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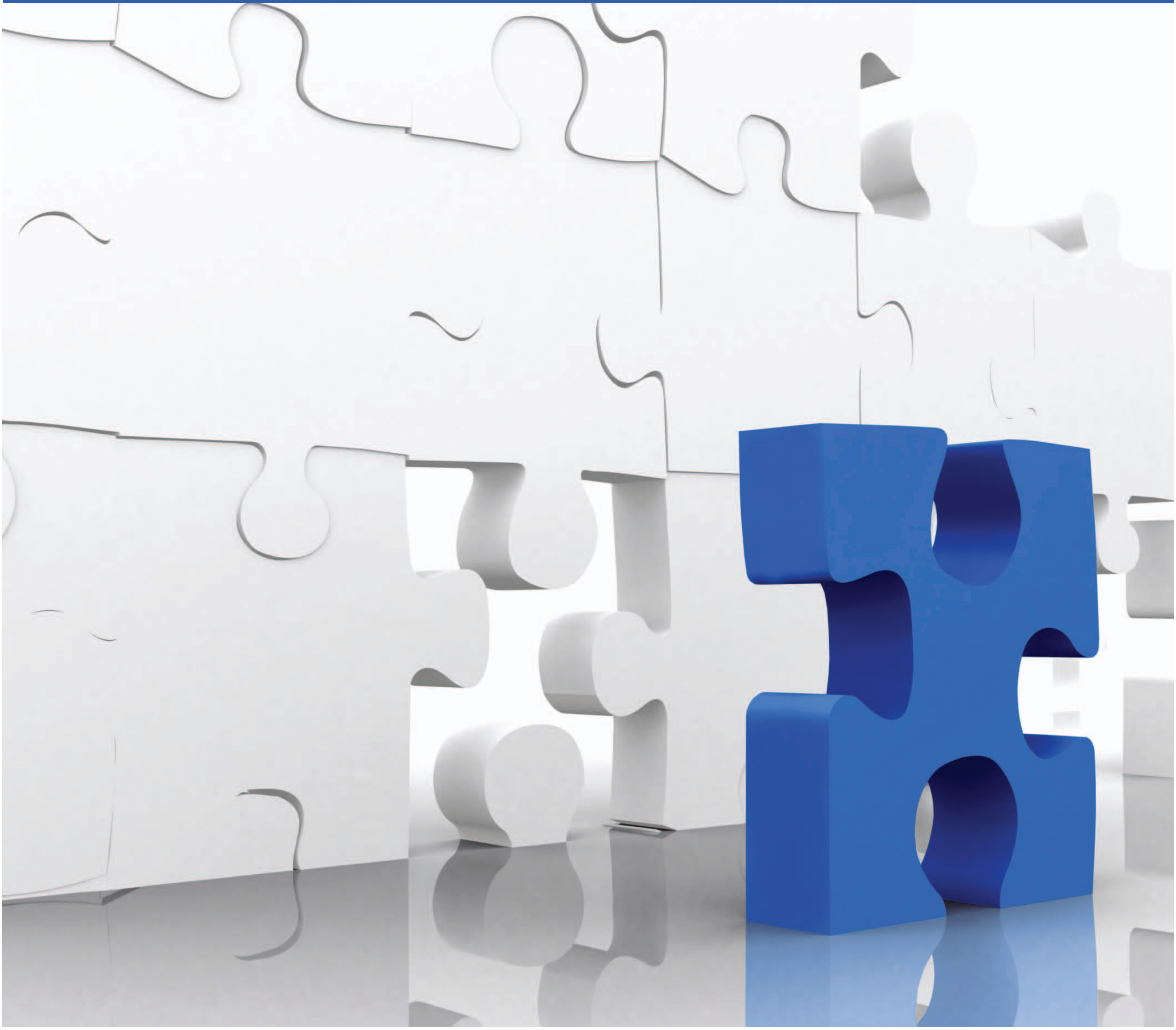

CIAT/AEAT/IEF
Tax Administration Review

No. 30
December 2010

Sponsoring Organizations

Inter-American Center of Tax Administrations - CIAT

State Agency of Tax Administration - AEAT

Institute of Fiscal Studies - IEF
Ministry of Economy and Finance of Spain

Editorial Policy

The Technical Cooperation Agreement signed by CIAT and the State Secretariat of Finance and Budgets, the State Agency of Tax Administration (AEAT) and the Institute of Fiscal Studies (IEF) of Spain, provided for the commitment of editing a review that would serve to disseminate the different tax approaches in force in Latin America and Europe.

An Editorial Council formed by CIAT officials (the Executive Secretary, the Director of Studies and Training and the Tax Studies and Research Manager) and the Heads of the Spanish and French Missions, are responsible for determining the topics to be considered in each edition of the review.

The articles are selected by the Editorial Council from a public announcement made by the CIAT Executive Secretariat for each edition of the review. Participation is open to all tax administration officials from the CIAT member and associate member countries and, following evaluation by the Editorial Council, to other members of the My CIAT Community.

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Author's Responsibility

The opinions expressed by the authors do not represent those of the institutions for whom they work or those of the CIAT Executive Secretariat.

CIAT/AEAT/IEF
Tax Administration
Review

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No. 30
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Editorial

Within the framework of the CIAT Executive Secretariat's (ES) new communication policy, it is a pleasure to present to all the officials of the tax administrations of the member and associate member countries of our organization and, in general, to the entire international tax community, the new format of the Tax Administration Review, published in accordance with the Technical Cooperation Agreement between CIAT and the State Secretariat of Finance and Budgets, the Institute of Fiscal Studies (IEF) and the State Agency of Tax Administration (AEAT) of Spain.

During these past years, the review was the means for disseminating the winning papers of the Essay Contest and the Research Scholarship. Nevertheless, the sponsoring entities had always wanted it to "serve as an instrument for describing the different tax approaches in force in Latin America and Europe". Therefore, a new format for the review was decided in the first semester of 2010, in order to fulfill this objective and thus make it a publication specialized in tax policy and administration issues to promote discussion and the exchange of ideas.

We greatly appreciate the acceptance of the announcement to submit contributions for this edition of the review. It was very difficult for the Editorial Council to select the articles given the great quality of all the proposals. This edition includes articles dealing with local taxation issues from several Latin American countries, such as tax decentralization, environmental taxes, actual tax burdens on industry and tax control, as well as others covering international taxation control aspects.

It is our sincere hope that the review will constitute a means for transferring knowledge, transforming information into learning and that it may, in turn, also be a useful resource with practical application in the international tax community.

