



RE2-04-003

**Economic and  
Sector Study Series**

**UNITED STATES COMPANIES  
OPERATING IN LATIN AMERICA:  
TAX ISSUES**

**Peter Byrne**



April 2004

**REGION II**

**Inter-American Development Bank**

This document in discussion is not an official publication of the Inter-American Development Bank. The purpose of the Economic and Sector Study is to provide a mechanism for diffusion of selected analytical work undertaken by the department in support of its operational program at the country or sub-regional level. Opinions and judgments expressed in these studies do not necessarily reflect the view of Bank Management or member countries.

## ***PREFACE***

Foreign direct investment has come to be regarded as an important contributor to economic growth, and practically all Latin American governments have recognized it to be so. While governments wish to attract foreign direct investment in order to create jobs, promote capital accumulation, and absorb foreign technology, many times they find themselves in the quandary that the attainment of these objectives requires tax incentives and, thus, forfeiting scarce tax revenues. Yet it is far from clear whether reduced taxation actually increases investment. Furthermore, often the reduced tax take in the host country simply raises tax liabilities in the companies' home country, thus representing a transfer from poor country governments to rich country governments.

This paper addresses the tax legislation of the United States and the extent to which corporate taxes paid abroad are effectively credited to tax liabilities in the United States. This document was elaborated as part of the project "Tax Reform for Human Development in Central America" with financial support from the Norwegian Agency for International Development (NORAD) and the Swedish Agency for International Development (SIDA).

The author of the paper is Professor Peter Byrne, of Georgetown University. The team for the Tax Reform for Human Development Project was led by Manuel R. Agosin, Regional Economic Advisor (RE2/RE2), and included Alberto Barreix (INT/ITD) and Roberto Machado (RE2/RE2). Miriam Perez-Fuentes was responsible for the production, editing and technical preparation of the document.

Miguel E. Martínez  
Manager  
Regional Operations Department II  
Mexico, Central American Isthmus, Haiti and Dominican Republic

Washington, D.C., April 2004

## Contents

I.	Executive Summary .....	1
II.	Ten Basic U.S. International Tax Rules .....	2
III.	Reduction of Taxes in Latin America as an Incentive to U.S. Investment .....	3
	a. Worldwide Taxation of Income & Relief of Double Taxation .....	3
	b. Deferral and Controlled Foreign Corporations .....	6
	c. Synthesis .....	7
IV.	Tax Reduction Strategies and Tax Treaties .....	9
	a. Transfer Pricing & Thin Capitalization .....	9
	b. Tax Treaties .....	11
	c. Synthesis .....	13
	 Bibliography .....	 15

## United States Companies Operating in Latin America: Tax Issues

### I. Executive Summary

Like any other investor, a United States investor operating in Latin America is interested in maximizing return on investment. “Return on investment” must be measured *after* taxes, and on a *worldwide* basis. Ordinarily, the investor is not concerned with which country receives the tax revenue.

Latin American governments have two priorities. First, they want to attract foreign investment, with the hope of creating jobs and promoting economic activity. Second, they want to increase tax revenue. However, these priorities are often at odds. In their haste to attract foreign investment, governments often reduce taxes on such investors. The revenue sacrifice associated with this reduced taxation is clear. Yet it is far from clear whether the reduced taxation actually increases investment. Furthermore, it is disturbing to learn that the reduced tax burden in Latin America often results in an increased tax burden in the United States.

How a government can attract investment and maintain revenue is a perennial question. This paper attempts to answer this question for Latin American governments *with respect to investors from the United States*. To do so, it is necessary to describe and analyze the U.S. tax rules applicable to U.S. residents who invest in Latin America.

The principal conclusions are:

- Tax exemptions or reductions offered by a Latin American country will result in an overall tax savings for most United States investors;
- In some cases, the tax savings will be sufficient to attract investments that would have gone to another country;
- In other cases, there will be a tax savings that, while appreciated by the United States investor, is not sufficient to alter an investment decision;
- In a substantial minority of cases, exemptions or reductions offered by a Latin American country will have little or no benefit for the U.S. investor, but rather will result in the U.S. Treasury collecting more tax;
- In all of the foregoing cases, there is a substantial revenue loss for the Latin American country, and *it is impossible to limit the incentives to those investors who would invest elsewhere without the incentive*.
- It is therefore necessary for a Latin American country to accept significant revenue loss with respect to the U.S. investors who would have come anyway in order to attract a minority of U.S. investors who would have invested elsewhere in the absence of the tax incentives;
- Transfer pricing rules are an important measure to protect the tax base in Latin American countries, and if they conform to international norms, may be attractive to U.S. investors. Advance Pricing Agreements (“APAs”) are an important part of transfer pricing rules;

- Latin American countries can facilitate the flow of capital for investments from the U.S. by providing a withholding rate on interest of less than 5%, but there must be safeguards to protect against abuses;
- Tax treaties are an important part of an overall strategy to create an attractive environment for U.S. investors. Such treaties involve minimal revenue sacrifice, but provide stability for investors. Tax treaties also provide clarity in several areas, such as transfer pricing, thin capitalization, and investor rights.

