admitted equity/loan ratio was set at 1 to 3 (i.e. three Col$ of loan from related foreign parties for every one Col$ of equity). In the event of a higher ratio, the tax bill established two courses of action: i. No deductibility of the interest paid for amount of loan in excess of the set ratio and ii. The amount of interest paid abroad will not be allowed as a deduction and a withholding tax will be imposed as the same rate of the general income tax rate (i.e. 33% today). Some exceptions were included for financial entities that comply with transfer pricing rules and for taxpayers that enter into and advance transfer pricing agreements.
The proposed new Tax Statute, including the thin capitalization proposal, was not approved by the Colombian Congress, and since then, no new proposal about thin capitalization has been discussed.

45 Article 55 of the 2006 proposed Tax Bill.

3.6. Summary of Alternatives

In the following chart, we summarize the different alternatives and their potential effects. The thin capitalization alternative looks like the most desirable option and its disadvantage, enforceability, is a common failure in all, except the general repeal of interest treatment. However, the repeal of interest treatment alternative does not meet any of the other criteria, and looks as the least desirable option.

Table N° 1

Summary of alternatives and their potential effects

No	Alternative	Only affects transactions between related parties	Desirable debt/ equity ratios are allowed	Feasible to be effectively en-forced by Tax Authorities	Tax treaties may allow this measure being practicable
1	Repeal of interest treatment	No	No	Yes	No
2	Disallow deduction to foreign related parties	Yes	No	Maybe	Maybe
3	Limit back-to-back loans	Yes	No	Maybe	Maybe
4	Formulary apportionment	No	No	No	No
5	Thin capitalization	Yes	Yes	Maybe	Yes

Source: Information collected by the author.

A thin capitalization regime has also some interesting and potentially beneficial features. It is broadly consistent with existing transfer-pricing practices, which makes its unilateral adoption feasible even in a non-cooperative environment in which national policymakers seek to maximize national welfare[46]. In addition, when policymakers perceive that the revenue loss associated with an interest expense deduction is offset by a compensating increase in domestic investment, a thin capitalization regime (allowed debt/equity ratio) can be adjusted to allow an additional allocation of such expense[47].

4. Is it Advisable to Impose thin Capitalization Rules in Colombia?

Colombia has a tax provision to protect the country against thin capitalization[48]. A presumptive taxable income regulation (a sort of alternative minimum tax) takes the

46 Edgar, Timothy, Farrar, Jonathan and Mawani, Amin, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis*). Canadian Tax Journal v. 56 no. 4 (2008), Available at SSRN: http://ssrn.com/abstract=1297354. at 14.

47 Ibidem, at 20 et seq.

48 Bernardi Luigi, Tax Systems and Tax Reforms in Latin America, (Routledge Economics, 2007) at 8.

net equity of a company in the previous taxable year and multiplies it by a percentage (currently 3%) and uses it, if it is higher than the taxable income determined under the general computation. The key issue for a related party debt is that this tax rule discourages the reduction of the net equity with liabilities with foreign related parties[49].

Nevertheless, this rule is not a perfect substitute for a thin capitalization regime. First, it is not clear that 3% may replace a rent extraction by means of interest payments. Second, conduit companies, because of the exchange rules, may be used to structure the transaction so that the liability is not with a related party. Finally, the excess of presumptive income over taxable income can be carried forward to offset taxable income in the future years. This allows the amount paid in excess of the taxable income to be recovered by the company.

On the other hand, financial models have found that when a thin capitalization rule is imposed, tax deductions are limited, borrowing becomes more costly, and the costs of the investment increase. The consequences will likely be a lower level of FDI.

FDI is an important factor in Colombia's economic development. Besides bringing capital, it produces several desirable external effects. It facilitates the transfer of technology, enhances national organizational and managerial skills and improves access to international markets.

It has been said that, from an economic point of view, businesses should be indifferent between paying for services indirectly, thorough taxes, and directly, through self provision, as long as the services are provided at equivalent cost. Therefore, they should be indifferent between a high tax country providing higher services and a low tax country which does not, assuming that the value they assign to the services is equivalent to their tax cost. Colombia, as a developing country, may not be able to directly provide its investors with all the services they require. When combined with the fact that Colombia has a generally high relative income tax rate, the interest rate deduction becomes a major factor in the international investment decision. In consequence, the enactment of thin capitalization rules may significantly reduce the expected FDI.

Other jurisdictions have modified their "thin cap" rules, fearing similar effects. In 2005, when Mexico established thin capitalization rules with a ratio of 3:1, they relaxed them one year later, allowing an excess over the 3:1 ratio in cases where companies require long-term financing for their activities[50].

49 Article 287 of the Tax Statute.

50 Del Toro Roberto, Cuellar David and Zamora Francisco Jose, Lawmakers to Reconsider Thin Capitalization Rules, International Tax Review, Vol. 17 (2006), at 19.

In Ireland, the relaxation of thin capitalization directly followed the forced termination of Ireland's split corporate tax rate, which had long been used as an instrument to provide preferential tax treatment to multinationals[51]. Ireland coupled the relaxation by strengthening another component of its corporate tax regime.

"Thin cap" rules are clearly a preferred regulation. However, their potential negative effect on FDI makes it less desirable in these recessionary times. In fact, Colombia's inward FDI dropped by 27% in the first quarter of 2009, compared to the same quarter in 2008[52]. The current economic climate also makes it harder to obtain debt financing, as banks and other financial institutions become more cautious while lending money.