Director of the Review
Márcio Ferreira Verdi

A New Paradigm for Retail Taxpayers Control and Supervision

Alves Fernandez, Marcelo Luiz; Botelho Junqueira, Álvaro Ribeiro; Hama, Renato; Hernandes Júnior, Nelson; Mitsutani, Heitor; Tsuha, Simone

SUMMARY

Brazil's tax administrations have been increasingly using technological innovations. However, the retail sector does not have an efficient system for supervision and data collection. The equipment currently used in the retail sector requires the physical presence of supervision at the taxpayer installations. This procedure is not viable in the state of Sao Paulo. This motivated a change in paradigm for the supervision of the retail sector, and the physical equipment focus is transferred to the transmission of documents with legal validity for the database of the Treasury Secretariat of the State of Sao Paulo.

Key words: SAT-CF-e, retail, change of paradigm, Electronic Tax Coupon, Tax Coupon.

The Authors: *Working in the Executive Management of the Tax Administration of the Ministry of Finance of the State of São Paulo. The team consists of professionals from various fields of study such as lawyers, engineers and computer specialists, contributing greatly to the solid structure of the project*

INTRODUCTION

Content:

This article analyses the retail taxpayers supervision model existing in the State of Sao Paulo, Brazil, shows its deficiencies, and addresses the need for establishing new and modernizing paradigms, using the emerging tools provided by the increasing IT usage by the Brazilian Tax Administration.

During the last two decades, the Tax Administration has promoted noticeable changes in service delivery, information providing, and internal administrative procedures, by using IT resources.

Examples of these changes are:

- Government elections are made by means of electronic voting nationwide, for more than one decade;
- Digital inclusion programs (such as the “Acessa Sao Paulo”, from the State of Sao Paulo) allow to any citizen free access to the Internet in public spaces equipped with computers.

This process of constant technological evolution and adoption of electronic government actions, coupled with the need for optimizing Tax Administration human resources, promotes the development of new supervision models. In former times, these models could not be implemented, due to such reasons as technology availability, and costs. To exemplify these models, we could mention these supervision projects of the Tax Administrations: the annual Income Tax Return form, the Electronic Tax Invoice, the SPED –Digital Bookkeeping Public System, and the data analysis at the Brazilian Internal Revenue Service.

With respect to the retail taxpayers supervising model, this article presents the concept of the SAT-CF-e project, under development at the Revenue Department of the State of Sao Paulo, which aims to introduce new supervising paradigms in this sector.

1. THE STATE OF SAO PAULO AND THE ICMS TAX COLLECTION

The State of Sao Paulo is the largest among the 27 Brazilian federative units, in terms of both population and economy. 41 million inhabitants[1] live in Sao Paulo, about 1/5 of the Brazilian population.

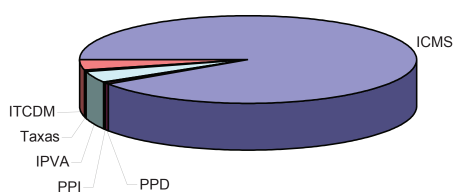
The state is responsible for about 34% of the Brazilian GDP[1], with approximately Br R$ 467 billion[1] (US$ 275 billion). The state is the largest industrial center of Brazil and mainly an exporter, despite the fact that its large population creates high consumption demand to the retail.

Promulgated in 1988, the Brazilian Federal Constitution defines state taxes, including the ICMS – tax on goods circulation and interstate and intercity transport and communications services-, the most important one. In the case of sales operations (goods circulation), the merchant is responsible for paying the tax due. A kind of value-added tax, ICMS is non-cumulative. In other words, it is possible to use the tax paid in previous operations in the production chain to compensate for the due value. Undoubtedly, it is the most important financial resource of the State.

In the State of Sao Paulo, during 2009 the ICMS was responsible for a collection of Br R$ 78.2 billion[2] (US$ 46 billion), equivalent to 34.4% of the whole Brazilian ICMS collection in the same period[2]. In a sector analysis, one can notice that the retail, although responsible for only 9.6% of the total collection[3], in absolute figures represents a great source of funds (Br R$ 7.5 billion[3], US$ 4.4 billion).

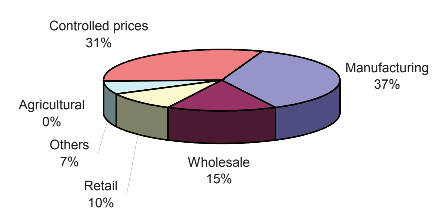
Figure 1 and 2 – ICMS Collection and ICMS Collection by sector

Collection by Tax



ICMS collection
in 2009: Br R$ 77 billion
* Not considering extraordinary collection and tax amnesty

ICMS Collection by Segment



Retail ICMS Collection
in 2009: Br R$ 7,5 billion
* Not considering extraordinary collection and tax amnesty

Source: Report on Tax Revenue of the State of Sao Paulo. July, 2010[3]

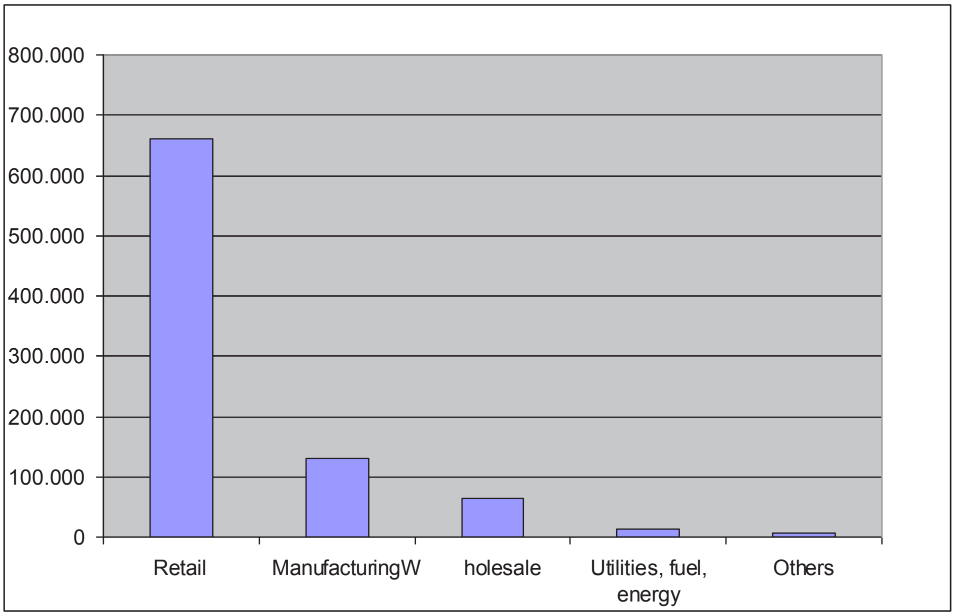
1 *SÃO PAULO. Informations about the State of Sao Paulo. Avaiable at: <http://www.investimentos.sp.gov.br/porque/porque_principal>. Acessed on August 23, 2010*

2 *SEFAZ-SP. Report on Tax Revenue of the State of Sao Paulo. July, 2010. Avaiable at: <http://www.fazenda.sp.gov.br/relatorio/2010/julho/tabelas/tabela14.asp>. Acessed on August 23, 2010*

3 *SEFAZ-SP. Report on Tax Revenue of the State of Sao Paulo. July, 2010. Avaiable at: <http://www.fazenda.sp.gov.br/relatorio/2010/julho/tabelas/tabela14.asp>. Acessed on August 23, 2010*

Differently from other sectors where collection is concentrated in a more limited number of taxpayers, there are more than 700,000 retail taxpayers registered at the Sao Paulo Tax Administration[4]. This number represents one of the challenges to the Sao Paulo Tax Administration to effectively track, monitor and control the due collection of taxes on goods circulation, and particularly on the sales to final consumers.