## II. Ten Basic U.S. International Tax Rules

Rule #1: any U.S. resident corporation (or, in the case of an individual, any resident or citizen) is taxed on the income it derives anywhere in the world (“worldwide” taxation).

Rule #2: for any U.S. resident, nearly all types of income<sup>1</sup> are aggregated and taxed the same way (“global,” not “schedular” taxation).

Rule #3: the prevailing income tax rate for U.S. resident corporations (exclusive of state and local taxes) is 35% of *net income*; for individuals, the rates are graduated up to a maximum of approximately 40%.

Rule # 4: income is generally taxed in the U.S. only when received by the U.S. person. In the case of direct ownership (or ownership of an interest in a “transparent” legal entity, such as a partnership or joint venture), income is received in the U.S. at the moment it is earned; however, income derived from an ownership interest in a foreign corporation is not considered received until a dividend is distributed.

Rule # 5: in a major exception to the foregoing rule, certain types of income (mostly dividends, interest and royalties) received by a foreign corporation will cause the U.S. shareholder of such corporation to be taxed as though a dividend had been distributed, even when there is no dividend distribution.

Rule #6: when the income is taxed in the U.S., a foreign tax credit is allowed for foreign income taxes paid on foreign source income; several limitations apply.

Rule #7: an important aspect of the U.S. foreign tax credit rules is the “basket” requirement. All income and foreign tax credit related to a certain type of income will be grouped together (in a “basket”) for purposes of calculating the U.S. tax. Each basket is the subject of a separate calculation.

Rule #8: transfer pricing rules (applied to international transfers between related parties) ensure that U.S. taxpayers do not manipulate prices to reduce their U.S. tax liability.

Rule #9: U.S. tax treaties (“Conventions to Avoid Double Taxation and Prevent Fiscal Evasion”) *do not* ordinarily alter any of the foregoing rules. The U.S. has a longstanding

---

<sup>1</sup> Capital gains are given special treatment.

policy that tax treaties are not for the purpose of reducing the U.S. taxation of U.S. residents. Such treaties are, nevertheless, important to U.S. investors.

Rule #10: the U.S. has a general culture of tax compliance. To ensure the continuation of this culture, extensive reporting on foreign operations is required, and penalties for evasion are severe. Extensive tax planning, however, is quite normal.

### III. Reduction of Taxes in Latin America as an Incentive to U.S. Investment

To measure the impact of tax exemptions or reductions on a U.S. investor, it is necessary to consider the U.S. system of worldwide taxation and relief of double taxation, as well as the concept of deferral.

#### a. Worldwide Taxation of Income & Relief of Double Taxation

U.S. residents, whether corporations<sup>2</sup> or individuals, are required to report and pay tax on income they have anywhere in the world.<sup>3</sup> The moment of including such income is generally the time it is accrued or received.<sup>4</sup> At that moment, qualifying foreign taxes may be used to reduce the “tentative” U.S. tax related to such income.

There are two general types of relief available. Any foreign tax (property taxes, value added taxes, excise taxes, etc.) is *deductible* from income. To illustrate, assume a U.S. corporation with a branch in Costa Rica. This branch has 100 units of net pre-tax income from manufacturing, pays 20 of Costa Rican property tax and no other tax. In this case, the net income of 80 would be subject to U.S. taxation, and the 35% U.S. income tax would reduce the after-tax income of this U.S. company to 52.

However, a more valuable type of relief, the foreign tax credit, is available when (at a minimum) the foreign tax:

- Is based on net income
- Was paid with respect to foreign source income (under U.S. rules)

To use the foregoing example of a U.S. corporation operating in Costa Rica, assume no property tax was paid, but that Costa Rica imposed a 30% income tax on the 100 of net income. Although only 70 of after tax income would be received in the U.S., the U.S. will impose its 35% tax on the full 100 of pre-tax net income (a “gross-up”), thus establishing a tentative U.S. tax of 35. However, the 30 of tax paid to Costa Rica is then “credited” against the 35, reducing it to 5 (the “residual” U.S. tax). This after-tax result of 65 units is far more attractive than the after-tax result of 52 obtained in the prior example.

---

<sup>2</sup> In the United States, corporate residence is based on the place of incorporation [U.S. Internal Revenue Code Section 7701(a)]

<sup>3</sup> IRC Sec. 61(a)

<sup>4</sup> IRC Sec. 451

It is easy to observe that a creditable tax is more attractive to a U.S. investor than a non-creditable tax. It is more difficult to ensure that a tax is creditable. At present, all standard business income taxes in Latin America are creditable. Alternative minimum taxes based on net income also are creditable. However, certain taxes and charges imposed in Latin America are not creditable: assets taxes and profit sharing charges,<sup>5</sup> though related to net income, do not meet the U.S. requirements.

