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## **Latin America races ahead with treaty negotiations**

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Latin American countries are focusing on tax treaties like never before as officials look to create tax systems that are more favourable to investors.

Revenue authorities in Latin America have been accused of being unenthusiastic about implementing tax treaties for fear of losing money. This is one reason for some countries' lack of agreements, but advisers argue that the fact many of these jurisdictions operate territorial systems meaning that double taxation is not seen as such a problem in the region.

Mexico has 38 treaties in place, six waiting to be signed and 26 in the process of negotiation. Key countries with negotiated agreements include the US and Canada.

Brazil also has a large number of treaties in force. The country was one of the first in the region to recognise the utility of these agreements, signing its first treaty in 1965.

Chile and Colombia only started negotiating treaties more recently, but are eager to progress their statistics.

At a New York seminar on tax law and tax treaties in their region, advisers from member firms of the Latin America Tax & Legal Network (Lataxnet) discussed the increase in treaties in effect across many countries there.

"Bilateral investment treaties are very important in Colombia," said Adrian Rodriguez of Lewin & Wills. "Now information exchange treaties are becoming increasingly popular."

"For many years Chile only had a treaty with Argentina," said Jorge Espinosa of Espinosa, Porte & Canales. "We now have 20 in place, with countries from all over the world. We are trying to get treaties with all the countries where trade is carried out."

Central American countries are the furthest behind.

"There is a lack of treaties in effect in Central America," said Adrián Torrealba Navas of Facio & Cañas in Costa Rica. "The territorial systems in place have slowed progress. But they are becoming increasingly important to attract foreign investment."

Costa Rica has recently negotiated and for the first time, filed with Congress a treaty with Spain.

In Ecuador there are 14 treaties in place, 12 of which are multilateral.

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## News Analysis: Should South American Countries Sign OECD Model Treaties?

by **Lee A. Sheppard**

Lee A. Sheppard explains why Latin American governments are hesitant to sign bilateral tax treaties based on the OECD model.

FIFA slapped Diego Maradona on the wrist the other day for a colorful bout of swearing as Argentina scraped into World Cup qualification. This is too bad, not because anyone deserves a long ban for swearing, but because Maradona's prolonged absence from the touchline might have caused the Argentine Football Association to reconsider his employment on seeing the squad managed by someone competent during the interim.

The latest "hand of God" goal is French. Les Bleus qualified for the World Cup on an admitted hand ball by Thierry Henry, who was also offside, in a hard-fought playoff battle with Ireland. Many observers, including French ones, believe that an energetic and determined Ireland deserved to prevail and that the referee favored France during the entire contest.

The result looks very bad on France. The popular Henry, who spent his best years at Arsenal, was revealed as a cynical professional. (Hand balls seem to have been allowable at Highbury.) Les Bleus probably won't get out of the group stage next year with the feckless Raymond Domenech still in charge. He and Maradona are having a competition to see who can make some of the world's best players look more like headless chickens.

Moreover, the British Isles are the main place where fans still believe that international football is supposed to be cleaner than club football, where anything goes. The World Cup, after all, grew out of the formerly amateur competition of the Olympics (the requirement of amateur status was eliminated when the Americans lost a Cold War basketball game).

The hand ball is an embarrassment for FIFA as well. FIFA was not going to tolerate finals without France, whose lackadaisical performance in the qualifiers would have justified their exclusion. There is precedent for replaying a qualifier. FIFA has refused to replay the match, but may yet be prodded to do that.

The World Cup favors Europeans, who are overrepresented in the tournament. Football has favoritism of European interests in common with OECD model tax treaties, among which the U.N. model must be counted.

Discussion at the **New York University** seminar Tax Law and Tax Treaties in Latin America on November 18 revealed that many aspects of OECD model treaties that Europeans and

North Americans take for granted are unsuitable to the South American context or impossible to comply with.