Figure 3 – Number of taxpayers by sector



(**Source:** Report on Tax Revenue of the State of Sao Paulo. July, 2010[3])

2. CURRENT MODEL OF RETAIL SUPERVISION – "PAULISTA" TAX INVOICE PROGRAM AND TAX VOUCHER ISSUER - ECF

The Revenue Department of the State of Sao Paulo – SEFAZ/SP is the institution at the State of São Paulo Government responsible for collecting taxes from taxpayers and managing the expenses originated by the State budget execution. To accomplish that mission, SEFAZ/SP began activities in 1892 with 10 employees[5] and now has a structure with almost 8,400 employees[6].

The State of São Paulo possesses an organized Tax Administration since 1925, when the Secretariat of Finance, moved by the expansion of State economy, created the Directorate of Supervision. Nowadays, tax collection management, a fundamental role for the State to execute the governmental actions, is performed by CAT (Tax Administration Coordination).

4 *SEFAZ-SP. Internal reports of the Secretariat of Finance of the State of Sao Paulo*

5 *SEFAZ-SP. About the Secretariat of Finance. Available at: <http://www.fazenda.sp.gov.br/institucional/oque.shtm>. Acessed on August 23, 2010.*

6 *SEFAZ-SP. Payroll statistical data – Statistical comparison of months June 2010 and May 2010. Available at: <http://www.fazenda.sp.gov.br/ddpe/comparativo/serv_ativos_total.asp>. Acessed on August 23, 2010.*

In order to perform its function in tax supervision, CAT is divided into 18 Regional Tax Supervisions throughout the São Paulo state, including 3 at the State Capital. Also, specialized Supervisions, each of them with expertise in a specific industry, are placed at the Renevue Department headquarters in the State Capital.

Retail tax supervision is based on two main lines of action: supervision of Tax Voucher issuers, and supervision of the “Paulista” Tax Invoice program. This one promotes fiscal education by encouraging consumers to require the issuing of the Tax Voucher at the point of sale. This entitles the consumer both to request a tax return of a portion of the ICMS tax due in the sale operation, and to an electronic ticket to compete for premiums in cash. This strong incentive for the consumer to ask the retailer for the issuing of the Tax Voucher establishes the connection between the two lines.

Retail ICMS taxpayers have the obligation to use the ECF (Tax Voucher Issuer) equipment, which stores the information about the sales operations, and print the corresponding Tax Voucher. In brief, the equipment consists of a printer, coupled to storage memories in a control motherboard; the equipment shell is sealed with security seals. To use the ECF, the taxpayer is required to make its registration at the SEFAZ site in the Internet, using a Taxpayer Services Portal.

After the ECF registration, and from the moment the equipment is put into use on, for each Sales operation a Tax Voucher is to be printed and handed to the consumer. The sale operation data is stored into a RAM memory in the ECF. By the end of the day, a command to the ECF starts the resume (“Z reduction”) procedure, which consolidates the daily sales into permanent memory and prints this consolidation. Because the current ECF models are only required to store the Sales operations data into the equipment, the taxpayers are now obligated to make electronic bookkeeping of these sales, by formatting the REDF (Fiscal Documents Electronic Registration) file, and transmitting it to the Tax Administration. The transmission can be made either automatically by using Webservices, or manually by uploading the files in the Taxpayer Services Portal in the SEFAZ site in the Internet. The transmission obligation is due 49 days after the sale operation.

With the exception of the situations when Tax Supervision physically inspects the ECF at the taxpayer’s premises, access to the sales operations data by Tax Supervision requires active participation of the taxpayer in the transmission.

In practice, the transmission not always occurs, for a number of reasons. Among them, we could mention tax evasion, the difficulty for the Tax Administration to inspect retailers, which are widely spread throughout the State, and also the time spent by taxpayers to comply with this obligation, which is diverted from the retailer’s core business – selling.

To promote both fiscal education and compliance to the REDF files transmission, the Secretariat of Finance created the “Paulista” Tax Invoice program, which became an essential element to the supervision of goods sales to final consumers.

We now describe the program functioning: when making a goods purchase operation, the final consumer (either a person or a business) is allowed to register his/her Identification Number among the Tax Voucher data. This registration entitles him to receive both cash prizes in raffles, and tax returns of a percentage of the ICMS tax due by the retailer in the sale operation. In this way, the consumer becomes an active participant in the supervision of the retailers, by demanding his printed Tax Voucher, and in consequence, the registration of the Tax Voucher in the ECF memory.

Because the financial rewards are calculated and granted to the consumers based on the REDF files information, the consumer has a strong incentive to supervise the information transmission. By accessing the "Paulista" Tax Invoice program site, hosted in the SEFAZ site in the Internet, he can check whether his Tax Vouchers were actually received and stored in the SEFAZ's database. With the printed Tax Vouchers in hands, the consumer can retrieve and check their information individually. Moreover, he can also check the cash prizes and tax returns he is entitled to, require these credits to be transferred to his personal checking account, or use them to reduce or fully pay the Tax on Property of Motor Vehicles - IPVA, another State Tax. Another possible destination for the credits is to donate them to charities or health institutions. In case his Tax Voucher is not found in the database, the consumer can file a complaint at the web site; he attaches an image of his printed Tax Voucher, and the system demands the retailer for an explanation. In case the retailer does not answer the demand, or his explanation is considered unsatisfactory, the consumer can convert his complaint into a formal process. In the SEFAZ IT environment, Tax Auditors can retrieve, sort and analyze the formal complaints, and eventually apply fines when necessary. This whole analysis process is completely digital, with no paper documents manipulation, making it fast and practical.

3. MOTIVATION FOR THE CONCEPTION OF A NEW PARADIGM

Despite the efforts of Tax Administration to lower tax evasion in the retail segment, and considering the large quantity of taxpayers, and the restricted number of Tax Auditors directed to inspect these retailers, there are four motives that enlighten the need for a paradigm change in retail supervision.

3.1. Quantity of ECF versus Quantity of Tax Auditors

In order to proceed to a particular inspection procedure, it is necessary to provide the Tax Auditor with a compatible amount of time, called Fiscal Effort. As we will see, in the current ECF situation, the quantity of equipments demands an amount of time greatly superior to the available Fiscal Effort for the retail segment.