Another important item to note is the *indirect* foreign tax credit. If certain conditions are met, the U.S. allows a credit to a U.S. corporation for taxes paid by foreign subsidiaries. This credit is called “indirect” because the tax has been paid by a different legal person from the legal person claiming the credit. To take our earlier example, assume that the U.S. corporation, rather than operating directly in Costa Rica, operated the same business through a 100% owned subsidiary. The 30 units of tax paid by the subsidiary could be taken as a foreign tax credit by the parent. This indirect credit is available when the parent has at least a 10% ownership interest in the subsidiary.<sup>6</sup>

Withholding taxes on payments to non-residents are also generally creditable, whether they are imposed on interest, dividends, royalties, rentals or compensation for services. Because such taxes are considered to be the liability of the recipient, the ownership limitations of the indirect credit do not apply. Taking the Costa Rica example, suppose that Costa Rica imposed a 10% withholding tax on dividend payments. After the 100 of income has been reduced to 70 by the 30% income tax, a dividend distribution of the remaining 70 is reduced to 63 by the withholding tax (7, or 10% of 70).

For the foreign tax credit calculation, the 63 units received by the parent company are grossed up to the original 100 and the 35% U.S. rate is applied, again resulting in a tentative U.S. liability of 35 units. For purposes of the foreign tax credit, there is no distinction between the dividend withholding tax (7 units) and the business income tax paid by the subsidiary (30 units).<sup>7</sup> The combined credit of 37 units completely eliminates the tentative U.S. liability. The balance of 2 units cannot be used in this scenario, thus becoming an “excess” foreign tax credit, and a real economic cost to the parent company.

U.S. companies operating in several countries are permitted to lump together all foreign source manufacturing income, regardless of its origin. If profitable operations are located in a high-tax jurisdiction, a tax reduction in a different country will benefit the investor directly. For example:

---

<sup>5</sup> It does not matter whether the assets tax is imposed as the principal tax or as an alternative minimum tax. See “The Business Assets Tax in Latin America- The Beginning of the End or the End of the Beginning?,” P.D. Byrne, Tax Notes International, September 22, 1997

<sup>6</sup> IRC sec. 902. The recipient of the dividend must also be a corporation, and the tax must be one that would be creditable if it had been paid by the parent. Though the minimum ownership for the indirect credit is 10%, the foreign tax credit calculation example may be different where the U.S. shareholder owns less than 50% of the foreign corporation.

<sup>7</sup> To achieve symmetry between branches and subsidiaries, many countries have a “branch profits tax” that approximates the dividend withholding tax. The foreign tax credit analysis is the same.

U.S. Company X has income of \$2 million in Sweden, which is subject to 40% income tax, and a 5% withholding tax on distributions. In the U.S., this income is taxed as follows: income grossed up to \$2 million, and tentative tax of \$700,000 is calculated (at the U.S. 35% rate). This tentative tax is reduced by the foreign tax credit of \$860,000 (composed of \$800,000 of indirect foreign tax credit and a \$60,000 credit for the withholding tax on the dividend of \$1.2 million). The Company X has after-tax income of \$1.14 million, and an excess foreign tax credit of \$160,000.

Now suppose Company X invests in a tax-free zone in Honduras, and this investment produces \$400,000 of income:

The \$400,000 of income will be combined with the Swedish-source income, and (after gross-up) subject to the U.S. income tax. A tentative tax of \$840,000 (35% of \$2.4 million) is reduced by the foreign tax credit of \$860,000 (the same as the prior example). No U.S. tax is due and now Company X has an excess foreign tax credit of \$20,000. Now the after-tax income of Company X is \$1.54 million (\$1.14 million received from Sweden and \$400,000 received from Honduras).

As can be seen, *no U.S. tax is paid with respect to the income from Honduras*. In essence, the Swedish taxes have absorbed the U.S. tax that would have been paid on the Honduran source income. Company X receives all of the tax holiday benefit. A similar result can be expected for other companies that are in an excess foreign tax credit position. Approximately half of U.S. multinational companies are in such a position.<sup>8</sup>

A significant limitation on the U.S. foreign tax credit must be noted at this point. Under the U.S. “basket” system, companies are required to separate different types of foreign income into baskets, and income of a similar nature from any foreign source can be combined in a single basket. However, foreign tax credit from one basket *cannot* be used to reduce the tentative U.S. tax liability arising from another basket.<sup>9</sup> Note that the reduced U.S. tax derived in the foregoing example would not be allowed if the Honduran income related to shipping, for example. Indeed, no income from one basket may be combined with that belonging to another basket- even if it is from the same country.

Unless otherwise noted, only the general limitation basket will be considered in this paper. Most investments sought by Latin American countries (manufacturing, sales operations, services) produce income that goes into the general basket.

One last item regarding the baskets should be noted. The separate basket for “high” withholding interest (5% or higher) has motivated several Latin American countries (including Mexico, Venezuela and Peru) to set a withholding rate of slightly less than 5% on certain types of interest. The impact of this policy can be favorable and will be discussed in the section on Thin Capitalization.

---

<sup>8</sup> Of course, the converse is also true: for U.S. companies that do not have excess foreign tax credits, Latin American countries could impose more than 35% tax without harming the U.S. investor. However, U.S. rules prevent the use of such “soak up” taxes that do not reflect the general tax rate. Note that U.S. tax liability related to U.S. source income can never be reduced by the foreign tax credit.

<sup>9</sup> IRC Sec. 904 creates separate baskets for, among others: passive income; high (i.e. 5% or more) withholding tax interest; financial services income; shipping income; and non-controlled company dividends.