CONCLUSION

Tax incentives have been found to be an important factor in FDI decision-making. In Colombia, among the new tax incentives introduced in these past years, there is a longstanding no taxation on interest paid to foreigners (with a broad scope, but lately limited by the tax authorities and court decisions), coupled with an exchange regime that encourages back to back loans, allowing the extractions of rents from Colombia by means of tax-free interest payments.

If Colombia decides to limit these extraction of rents, the thin capitalization rules seems to be the more appropriate and effective device, rather than other alternatives such as the repeal of interest treatment, the deduction disallowance for interest paid to related parties, the limitation of back to back loans or the establishment of a formulary apportionment of interests.

In fact, thin capitalization rules may only affect indebtedness with related parties due to the fact that these are aimed to set desirables debt/equity ratios that may be changed if required and should not come into conflict with tax treaties. All these features combined are not achievable with one of the other alternatives. On the flip side, the enforceability of these rules has some complexity because of the lack of information to determine whether the final lender is a foreign related party, particularly when a back to back structure is used. However, this issue applies to almost all other alternatives and could be overcome as Colombia enters into information exchange agreements, usually embedded in the tax treaties negotiated with other jurisdictions.

51 Haufler, Andreas and Runkel, Marco Firms. *Financial Choices and Thin Capitalization Rules under Corporate Tax Competition*. CESifo Working Paper Series No. 2429 (2008). Available at SSRN: http://ssrn.com/abstract=1284971

52 Information available at www.portafolio.com.co, April 8, 2009 edition. Webpage of one of the most important Colombian economic newspapers.

Nevertheless, establishing thin capitalization rules may have a big impact on inward FDI, making the borrowing more costly, particularly in the current global economic downturn, and discouraging the investment as well. It is important to remember that FDI is an important aspect in Colombia's economic development. Besides bringing capital, it produces several desirable externalities. It facilitates the transfer of technology, enhances national organizational and management skills and improves access to international markets.

Therefore, an enactment of thin capitalization rules in Colombia may be carefully considered, to establish an adequate equity/debt ratio that does not reduced FDI beyond an acceptable limit, and avoid the need to change or waive them soon after their introduction, since this has happened in other jurisdictions. Additionally, the inception of these rules may be considered with some sort of reduction in the corporate tax rate, which is considered high in Colombia from a foreign investor's perspective. Finally, we need to keep in mind that the global recession makes the competition to attract FDI harder; such a situation is an inconvenient to consider the thin capitalization rules in Colombia at this time.

Bibliography

A, Haufler and M, Runkel, *Firms' Financial Choices and Thin Capitalization Rules under Corporate Tax Competition,* CESIFO Working Paper Series No. 2429, (2008). Available at SSRN: http://ssrn.com/abstract=1284971

C, Rozo Gutiérrez, *¿Fin a la exención por financiación externa*? (End of the foreign indebtedness exemption?), *Portfolio Newspaper*. Available at http://www.portafolio.com.co/economia/justicia/2009-04-16/ARTICULO-WEB-NOTA_INTERIOR_PORTA-4987452.html

E, Timothy; J, Farrar and A, Mawani, *Foreign Direct Investment, Thin Capitalization, and the Interest Expense Deduction: A Policy Analysis*, *Canadian Tax Journal,* Vol. 56, N°. 4, (2008). Available at SSRN: http://ssrn.com/abstract=1297354.

G-20, *Report of the Working Group on Reinforcing International Cooperation and Promoting Integrity in Financial Markets*, (27, March 2009). http://www.g20.org/Documents/g20_wg2_010409.pdf.

J, Roin, *Competition and Evasion: Another Perspective on International Tax Competition, Georgetown Law Journal,* Vol. 89, (2001).

L, Bernardi, *Tax Systems and Tax Reforms in Latin America* (Routledge Economics, 2007).

Organization for Economic Co-operation and Development (OECD). Committee on Fiscal Affairs, *Harmful Tax Competition an Emerging Global Issue* (1998).

R, Del Toro; D, Cuellar and F.J, Zamora, *Lawmakers to Reconsider Thin Capitalization Rules*, *International Tax Review*, Vol. 17, (2006).

R.O, Orduña Rojas, *Generalidades de la Inversión Extranjera y Tributación en Colombia* (DIAN, Working Paper Document, Web 011, March, 2006).

R.S, Avi Yonah, *Globalization Tax Competition and the Fiscal Crisis of the Welfare State, Harvard Law*, Vol. 113 (2000).

UNCTAD, *Global FDI in Decline Due to the Financial Crisis, and a Further Drop Expected, Investment Brief No 1* (2009). Available at http://www.unctad.org/en/docs/webdiaeia20095_en.pdf.

United Nations, Conference on Trade and Development (UNCTAD), *Tax Incentives and Foreign Direct Investment – A Global Survey*, (ASIT Advisory Studies No 16, 2000).

W.S, Clark, *Tax Incentives for Foreign Direct Investment: Empirical Evidence on Effects and Alternative Policy Options*, *Canadian Tax Journal*, Vol. 48, (2000).

WEB DIRECTIONS

www.unctad.org

www.banrep.gov.co

www.portafolio.com.co