From a total of 3,800 Tax Auditors acting in São Paulo Tax Administration[7], about 2,100 effectively work with Tax Direct Inspection[7].

In a preliminary evaluation, it would be concluded that each Tax Auditor working in FDT would be responsible for regularly inspect 115 ECF.

3.2. Fiscal Effort for ECF inspection

This high ratio would not be a problem, provided that all Fiscal Effort is dedicated exclusively to retail ECF inspection.

However, considering that about 10%[8] of total ICMS collection comes from the retail segment, the largest portion of the Tax Auditors contingent is dedicated to actions related to more revenue-

7 *SEFAZ-SP. Internal reports of the Secretariat of Finance of the State of Sao Paulo*

8 *SEFAZ-SP. Report on Tax Revenue of the State of Sao Paulo. July, 2010. Avaiable at: <http://www.fazenda.sp.gov.br/relatorio/2010/julho/tabelas/tabela14.asp>. Acessed on August 23, 2010.*

expressive segments, such as manufacturing, wholesale, communications, and energy. Even in the retail, the Tax Administration actions also comprise non-ECF related inspections, such as Fiscal Bookkeeping Analysis, Taxpayer's Register alterations, other Fiscal Inspections. In sum, not all Tax Auditors work with Direct Tax Inspection in the retail, and even these are not focused on ECF regularity inspection.

By consulting the Secretariat historical records, it is possible to estimate that it would take approximately 45 years to inspect all installed ECFs, not taking into account new equipments and maintenance during this period.

3.3. Increasing ECF cost

ECF usage is an obligation only for the retailers who attain over BR R$ 120,000 (US$ 68,571) of annual revenue. The others, corresponding to 70%[9] of the retail taxpayers, currently issue their fiscal documents manually, using printed books of Consumer Sales Tax Invoice. In this sense, the usage of the ECF suffers from a limitation, related to the cost of the equipment. A new legal specification for the ECF, ruled by Convenio ICMS 09 (ICMS Agreement # 9), April 3, 2009, establishes new security mechanisms, including encryption keys, equipments interconnection, and communication with Tax Administration, which are expected to increase the ECF cost even more.

By comparing a non-fiscal printer (with no security features) to the current ECF, it is possible to note a great price difference. A research in a commercial automation equipment seller shows that the average price of an ECF is 196% higher than that of a non-fiscal printer.

Printers	Fiscal	Non-fiscal	Differences
Average price	R$ 2.656,34	R$ 898,89	196%
Lower value	R$ 1.647,10	R$ 565,25	138%
Higher value	R$ 6.043,90	R$ 1.213,15	398%

Source: www.automateq.com.br. Accessed on August 20, 2010.

9 *SEFAZ-SP. Internal reports of the Secretariat of Finance of the State of Sao Paulo*

3.4. Limitations about received electronic information

As mentioned before, since the implementation of the "Paulista" Tax Invoice program, Tax Administration receives information about Sales operations in the retail, by means of REDF (Fiscal Document Electronic Registration). The REDF is used to calculate credits and prizes for those consumers who included their Identification Number in theTax Voucher.

However, despite the monthly obligation to transmit these data to the Tax Administration (all taxpayers included), it is noticed that:

1. Although obliged to deliver the REDF, many taxpayers do not comply with it, especially those that do not use the ECF, thanks to the effort to transcript the information of the manually issued invoices;
2. In general, REDF are sent by upload, an error-prone process, especially among small taxpayers; usage of automated Webservices is an exception;
3. REDF does not have a binded digital signature, and thus its integrity, authentication are not guaranteed by Brazilian regulations on digitally signed documents (Provisory law 2.200-2/01).
4. REDF files have a specific layout, used only at São Paulo State.

Due to the difficulties to send electronic information about the fiscal documents to the Tax Administration databases, consumers often file complaints in the "Paulista" Tax Invoice program.

4. THE CONCEPT OF SAT AND ELECTRONIC TAX VOUCHER

4.1. Objectives to be accomplished with SAT

The current model for Sales operations control with the ECF generates outcomes for the general retail supervision model:

1. Because ECF stores information in protected memories inside itself, it is necessary that Tax Auditors physically inspect the equipment at the taxpayer's premises. These actions require costful Fiscal Effort, which limits the number of taxpayers the Tax Administration can reach.
2. REDF model presents a large degree of non-compliance and data inaccuracy.

The intent to spread the retail control by means of the ECF is limited by its increasing cost, which represents considerable burden to the taxpayer. In sum, it is necessary to provide a new fiscal model that attains the following objectives:

- **Efficiency:** Utilize small Fiscal Effort for supervision and inspection
- **Coverage:** Be possible to be implemented at taxpayers that do not use the ECF today.
- **Simplicity:** Make it easy for the taxpayer to fully comply with its legal tax-related obligations
- **Safety:** Guarantee integrity, authenticity and serve as a fiscal document for all purposes.

4.2. SAT equipment characteristics

In order to accomplish the above mentioned requisites, SEFAZ has specified the SAT-CF-e (Electronic Tax Voucher Authenticator e Transmissor System), with the following basic characteristics:

- Broadband Internet technology for communication (Wi-Fi or Ethernet) – in order to allow fast information transmition;

- CF-e (Electronic Tax Voucher) with its layout based on that of the NF-e (XML standard). Adoption of XML is motivated by the fact it is an open, widely disseminated standard. Besides that, it is a concern that both CF-e and NF-e layouts would be similar in any possible aspects, from structure to field names, in order to facilitate the CF-e dissemination, given that NF-e is already mandatory to taxpayers of other industries that not the retail;

- Equipment has its own digital certificate, capable of digital signing of sales operation data. Fundamental to assure authenticity and integrity of the CF-e. All CF-e generated by SAT will be signed with this Digital Certificate, which will be checked by SEFAZ upon its receiving;

- Printing with ordinary, non-fiscal printer. The printing mechanism and its controlling board inside the ECF are responsible for great part of the security features of the ECF, and for increasing its price. By allowing the printing to be done outside its shell, the SAT will gain in simplicity and cost reduction;

- Low cost – Initial estimates show a selling price around US$ 200,00 (R$ 350,00[10]), much lower than the average ECF price (R$ 2.200,00).

- Remote commands from SEFAZ to SAT – will allow the SAT operating to be monitored and parametized from SEFAZ, without human intervention at the taxpayer's premises. It will be possible, for example, to change the frequency of CF-e transmission, according to taxpayer's geographical location, industry, risk profile, etc. Other commands designed are: update the Basic Software of SAT, update its Digital Certificate, among others;

- Autonomous equipment – differently from ECF, SAT will not require a third-party technician for maintenance. In case of problems, the equipment will be returned to its manufacturer and replaced by a new one.

- Transmission monitoring by the taxpayer – The background system, to be implemented at SEFAZ will allow all CF-e to be monitored, from its transmission to the successful reception. One function will allow the taxpayer to follow its own issued CF-e.