## b. Deferral and Controlled Foreign Corporations

As noted, the U.S. taxes corporate residents on their worldwide income. This system not only serves to raise revenue, but also discourages investment outside the U.S. that is motivated by tax rather than business reasons.<sup>10</sup> At the same time, income of foreign operations derived by subsidiaries of U.S. taxpayers generally is not taxed in the U.S. until a dividend reflecting such income is paid to the U.S. person. This concept is known as “deferral,” and reflects both the legal principle that income should not be taxed until it is received, and the practical consideration that U.S. companies would be at a competitive disadvantage in low-tax jurisdictions if local companies had to pay only the local tax (20%, for example) and U.S. companies had to pay 35% (20% plus the difference of 15% in the U.S.).<sup>11</sup>

Many years ago, the U.S. government realized that taxpayers were exploiting the concept of deferral simply to delay payment of U.S. taxes. Particularly offensive to U.S. policymakers was the practice of forming intermediate corporations in tax havens (such as Panama or the Cayman Islands) where no commercial activity was occurring- rather, such intermediate company served only to hold dividends and other income until they could be reinvested, or until the shares of such company were sold. Furthermore, U.S. banks suffered because interest income (taxable in the U.S.) on the funds held by such intermediate companies was generally not taxed in the tax haven. Thus, the U.S. found itself in a dilemma: continue to allow these abusive practices, or aggressively tax foreign income of foreign corporations, a strategy that disregards traditional legal principles and jeopardizes the competitiveness of U.S. companies with foreign operations.

The U.S. has attempted to steer between these two extremes. Various regimes exist to force certain U.S. taxpayers to treat certain income as though it were distributed.<sup>12</sup> In broad terms, such provisions cover income from investments that are of a passive or mobile nature, when such income is derived by a person with a level of ownership that suggests control.<sup>13</sup> Yet foreign subsidiaries of U.S. corporations that are involved in active businesses (mostly of the sort producing income falling into the “general” basket described in the foreign tax credit discussion) are generally permitted to retain earnings with no U.S. tax consequences.

Take as an example a U.S. corporation with a wholly-owned subsidiary (a *sociedad anónima*) in Panama, which in turn owns 100% of a Chilean S.A. The Chilean S.A. is engaged in mining, and the Panamanian S.A. has no other assets or operations other than

---

<sup>10</sup> This principle is known as “capital export neutrality,” and can be illustrated as follows: an investment in the U.S. may be determined to generate 100 of pre-tax income, leaving 65 of after-tax income, whereas the same investment in a tax free zone of Peru may generate 80 (both pre-tax and after-tax). Only by taxing the Peruvian income in the U.S. will the investor see it in his interest to locate the investment in the U.S.

<sup>11</sup> This principle is known as “capital import neutrality.” The notion that all competitors in a country should be taxed at the same rate (and particularly with no tax imposed in the residence country) is reflected in the territorial system of taxation, still used in several Latin American countries.

<sup>12</sup> IRC Sections 551-8 (Foreign Personal Holding Companies); 951-964 (Controlled Foreign Corporations); 1291-7 (Passive Foreign Investment Companies) and others.

<sup>13</sup> Shareholders without control cannot force the distribution of dividends, so they are treated less harshly.

the shares of the Chilean company. If the Chilean S.A. has income of 100 units, it may retain such earnings (regardless of the taxation in Chile) and there will be no U.S. tax consequences.<sup>14</sup> This can continue for years, with the Chilean company using the earnings for working capital or for re-investment in Chile or elsewhere. In light of Chile's 15% tax rate on undistributed income, the difference between the amount paid in Chile and the residual amount to be paid at the U.S. rate of 35% is significant indeed. Considering the time value of money, the longer the subsidiary retains the money (deferring the tax) the less the real cost to the U.S. parent of the U.S. tax.<sup>15</sup> However, if the Chilean S.A. distributes a dividend to its Panamanian shareholder, the U.S. likely will tax such dividend *as though it were distributed to the U.S. parent*. This eliminates any advantage of the Panamanian intermediary.

Until recent years, the U.S. rules steadily expanded the categories of both foreign income and taxpayers subject to current U.S. taxation. The most recent major change, however, makes deferral easier. The "check-the-box" rules<sup>16</sup> make it easier for U.S. companies to use intermediate companies and still receive the benefit of deferral. Among the reasons for the "check-the-box" rules are a desire to maintain the competitiveness of U.S. investors, fear that companies will choose not to incorporate in the U.S. (thus avoiding U.S. residence and worldwide taxation), and a recognition that certain aspects of the complex anti-deferral rules are not workable.

It is interesting to observe that several Latin American countries (among them Argentina, Brazil, Mexico and Peru) have adopted rules over the last few years that make use of intermediate companies unattractive.<sup>17</sup> These new rules are designed to protect the source country tax base; by contrast, U.S. anti-deferral rules are designed to protect the U.S. tax base with respect to foreign source income. Both make use of intermediate holding companies unattractive, but the Latin American rules have taken effect at the same time that the U.S. has relaxed its rules.