Take a simple question like the promise that the treaty partner will make a corresponding adjustment in cases of double taxation in article 9(2) of the OECD model. The availability of an adjustment is a given in the United States and Europe. A corresponding adjustment is impossible in Brazil because it is illegal for tax examiners to make adjustments. Why?

Fear of corruption. In Europe and the United States, the corruption takes place at a much higher, more polite level, while lowly tax examiners can be counted on to be honest.

Oh, but South American countries didn't want treaties in the recent past! That fashion is changing, as South American companies make outbound investments and want their investments protected. (Of course, no tax treaty really protects foreign investments; an investment treaty does that.) Mexico and Chile are OECD members and are having to change their ways to conform to European rules. Chile has given up bank secrecy. Colombia has signed five tax treaties since 2006, and advertises itself as a home for investment vehicles.

Brazil's big companies want to make outbound investments so Brazil is even making nice to the United States. Brazil's parliament is about to ratify a tax information exchange agreement with the United States, despite having threatened to blacklist American states that permit anonymous investment, according to **Luis Rogerio G. Farinelli of Machado Associados**.

In seemingly endless negotiations for a tax treaty, however, Brazil continues to insist on tax sparing, which the United States does not have in treaties. (Tax sparing is available through the generous foreign tax credit.) Brazil is also trying to negotiate treaties with Britain and Switzerland.

But another trend goes in the opposite direction, as Venezuelan strongman Hugo Chavez extends his philosophical influence to his neighbors.

Venezuela has quit the Andean Pact, a trade pact that seeks to preserve source taxation and harmonize some indirect taxes. Venezuela's autarkic stance has extended to neighboring Ecuador. Tensions were evident among the panelists at NYU, even as lawyers were reluctant to defend the antitrade practices of their home governments.

Even for believers in the OECD model, the idea that giving up quantifiable revenue from income earned by nonresident investors in a source country for the vague and unquantifiable promise that more investors will show up has always involved a leap of faith, according to **Peter Byrne**, a former U.S. treaty negotiator who lives in Peru.

For many years, revenue-conscious South American countries were not willing to make that leap, and even now they keep a weather eye on the revenue loss. They are also worried about the cost of complying with treaties. Most countries have, of necessity, gone to a worldwide system of taxation, but nonetheless retain a "territorial mentality,"

according to Byrne. They are loath to give up source taxation of everything within their borders -- the central concession required by OECD model treaties.

### Model as Template

The unstated question at the NYU seminar was whether the OECD model is a template that users can tailor to their own needs or some sort of holy writ that must be obeyed and untouched -- and that brings with it baggage such as the OECD model commentaries, which change with the whims of the larger members, and the transfer pricing guidelines, which are impractical and unenforceable.

South American countries regard the model as a template they can adapt to suit their own needs, for which they are routinely rounded on by the OECD bureaucracy as dangerous heretics. These countries use the OECD model as a starting point for negotiations, adding their own idiosyncratic changes. Chief among these are a technical services clause, an unwillingness to reduce withholding to zero, and a broad concept of permanent establishment.

They view the OECD model commentaries as optional tools to interpret treaty terms, not commands that must be followed. When the commentaries change, countries like Mexico and Venezuela ask that the change nonetheless be spelled out in the terms of the treaty document. On the question of limitations on benefits, South American countries take a direct approach, requiring copious documentation of beneficial ownership, and using thin capitalization rules to stop income stripping.

The OECD transfer pricing guidelines are a major area of variance. Large, developed countries with sophisticated tax administrations enforce them by cutting deals with taxpayers so that compliance becomes an end in itself and multinational companies get the income stripping result they want in the end.

Nothing in article 9 of the OECD model requires the use of the transfer pricing guidelines to allocate income among affiliated companies. South American countries tend to take shortcuts, like Brazil's prescribed profit margins, which greatly upset multinationals and their home governments. On top of this, South American governments have very little experience with the mutual agreement procedures contained in their treaties.