10 BACEN. US$ Exchange rate on August 23, 2010. Avaiable at: <http:// http://www.bcb.gov.br/>. Acessed on August 23, 2010

5. SAT-CF-e OPERATIONAL MODEL

5.1. Hardware and software requirements for the taxpayer

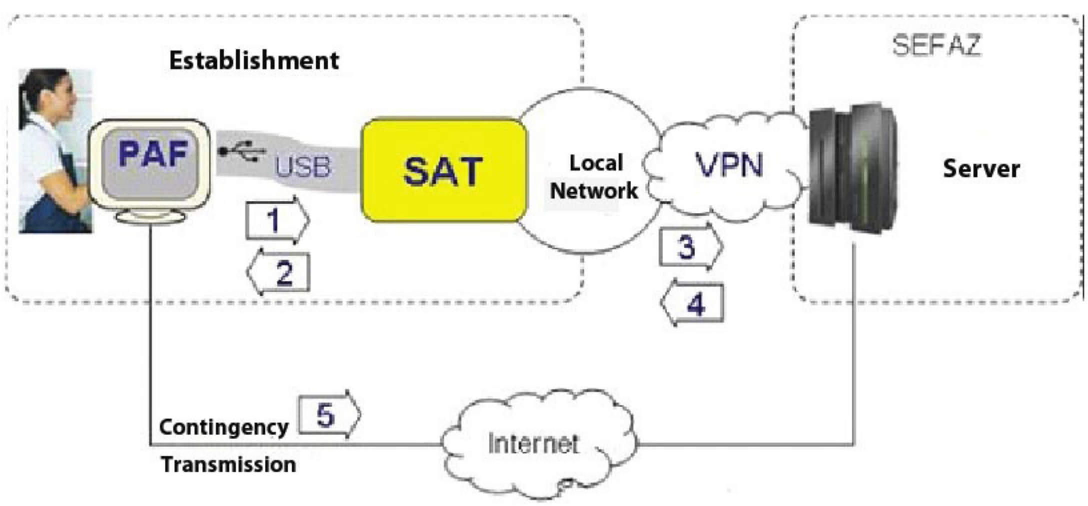
Listed below are the requirements for using the SAT:

- Checkout Application Program – CAP or PAF: controls and registers Sales at the retail checkout, sends necessary data for the SAT to create and transmit the CF-e. Similar programs work with the ECF, controlling its operations.
- PC for the PAF – it is assumed that today this requirement is already satisfied by a large portion of the retailers that use ECF
- Non-fiscal printer – As mentioned, any ordinary printer can be used to print a CF-e printout for the consumer
- Internet Access with broadband connection – most large and medium taxpayers already have this access in the Sao Paulo State. Penetration among small ones increases, fueled by Federal and State Internet popularization programs.

5.2. Simplified operational schema

Operational model Will follow the below depicted schema:

Figure 4 – SAT-CF-e Operational Model



Steps:

- (1) e (2) – SAT executes local authentication of Sales operation at taxpayer's establishment
- (3) – Automatic periodical transmission of sales tax vouchers (CF-e) from SAT to Tax Administration (SEFAZ) through taxpayer's local network, which will communicate over the Internet, using a secure connection.
- (4) – Reception of information from SEFAZ to SAT for executing specific commands and receiving CF-e successful transmission receipt.
- (5) – Transmission in contingency mode, where taxpayer has to copy CF-e files stored in CAP/PAF and manually upload them to Tax Administration.

After reception by Tax Administration, CF-e will be released for query by consumers in two ways:

- Through the "Paulista" Tax Invoice program website - For consumers enrolled in the program, who need to inform their ID number at the moment of the sale operation at the retailer;
- Through a query key - For consumers not enrolled in the "Paulista" Tax Invoice program, there will be the possibility to query their Tax Vouchers by means of a query key to be displayed in the printed CF-e at the moment of the sale operation at the retailer.

5.3. Taxpayers' processes:

- Initial enrollment - After acquiring the SAT equipment, the taxpayer will have to register it at Tax Administration, through a specific functionality in SEFAZ's website in the Internet;
- Activation and tests - After registering the SAT equipment, the taxpayer will connect it to his PC, and execute a activation procedure and functionality and Internet connection tests;
- Sale operation and CF-e issuing - as described at 6.2;
- Follow the CF-e transmission - as mentioned above, the taxpayer will be able to follow the transmission of his CF-e until its successful reception, through functionality available in the SEFAZ website. This process will become a future obligation for the taxpayer.

6. A NEW RETAIL SUPERVISION MODEL

With the future introduction of SAT-CF-e, a new model of retail supervision will be adopted, in order to overcome the deficiencies of the current one, as exposed in 5.1.

This new model should change the focus of Tax Administration, from equipment controlling to a wider control of taxpayer's fiscal behavior.

The main components of this new model are:

- Evaluation of fiscal behavior by means of data analysis – By receiving reliable information through the efficient reception of the CF-e, Tax Administration will be able to establish behavior control based on analysis of information available in its databases. As an example, it will be possible to evaluate the compatibility between the value of inbound merchandise received by the taxpayer, and the volume of registered sales. The inbound volume will be given by the NF-e issued by the taxpayer's suppliers; these NF-e are already electronically registered in Tax Administration database. The sales volume will be given by the issued and registered CF-e. An expressive difference between the two values may indicate non-declared revenue (sales operations without issuing the correspondent tax vouchers), to be inspected by auditing procedures.

Tax Administration will be able to create many other analysis using the CF-e and other available information.

In the future, automated reports will indicate to Tax Auditors the existence of possible irregular behavior, to be investigated in deep, allowing for a more effective use of the scarce human resources.

- Consumer perspective – The consumer will be able to visualize the registry of his purchases at the SEFAZ website in a much shorter time span than today, given that the transmission of his Electronic Tax Vouchers will be done automatically, without human intervention. By perceiving this improvement in the process, the consumer will be stimulated to demand more frequently the issuing of Electronic Tax Vouchers in all his purchases.

7. CONCLUSIONS

Retail is an important component in Tax Revenues of the State of São Paulo, with a 10% share of all collected ICMS taxes.

Despite this importance, Tax Administration did not have an efficient systematic to track Tax Vouchers issuing by retail taxpayers. This issue was faced with a program for Fiscal Citizenship stimulus launched in 2007, the “Paulista” Tax Invoice program.

This initiative, however, brought an additional obligation to retail taxpayers, as they have to inform to Tax Administration an electronic registry of his sales operations.

The SAT-CF-e is proposed as a solution for the Tax Administration to enhance its control over taxpayers, reduce both time for registering Tax Vouchers at revenue Department and costs for the taxpayers.

All involved parties will benefit from this system, as Tax Administration will better intercede to avoid unfair competition caused by tax evasion, society will help attack tax evasion with agility, and taxpayers will be able to dedicate more time to its core businesses, which is selling and serving its customers.