### c. Synthesis

Taking the simple case of a U.S. investor with a manufacturing investment in Latin America and a general policy of repatriating earnings (a branch, or a subsidiary that promptly distributes dividends), there is virtually no benefit in a tax holiday. As long as the combined income tax burden does not exceed the U.S. rate, any reduction in the local

<sup>14</sup> As long as the retained earnings are not excessive.

<sup>15</sup> In this sense, deferral undermines the goal of capital export neutrality that constitutes the foundation of the worldwide system of taxation.

<sup>16</sup> IRS Reg. 301.7701. These rules allow certain entities (though not most Latin American *sociedades anónimas*) to be treated as "transparent" entities. The income received by intermediate companies (the owners of such transparent entities) is characterized as business income (rather than passive income), and therefore not treated as distributed to the U.S. parent.

<sup>17</sup> This movement contrasts with the efforts in other Latin American countries to attract investment by offering tax holidays. Countries less concerned with protecting the revenue base can help U.S. companies reduce their worldwide tax burden by making available legal entities that are transparent for U.S. purposes, but allowed under internal law to make deductible payments of interest and royalties to their parent. Low withholding rates also benefit such companies.

tax will lead to a corresponding increase in U.S. income tax.<sup>18</sup> In these cases, any tax reduction in the Latin American country will benefit the U.S. Treasury, not investors.

The foregoing scenario must be compared to the situation where a U.S. investor operates in Latin America and *does not* repatriate earnings for several years. As mentioned above, the actual tax treatment in the U.S. will be the same whether the dividend is distributed in Year 1 or Year 10. Even in the case where there is a deferral benefit, there is greater U.S. taxation as a direct result of the source (i.e., Latin American) country not imposing a tax. Nevertheless, the economic cost of the U.S. tax liability is less in Year 10 because of the time value of money. The greater the residual U.S. tax liability, the greater the benefit will be. Of course, the residual U.S. tax liability is directly related to the difference between the combined local income tax rate and the U.S. rate. Therefore, a tax holiday or reduced tax rate will be very attractive to investors who do not intend to repatriate income for many years.<sup>19</sup>

At the same time, it would be typical for an investor to seek a tax reduction to obtain a minor deferral benefit. For such investor a small savings is better than nothing, but such savings may be completely disproportionate to the revenue sacrificed by the country where the investment is located. For example, an investor may seek an exemption on an investment where \$1 million of income is expected in Year 1, because no dividends will be distributed until Year 3. If the local government agrees to the exemption, the investor will receive a small benefit for the deferral, but \$300,000 of revenue may have been transferred to the U.S. Treasury.<sup>20</sup> One way to approach this problem is to impose a light tax at the time income is earned, and an additional tax at the time of distribution.<sup>21</sup>

Another complex issue is presented by the case of U.S. investors with operations in several countries. As noted above, the U.S. “basket” system allows income from several countries to be combined for purposes of calculating U.S. tax to be paid on foreign income. The case involving manufacturing income from Sweden and Honduras illustrates how a U.S. taxpayer with excess foreign tax credits may receive the full benefit of a tax reduction or holiday, with no transfer of revenue to the United States.<sup>22</sup> It must be recognized that this benefit to the U.S. investor only occurs because another country is taxing U.S. companies at a rate higher than the U.S. rate. In a sense, a Latin American country offering the tax reduction is subsidizing the high tax rates of other (often European) countries.

---

<sup>18</sup> If the local combined rate (business income plus withholding) is higher than the U.S. rate, a reduction would benefit the investor, as would a reduction in any non-income tax.

<sup>19</sup> There are several reasons why U.S. investors may not keep their earnings offshore. Return on such funds may be low, the investor risks punitive taxation under the Accumulated Earnings Tax provisions (IRC sections 531-7), or the investor may be in an excess credit position.

<sup>20</sup> The tax on \$1 million of income, assuming a 30% local rate. The value of the deferral to the investor would be no more than \$50,000.

<sup>21</sup> Chile taxes income as earned at 15%, and then imposes an additional 20% (for a total of 35%) at the time of distribution. An investor from the U.S. would benefit from the deferral of the 20% tax, and such tax may be immediately creditable in the U.S.

<sup>22</sup> Of course, the converse is also true: for U.S. companies that do not have excess foreign tax credits, Latin American countries could impose more than 35% tax without harming the U.S. investor. However, U.S. rules prevent the use of such “soak up” taxes that do not reflect the general tax rate.

In summary, it is impossible to generalize about the effect on U.S. investors of high tax rates, low tax rates, or tax-free zones. In the case of a tax holiday or low tax rates, the certainty of revenue loss must be weighed against the possibility of increased investment that may be motivated by tax savings. Some investors will realize a tax savings through deferral, and others because they are in an excess foreign tax credit situation. In the case of deferral, the investor may derive substantial tax savings, but for many investors the savings may be insignificant compared to the revenue sacrificed by the Latin American country. In the case of taxpayers with excess foreign tax credits, a reduction in income tax will represent a real tax savings. But the Latin American country cannot differentiate between investors who will benefit from a tax reduction and those who will not.<sup>23</sup>

#### **IV. Tax Reduction Strategies and Tax Treaties**

Any discussion of U.S. international tax principles would be incomplete without a discussion of transfer pricing, thin capitalization, and tax treaties. These issues are components of most U.S. investors' international tax strategy, and the policies of Latin American countries with respect to these issues therefore will affect investment decisions.