Another area of variance is the concept of PE. South American countries do not yet take the economic nexus position of some American states, but they enforce the physical presence concept aggressively. Mexico deems a PE to exist when any combination of exempted activities exists, according to **Jose Manuel Trueba of Ortiz, Sosa, Ysusi & Cia.**

In South America, the idea that treaties automatically trump domestic law is contentious. In Europe, treaty primacy is a function of the Vienna Convention on the Law of Treaties. South American countries have civil law systems derived from Europe. Nonetheless, more

than one South American country requires any treaty signed by the executive branch to undergo a legal analysis to determine whether the treaty is consistent with the country's constitution.

In Colombia and Chile, the judicial branch must rule that a treaty is constitutional for it to go into effect. In Brazil, despite a new constitution, it is not clear whether a treaty prevails over domestic law, though Brazil has adopted the Vienna Convention.

Chile has also adopted the Vienna Convention. In Mexico, an OECD member, a treaty trumps domestic law. Mexico nonetheless has disputes with European counterparties about its interpretation of OECD model treaty terms. Mexico reserves on the 1999 OECD partnership report, which requires treaty benefits to be granted to partners. Mexico regards the partnership as the taxpayer, and specifically provides for proportionate treaty benefits for partners in its U.S. treaty. Other countries also treat partnerships as entities.

In Argentina, the constitution and the Supreme Court say that the treaty prevails, but an override is possible when domestic law gives the taxpayer a better deal, according to **Juan Manuel Soria of Mitrani, Caballero, Rosso Alba, Francia, Ojam & Ruiz Moreno**. Brazil and Argentina both maintain domestic provisions that arguably violate their treaties.

Since the pair are the two largest economies in South America, what they do influences other countries.

#### Our Own Model

The OECD model is mostly used among European countries, for which it is principally suited. South American countries are trying to develop a model for use among themselves and another model for negotiating with the outside world, according to Natalia Quinones of Quinones Cruz. The internal model is furthest along in development.

"We do need a different perspective," said Quinones, who described some of the decisions that have been made for the models. The internal treaty for Latin American will be multilateral. All types of taxes, not just income taxes, will be addressed.

The models will protect source taxation. But the taxpayer will have an affirmative right to compel the tax administrator to make a corresponding adjustment in cases of double taxation, with arbitration as a backstop. The models will contain a nondiscrimination clause, which has the same importance to South Americans as it does to Europeans.

Importantly, the models will contain a broad definition of PE. There will be no time limits and no exceptions for any fixed place of business, Quinones explained. The models will provide for residence taxation of dividends, royalties, and interest, and will call for a maximum withholding rate of 15 percent in deference to countries that want to preserve withholding.

Several South American countries retain bank secrecy, which can be overridden by court order. These countries are reluctant to agree to information exchange. Uruguay is resisting, according to Quinones.

Nonetheless, the drafters of the models want to provide for a broad ability of tax administrators to request information without first having developed a case on an identified taxpayer, as required by the OECD model. Quinones admitted that the drafters will have to compromise on this point. She added that there are better methods to obtain information than treaties, such as domestic reporting laws, amnesties, and whistle-blower programs.

#### Tax Analysts Information

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Political and legislative problems are hindering the development of treaties in some countries.

"The socialist government in Ecuador doesn't want to negotiate any new treaties at this time," said Cesar Holguin of Lawnetworker Asesores Legales. "The president has expressed his intent to terminate bilateral treaties, including the one with the US."

Politics is also a hurdle in Venezuela. The public denunciation of arbitration procedures led to the end of the treaty between the Netherlands and Venezuela.

"All investments made under that treaty are protected for 15 years, however," said Federico Jagenberg of Macleod Dixon.

In Brazil the country's transfer pricing rules are a problem, they differ so crucially from international norms that they are hindering treaty negotiations.

"The discussions with Germany are being held up by transfer pricing matters," said Luís Farinelli of Machado Associados.

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