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Fiscal Federalism and Transference Systems for Financing Sub-National Governments in Latin America

Elvira Hebe Balbo

SUMMARY

The dispute settlement mechanism linked to the multiple horizontal taxation of the Economic Activities Tax is described in the framework of the inter-jurisdictional agreement signed by the Argentine provinces and the Autonomous City of Buenos Aires. This successful standard harmonization experience and coordination of different tax administrations may be analyzed and replicated, in its substantive aspects as well as in procedural matters, in other countries with similar problems.

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INTRODUCTION

Contents:

We intend to show the way in which Argentina has quite successfully solved the multiple horizontal taxation problems of the so-called Economic Activities Tax[1], existing in several countries of the region. To that end, the provinces and the Autonomous City of Buenos Aires[2], which hold the tax authority of the same, have agreed on a mechanism that considers the distribution of its taxable base and an alternate way to dispute settlement that could be brought about by the aforementioned distribution. Additionally, we will comment on how the provincial Tax Administrations and the Federal Public Revenues Administration – AFIP – have coordinated their work carrying out joint actions for the benefit of the public treasuries and taxpayers involved.

1. HOW ARE TAX POWERS DISTRIBUTED IN ARGENTINA

It is not our objective to detail the fabric of fiscal relations that underlie the Argentine federal system. However, we will undertake a brief tour of its fundamental parts in order to locate ourselves in the issue before us in this opportunity. The original drafters enshrined in our Constitution a Federal State where three levels of government coexist: the National Government, the Provinces and the Municipalities. In view of this, political and administrative decentralization is the essence of this form of government that is based on federalism. In Argentina, there are twenty three provinces, the Autonomous City of Buenos Aires and approximately 2216 municipalities, communes or similar entities. The 1853 Constitution established the principle of separation sources of tax origin between the Nation and the Provinces, which may be summarized in the following table[3]:

1 *In Argentina, it is currently known as: Tax on Gross Revenues. It has previously been called: Profitable Activities Tax and Tax on For-Profit Activities.*

2 *The juridical status of the Autonomous City of Buenos Aires is not identical to the one held by the provinces. However, and only for the purpose of simplifying the development of this document, it will be understood that when mentioning the provinces we are referring to these and the Autonomous City of Buenos Aires – CABA-.*

3 *By the Author: "Municipal La coparticipación municipal: no es sólo cuestión de especialistas". Revista IR 3. Edited by the Tax, Customs and Social Security Studies Institute –under the AFIP-. Buenos Aires. 2008. Available in:* www.afip.gov.ar/instituto

Classes of Tax Resources	Powers	
	Federal Government	Provinces
Foreign Trade	Exclusive and excluding	Forbidden
Direct Contributions	Exceptionally	Regularly
Indirect	CN 1994: concurrent power	

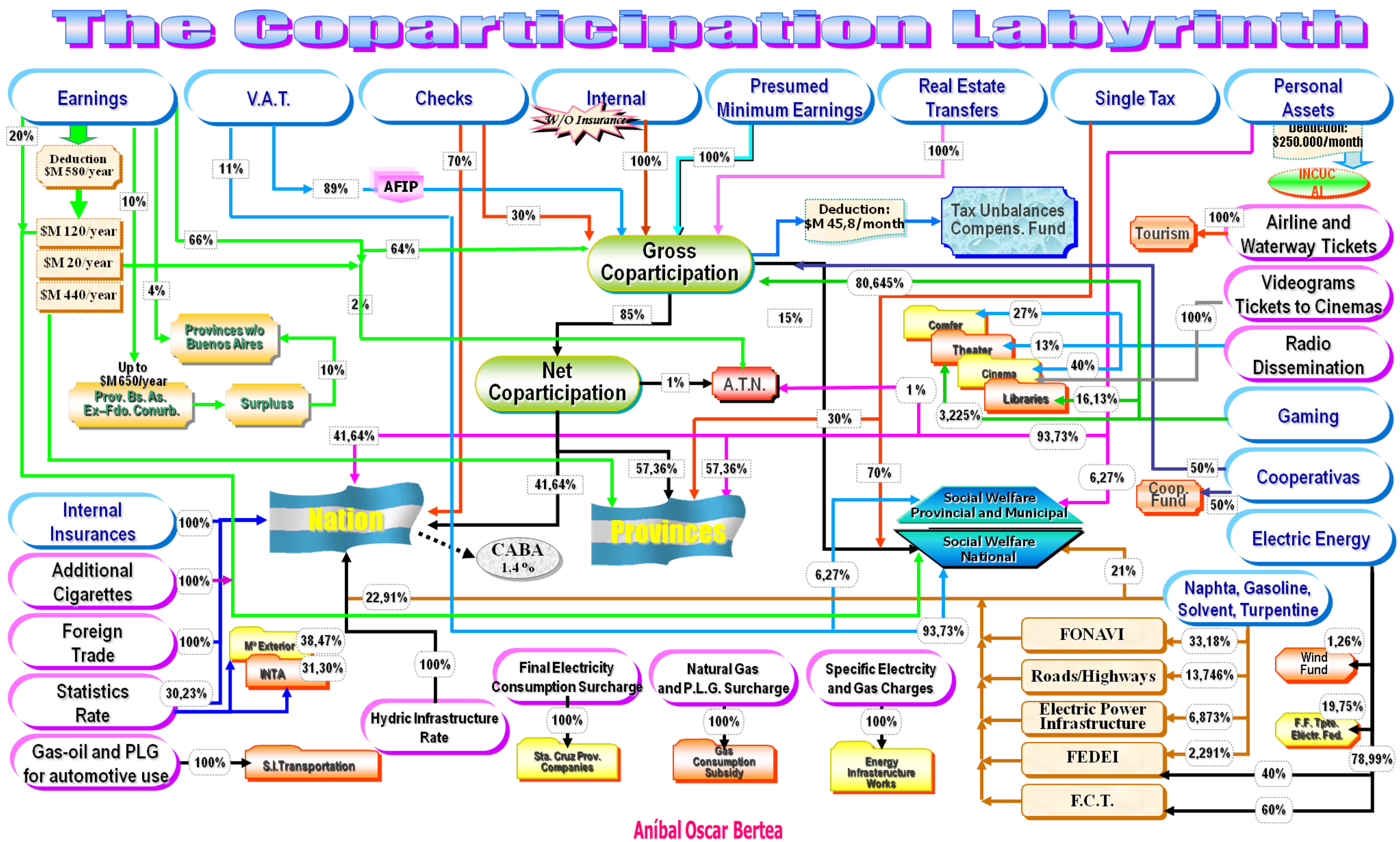
In addition to the separation of sources, used for foreign trade, a system called Federal Tax Co-Participation is in force in Argentina. The Provinces have delegated on the Federal Government the collection of taxes legislated by this last level, but which are of its exclusive property (direct contributions; v.gr Income Tax) or concurrent property (indirect contributions). The last Co-Participation law enacted was Law 23,548 of 1988 that provides a "transitory regime for the distribution of tax resources between the Nation and the Provinces" that will "be in force from January 1, 1988 until December 31, 1989". Its life was extended automatically in view that there was no regime to substitute this one.