##### **a. Transfer Pricing & Thin Capitalization**

Approximately three-quarters of international sales are between related parties. Furthermore, every time a multinational corporation realizes an investment, it must finance such investment with either debt or equity. The "transfer" price of every related party sale and the debt/equity ratio of every investment have tax consequences for both of the countries involved. Both issues, if not properly addressed, present opportunities for foreign investors to reduce their tax liability on investments in Latin America.

Transfer pricing is probably the most discussed international tax issue in both Latin America and the U.S. However, the U.S. has been dealing with the issue for decades, whereas Latin American countries only recently have understood the implications of transfer pricing. Take a simple example:

Specific Motors Inc. manufactures an automobile in the United States for a cost of \$8000. It then sells the automobile to its subsidiary in Colombia, which sells this automobile to the public for \$18,000 after incurring \$2000 of transportation and local costs. It is clear that \$8000 has been earned on the transaction. But how this \$8000 is split for tax purposes depends on the transfer price, which is wholly under the control of the company (since the parties are related, the market does not establish the price). Both countries have a 35% tax rate, but Colombia imposes a remittance tax on dividends paid to foreign shareholders. To avoid this cost, Specific Motors deems \$15,000 to be the transfer price. The U.S. income is \$7000, and the Colombian income is \$1000.

Knowing all the facts, it certainly appears that the transfer price should have been lower, thus allocating more income to Colombia. However, Latin American countries

---

<sup>23</sup> As noted in the prior footnote, U.S. rules provide that taxes imposed only on taxpayers able to use the foreign tax credit results in forfeiture of the foreign tax credit.

traditionally have not had the information from other countries to determine a fair transfer price, nor the legislation to adjust the transfer price in the event of suspicious circumstances. Many countries' tax laws merely require the parties to assign a market price to transfers. But it is easy to defend a wide range of market prices: in the example, who is to say that \$15,000 is not a market price? Many Latin American countries have *never* adjusted a transfer price. The U.S., by contrast, has comprehensive transfer pricing rules that narrow considerably the range of prices that companies can assign to related-party transfers.<sup>24</sup> Thus armed, the U.S. tax authorities routinely "adjust" the transfer prices assigned by companies.

It is natural for a company to allocate relatively more income to a lower-tax jurisdiction, and most Latin American countries have had lower tax rates than the United States for more than a decade. U.S. companies therefore have little incentive to allocate more income to the U.S. and less income to Latin America.<sup>25</sup> However, there may be situations where transfer pricing is used to allocate income to tax havens, at the expense of Latin American countries. Therefore, it is important for Latin American countries to protect their revenue by implementing modern transfer pricing rules.

Though transfer pricing disputes between U.S. companies and Latin American governments may not be common, it is extremely important for U.S. investors that other countries' transfer pricing rules be consistent with the U.S. rules. While it would be unwise for any Latin American country to copy the complex U.S. rules, it is essential to follow the international norms.<sup>26</sup> A permutation of the foregoing example illustrates the problem.

Specific Motors, following the U.S. transfer pricing rules, assigns a transfer price of \$13,000 per automobile, resulting in an allocation of \$3000 to Colombia and \$5000 to the U.S. Colombia, applying transfer rules that are inconsistent with international norms, determines that the income allocable to Colombia is \$5000. Now Specific Motors must pay income tax on \$10,000 per automobile (\$5000 to each country) when the total income was only \$8000 per vehicle.

This is a clear case of double taxation. Unless there is some way to resolve this difference (usually in a tax treaty, described below), the U.S. investor suffers double taxation, which is a significant barrier to investment. Until a tax treaty is in place, a transfer pricing regime consistent with international norms is the best way to avoid this possibility of double taxation. To further ensure that double taxation will not occur, a country may implement an Advance Pricing Agreement ("APA") system. Pursuant to an APA, the company and the government agree on the proper price (with some flexibility) prior to the actual transfers. This allows both the tax authority and the company to view the transaction from the same perspective, rather than the tax authority looking at the price

---

<sup>24</sup> IRC Sec. 482. The accompanying regulations are extraordinarily complex.

<sup>25</sup> Though transfer pricing disputes between U.S. companies and the Mexican authorities are increasingly common, because Mexico's taxes can be higher than the U.S. taxes.

<sup>26</sup> The OECD (Organization for Economic Cooperation and Development) transfer pricing guidelines are the accepted norms. These guidelines are the product of years of thought by international experts. There is no reason for developing countries to "re-invent the wheel."

several years later in the course of an audit. Such procedures also help to build trust between the tax authority and companies.

Because the U.S. taxes interest income at the same rate as other income, investors are indifferent as to the type of income they receive (as long as there is no issue with the foreign tax credit baskets mentioned above). At the same time, many tax-saving strategies for investments in Latin America involve financing with debt rather than equity. Interest is deductible from the business income tax, which involves substantial tax savings.<sup>27</sup> Some Latin American countries attempt to offset the tax savings by imposing a substantial withholding tax on related-party debt. Companies often respond by structuring “back-to-back” loans through banks (i.e., the company lends to a bank, which in turn lends the money to such company’s foreign subsidiary).