The mass of funds to be distributed is made up by the ones generated by the collection of all national taxes currently existing or to be created with the following exceptions:

- Import and export duties that correspond exclusively to the Nation, as is foreseen in article 4 of the National Constitution.
- Taxes whose distribution, among the Nation and the provinces, is foreseen or will be foreseen in other special co-participation systems or regimes.
- National taxes or contributions with specific assignment to defined purposes or destinations and for a specific time.
- National taxes and contributions whose product is destined to performing investments, services, works and the promotion of activities, declared as of national interest by means of agreement between the nation and the provinces.

Of the total amount collected, with the restrictions described above, 42,34% will be automatically distributed to the Nation (primary distribution), 54,66% to the set of Provinces (secondary distribution), 2% for the relative recovery of some provinces and el 1% for the Contributions to the National Treasury (Aportes del Tesoro Nacional - ATN) Fund, which will be destined to emergency situations and financial unbalances of the provincial governments and will be allocated according to decision made by the Ministry of the Interior.

From 1992 to 2002 the Nation and the provinces signed several agreements fiscal pacts and agreements. In addition, the National Constitution was modified in 1994 and it was established that, in its sixth transitory clause, a new co-participation regime would be arrived at before December 1996, not yet approved. The current distribution of the product of taxes is shown in the graph below:



Author: Aníbal Oscar Bertea[4]. Source: *www.cfi.gov.ar*

The graph above shows, in its top part, taxes that constitute the mass to be distributed and the destination of each one of them that are destined to pre-co-participations until arriving at the primary distribution among Nation and Provinces.

4 *The author of the attached graph is Dr. Aníbal Oscar Bertea, Legal Advisor of the Federal Tax Commission, body in charge of overseeing the compliance with the Federal Tax Co-Participation Regime. Available in: www.cfi.gov.ar*

1.1 Municipal Resources

Although the National Constitution does not distribute tax powers to the municipalities, it does secure the municipal regime in its 5th article when it establishes that: "Each province shall dictate for itself a Constitution under the republican representative system, of agreement with the principles, declarations and guarantees of the National Constitution; and that ensures its administration of justice, its municipal regime, and elementary education. Under these conditions the Federal Government, guarantees to each province the enjoyment and exercise of their institutions".

Also, the Federal Tax Co-Participation law determines that the provinces are obliged "to establish a system for the distribution of revenues originated in this Law for the municipalities of their jurisdiction, which must be structured ensuring the objective setting of the distribution indices and the automatic and biweekly remittance of the funds" (article 9th, Law 23,548, Obligations Arising from the Regime).

The above shows that the existence of a municipal regime is of unavoidable compliance by the provinces because, only if the provinces secure it, the Federal Government guarantees "the enjoyment and exercise of their institutions". Therefore, there are no provinces without municipalities in Argentina. Furthermore, in its article 123, the National Constitution ensures municipal autonomy, although it establishes that its scope will be regulated by the Provincial Constitution[5].

Apart from the resources municipalities receive from other government levels through co-participation (Nation/province and province/municipality), own taxes authorized by the Constitutions of the provinces they belong to also apply. These taxes must not impinge the Federal Tax Co-Participation Law, which does not allow municipalities to apply taxes that are analogue to the national co-participation ones. This limitation to municipal tax powers, arising from the tax coordination regime, determines that the typical municipal tax species be the rate because, there are practically no other tax "wastelands" left to be used by the local governments without impinging the commitments assumed of a federal rank.

1.2 Provincial Resources

These are made up by the accreditations, which the provinces and the Autonomous City of Buenos Aires receive from the Nation for the application of the federal tax co-participation regime and by the provincial taxes legislated in their own Tax Codes, in the light of the Constitutions of the provinces[6].

The main taxes that are applied by the provinces are[7]: stamp tax[8], real estate tax, automobile tax or license plate tax, some taxes on salary payroll destined to welfare purposes and the tax on gross revenues, similar to the also called economic activities tax[9]. It is precisely this last tax the one that grants to the provinces the highest own collection to support provincial budgets[10].

5 *"Each province dictates its own constitution, pursuant to what is provided in article 5th ensuring municipal autonomy and regulating its scope and contents in the institutional, political, administrative, economic and financial order" (National Constitution, art. 123).*

6 *The provinces where non-renewable natural resources are exploited also receive Royalties from the same.*

7 *It is highlighted that given the autonomous nature of the provinces, each one of them legislates in tax matters and that is why taxes are not identical in all of them, although they are similar.*

8 *It encumbers acts, contracts and operations included in the provisions of the Tax Code of the province that are signed in it or that have effect in their territory, in agreement with the amounts and aliquots established in the tax law.*

9 *Apart from the taxes mentioned, it must be underscored that the Province of Buenos Aires, the most populated one in the country, approved in 2009 a Tax on the Free-of Charge Transfer of Assets – inheritance tax - Law No. 14,044, which is no legislated in other provinces.*

10 *According to the National Directorate for Tax Coordination with the Provinces, under the Ministry of Economy of the National Executive Branch, in the first semester of 2009 from a collection of approximately 25 billion pesos, for the totality of the provinces plus CABA (Autonomous City of Buenos Aires), 18 billion correspond to the tax on gross revenues. http://www.mecon.gov.ar/hacienda/dncfp/resources_tributarios/corrientes/1Sem2009.xls*

2. TAX ON GROSS REVENUES

2.1 Generalities

This tax encumbers the customary exercise and on a payment basis, in the jurisdiction of a province, of trade, industry, profession, craft, business, location of assets, works and services, or of any other activity - for profit or not – whichever the nature of the subject that provides them, included cooperatives, and the place where they take place (port zones, railway spaces, airstrips and airports, transportation terminals, buildings and public and private domain spaces and any other of a similar nature).

As background for this tax, towards the end of the 1940s, the tax on profit-generating activities appeared in the Tax Code of the province of Buenos Aires and, shortly thereafter, it began to be in force in the Autonomous City of Buenos Aires, at that time the Municipality of the City of Ciudad de Buenos Aires[11]. Afterwards, it became a part of the tax regime of other provinces and it has been in force for many years in the twenty four jurisdictions – twenty three provinces and the Autonomous City of Buenos Aires-. Its original structure was simpler than the one in force and its old design made it less distortive tan the current tax, where emphasis has been made on the multiphase and cascade effect, hand in hand with an inconveniently high aliquot[12]. This tax has withstood several abolitionist attacks throughout its lengthy presence in Argentina. In the 1970s it was going to be replaced by the Value Added Tax. However, perhaps due to the significant importance its collection has for the provinces, it survived and coexists with the value added tax, which is a national tax. In the 1990s, by virtue of a Fiscal Pact signed by the Nation and the provinces, there was an attempt to replace it with another tax that would apply only to retail sales. With the intention of improving the competitiveness of the economy, some activities, such as primary production, industry and construction were going to be gradually exempted from the tax until its cancellation. Due to diverse situations, this reform did not fully take place and many of the jurisdictions that had granted exemptions or lowering of the aliquots, as time went by, they did an about face and once again included, in diverse manners, the activities previously exempted. In conclusion, the tax before us is fully in force in all provinces and in the Autonomous City of Buenos Aires and, with relation with it, multiple banking withholding, receiving and collection regimes have been generated, which advance and ensure the entry of funds to the jurisdictions.