The temptation to prevent back-to-back loans by raising the withholding rates on all loans must be resisted. U.S. banks are an important source of credit, and ordinary (not back-to-back) loans are severely impeded if the withholding rate is more than 4 or 5%. The withholding rate is on gross interest. The bank’s net profit is often only 10% of the gross amount, which makes a 4% withholding rate equal to a 40% tax on net income. Furthermore, borrowers normally bear the cost of withholding tax, which is not desirable.

The solution to this problem is specific legislation to disallow back-to-back loans. In the absence of tax treaties, such legislation will be difficult to enforce. But tax treaties are becoming more common in Latin America. Moreover, it must be recalled that U.S. companies rarely will violate local laws, even when the violation cannot be detected.<sup>28</sup>

## b. Tax Treaties

It is the expressed policy of the U.S. Department of the Treasury that tax treaties between the U.S. and other countries are *not to reduce U.S. tax on U.S. residents*. Furthermore, tax treaties provide information exchange with countries where such U.S. companies or their affiliates may be operating. Given the foregoing, it may be surprising to learn that U.S. multinational companies almost uniformly want more tax treaties. There are three fundamental reasons for this: first, tax treaties often reduce the tax burden in the country where a foreign investment is located (for our purposes, Latin America); second, tax treaties offer a measure of stability, which is critical to companies considering investment in Latin America; and third, tax treaties offer certain guarantees to foreign investors that they do not have absent a treaty.

It is important to review what tax treaties *do not affect*:

---

<sup>27</sup> The same tax savings can be achieved through royalty payments, or payments for services. However, such payments must be justified, so there is far less abuse.

<sup>28</sup> If a Latin American country wishes to reduce the tax burden on foreign investors without tax incentives, simply allowing this “earnings stripping” through related-party debt, royalties or services will achieve this purpose.

- U.S. tax rates;
- U.S. foreign tax credit rules;
- U.S. controlled foreign corporation rules or deferral;
- U.S. transfer pricing rules.

In other words, tax treaties do not affect the substantive rules related to the topics this paper has discussed as the major U.S. tax issues influencing foreign investment. However, tax treaties definitely affect *how* these rules are applied.

*Treaties Facilitate Limited Economic Activity-* U.S. tax treaties eliminate taxation at source<sup>29</sup> when a U.S. business is carrying on limited activity in the source country. In the case of companies or persons providing independent services, they generally will not be taxed in the source country if they do not have a “permanent establishment,”<sup>30</sup> and in the case of services (whether dependent or independent), only significant physical presence will make such individuals taxable in the source country. It should be noted that the goal of these provisions is not to reduce revenue in the source country: they are to save these taxpayers the administrative burden of complying with local tax rules when their activity is limited. It is also worth noting that, in the absence of a treaty, such limited activities do not generate significant revenue, and collecting tax related to limited activities is never easy (lack of physical presence makes tax collection administratively difficult).

*Limitation of Withholding Rate at Source-* Important provisions of tax treaties limit the withholding that may be imposed on dividends, interest and royalties paid to non-residents.<sup>31</sup> The rates are normally between 5 and 15%. Whether this limitation affects the withholding rates of a Latin American country depends on the rates established in domestic law. For example, a 5% limit on the dividend withholding rate will not change anything if the domestic rate on such dividend payments is 0%. On the other hand, a 30% domestic withholding rate on royalties will be reduced to 15% if the treaty establishes this rate. The reason for these rate reductions is as follows: withholding rates are on *gross* income, and a rate higher than 10 or 15% on interest or royalties translates as an excessively high rate on *net* income (which could lead to excess foreign tax credit for the U.S. investor). Furthermore, tax treaties allow information exchange, so the Latin American authorities can verify that the interest and royalties are reasonable.

*Tax Treaties Provide U.S. Companies with Guarantees-* Articles 23, 24 and 25 provide guarantees to U.S. investors that may not be assured under domestic law: relief from double taxation, non-discrimination, and competent authority procedures. The first provides the investor with certainty that income taxes paid to the treaty partner will be

---

<sup>29</sup> In the case of a U.S. company doing business in Latin America, the Latin American country is the source. Of course, all treaties are reciprocal, but this paper focuses on the activity of U.S. companies in Latin America.

<sup>30</sup> Normally Article 5 of tax treaties. The term used in Article 14 (Independent Personal Services) is “fixed base,” but the concept is the same. There are many exceptions to this rule in the following articles of the treaty.

<sup>31</sup> Articles 10, 11 and 12.

creditable in the U.S. (i.e. doubt is eliminated that the U.S. will say the tax does not qualify as an income tax for U.S. purposes). Non-discrimination guarantees the investor that it will not be the subject of discriminatory taxation (compared to local companies or companies owned by other foreign companies).

Competent authority/ mutual assistance may be the most important guarantee: U.S. investors are allowed to seek the assistance of the U.S. Internal Revenue Service when there is a dispute with a Latin American tax administration over any issue covered by the treaty. When there is a tax treaty, the two tax authorities involved are committed to work together to find a resolution to the problem. Such direct communication regarding a particular taxpayer would be illegal without a treaty. This procedure is particularly useful in the transfer pricing area, where a company may be able to arrange a single APA that is binding in both countries. In the absence of a treaty, no such collaboration is possible.

*Stability-* Though the foregoing tax limitations and guarantees are important to U.S. investors, the stability offered may be the most important aspect of a tax treaty. In a region viewed as somewhat risky, treaties are viewed as islands of stability. Though dividend withholding rates are currently low, a treaty ensures that they will never rise above 5 or 15%.<sup>32</sup> Though there may currently be no discriminatory taxation of foreign investors, a treaty ensures that there never will be. And finally, a treaty network suggests that a country is becoming a member of the international tax community, which indicates that it is unlikely to pass future tax laws that are inconsistent with international norms.

Tax treaties also have the positive effect of encouraging investment directly from the United States to a treaty partner. Treaty benefits are not available when an investment is channeled through a tax haven.

### c. Synthesis

Transfer pricing is a significant issue for most multinational taxpayers. Transfer pricing rules should be adopted both for the benefit of investors and the Latin American countries.

It is important for countries in Latin America to have transfer pricing rules in order to protect their revenue. Aggressive transfer pricing by multinational companies can reduce the local tax base.<sup>33</sup> Transfer pricing principles also help to prevent excessive payments of royalties and interest, or for services. The larger Latin American countries have already enacted transfer pricing rules to prevent erosion of the local tax base, and other Latin American countries should be concerned with the issue.

---

<sup>32</sup> “Never” meaning the foreseeable future. Though treaties can be rescinded, they rarely are.

<sup>33</sup> Only in unusual cases, however, would transfer pricing rules (or lack thereof) create an opportunity for tax savings that conceivably would attract U.S. investment. Accordingly, the revenue loss cannot be viewed as a cost that has a benefit.

U.S. multinational companies also may benefit from transfer pricing rules. Such investors fear uncertainty, especially when the uncertainty relates to potential double taxation. The lack of transfer pricing rules leaves investors with the worry that the country of their investment will implement transfer pricing rules that are inconsistent with international norms (as Brazil did). It must be recalled that inconsistent transfer pricing rules can lead to double taxation. Therefore, it is advisable for Latin American countries to adopt transfer pricing rules *that are consistent with international norms*.<sup>34</sup> An APA program is a further step in this direction

Tax treaties give U.S. investors even more certainty. There are transfer pricing disputes between companies and countries even when transfer pricing rules are consistent- the tax authorities and the companies simply do not agree on criteria. A tax treaty virtually eliminates the possibility of double taxation.

U.S. investors also favor tax treaties because they limit certain Latin American taxes that are either excessive or administratively difficult. The withholding rates are low for good reasons: royalties are limited to a rate reflecting reasonable international norms. Other provisions involve no revenue sacrifice. For example, the limitation on dividends would have no effect in the many countries where internal law calls for no tax on dividends distributed. But it is comforting for investors to know that such rates cannot be imposed at a rate any higher than that allowed by the treaty.

The supposed revenue loss associated with the aforementioned provisions of a tax treaty must be compared with the increased revenue associated with additional powers (especially information exchange) granted to a country's tax administration. Latin American officials from countries with treaty programs indicate that the balance is favorable. Finally, one must consider the increased economic activity from investment that may result after a tax treaty is in force. Investors repeatedly mention tax treaties as a component of a climate that is good for investment. Such economic activity generates additional revenue. The minor cost of negotiating and maintaining a tax treaty program suggests that treaties are worthwhile for countries seeking to attract investment.

---

<sup>34</sup> The best source for such norms is the Organization for Economic Cooperation and Development (OECD).

## BIBLIOGRAPHY

Doernberg, R.: International Taxation (5<sup>th</sup> ed.) West Group, 2001.

Gustafson, Peroni and Pugh, Taxation of International Transactions, West Group, 2001.

Isenbergh, J.: International Taxation, Foundation Press, 2000.

And the following articles by the author:

“Tax Incentives in Latin America” (forthcoming)

“The Future of the Income Tax in Open Economies” United Nations Commission on Latin American Economic Development, January 1999

“Tax Treaty Prospects in Latin America,” Tax Notes International, January 5, 1998

"The Business Assets Tax in Latin America- The Beginning of the End or the End of the Beginning?" Tax Notes International, September 22, 1997; also published in the Latin American Law and Business Report

“Tax Treatment of Foreign Payments in Latin America Compared” (with others), Tax Notes International, February 3, 1997

"Developing Countries, Tax Treaties, and the United Nations Model Tax Convention" ILSA Law Journal, Summer, 1996

"Local Tax Issues Facing U.S. Businesses Doing Business in Latin America" published April 15, 1996 in Tax Notes International, and also published in the University of Miami Law Review

"The Business Assets Tax in Latin America- No Credit Where It Is Due," Tax Notes International, August 15, 1994. Reprinted in the Harvard University Development Discussion Papers, March 1995.