2. 2 Multilateral application

Although this tax is called “tax on gross revenues” in Argentina, it is important that we highlight that the taxable fact it refers to is made up by the exercise of an activity in a customary manner and for a consideration. Its name has been taken from the parameter chosen by the legislator to measure the development of that activity: gross revenues earned by the taxpayer that, actually, make up the taxable base of the tax. The fact that all the provinces can apply it, and that the tax encumbers the development of the activity, inexorably leads to several of them may concur on a same taxable base and that multiple impositions of a horizontal nature may

11 *Bulit Goñi, Enrique. Impuesto sobre los Ingresos Brutos. Editorial Depalma. Buenos Aires. 1997*

12 *The current general aliquot– rate – of the tax on gross revenues is 3.5% in the majority of the jurisdictions. In its origins the same was 0.4%.*

take place. Although this situation generates no constitutional tort, and it is not illegal, its economic effects are undesirable and that is why it must be avoided.

In the 1950s the Province of Buenos Aires and the Municipality of the City of Buenos Aires (today the Autonomous City) signed a bilateral agreement bilateral to avoid this tax overlap[13]. Shortly after, this agreement was adopted by the rest of the provinces that apply it to date, unanimously, with a text that is in force since 1977 and that is called: Multilateral Agreement[14]. As may be seen in the following table, if two jurisdictions A and B legislate the tax on gross revenues may take place in different situations. There will be taxpayers that will only pay taxes in one of them because the development of their activity does not go beyond the provincial territory. In this case there will be no double taxation and the subject will be a "pure" or direct taxpayer of A or B, as may be the case, as is shown in cells (1) and (2). If neither of the two jurisdictions of the example applies the tax (situation that does not take place in reality), there would be no taxation[15] and we would be in the case of cell (3). In these two assumptions, the direct taxpayer one and the no taxation one, no inconveniences are generated. However, business dynamics respect no borders and economic agents extend their arm outside their home province attempting to reap greater revenues. This is the case displayed in cell (4) and that gave rise to the implementation of the mentioned agreement.

A / B	SUBJECT TO TAX	NOT SUBJECT TO TAX
SUBJECT TO TAX	DOUBLE TAXATION (4) MULTILATERAL AGREEMENT	PURE TAXPAYER OF A (1)
NOT SUBJECT TO TAX	PURE TAXPAYER OF B (2)	NO TAXATION (3)

13 *The source of inspiration for the Bilateral Agreement and then of the Multilateral was professor Dr. Dino Jarach, renown Italian jurist with a broad track record in Argentina.*

14 *The obligation to unanimously apply the Multilateral Agreement is established in the Federal Tax Co-Participation Law. In this manner, the two tax harmonization mechanisms that exist in Argentina – vertical and horizontal-, interlink and support each other mutually.*

15 *The twenty three provinces and the CABA apply the Tax on Gross Revenues and the Multilateral Agreement. The no taxation cases of cell (3) may take place if the jurisdictions consider that the individual is not subject to the tax or if the same was exempt.*

3. THE 8/18/1977 MULTILATERAL AGREEMENT: A HORIZONTAL COORDINATION MECHANISM

The solution that has been found in Argentina to avoid multiple horizontal taxation in the en el Tax on Gross Revenues (tax on economic activities) is depicted in a multilateral agreement signed by all the provinces and the Autonomous City of Buenos Aires and afterwards ratified by each one of the legislative branches of these jurisdictions[16]. With its implementation, apart from avoiding undesired taxation overlap, conflicts that could arise between the public treasuries that aspire to a portion of the taxable base, namely the gross revenues of the inter-jurisdictional taxpayer, are minimized. The activities the Agreement refers to: "are those exercised by a same taxpayer in one, several or all its stages in two or more jurisdictions, but whose gross revenues, coming from a single process, economically inseparable, must be jointly attributed to all of them whether the activities are exercised by the taxpayer on his/her own or by third parties, including those carried out by intermediaries, brokers, commission agents, agents, travelers or consignees, etc, with or without a dependence relation. (Article 1º).

The distribution of the taxable base corresponding to the inter-jurisdictional activity is made using a coefficient made up by the revenues and the expenses of the taxpayer in each province (article 2º)[17]. In addition, the agreement establishes a mechanism for the resolution in administrative headquarters of the concrete cases that may arise, between the public treasuries and the taxpayers, that are submitted to the decision of a professional body called Arbitration Commission that, in its plenary composition, is made up by representatives from all the provinces and from the Autonomous City of Buenos Aires.

3.1 "Inter-jurisdictional" tax obligation

With the application of the Agreement mentioned in the preceding paragraph, a special category of taxpayers arises that we will call "inter-jurisdictional". It is an individual that is answerable to several public treasuries simultaneously, for the same tax liability. The traditional concept of the legal-taxation liability, where there is a passive individual and an active individual, is modified. In the inter-jurisdictional liability, the passive individual continues to be unique, but responds to several active individuals that aspire to the same taxable base. In that manner, there could be the case where a taxpayer that has declared and paid the total that corresponds to him may, nonetheless, appear as a debtor before a tax administration if it does not accept the mechanism that has been applied in the distribution.

3.2 The shared taxpayer administration

The exteriorization of joint wills depicted in the Multilateral Agreement, which defined different manners to distribute the la taxable base of the tax on gross revenues, was inspired in the ideal of facing coordinated actions and harmonizing the procedures of the public treasuries. The party jurisdictions committed to: "provide to each other the necessary collaboration in order to ensure proper compliance by the taxpayers of their tax obligations. Said collaboration will especially refer to the tasks related to information, collection and examination of the tax" (article 31st).

16 *Bulit Goñi, Enrique. Convenio Multilateral. Distribución de Ingresos Brutos. Editorial Depalma. Buenos Aires. 1992.*

17 *The distribution regime established in article 2nd of the Multilateral Agreement is called General Regime and is made by using a unified coefficient, made up by 50% of the revenues coming from one jurisdiction and 50% of the supported expenses in the same. To distribute the taxable base of some special activities the Agreement provides other procedures, which are found established in articles 6th to 13th, and that are called Special regimes.*

However, the aforementioned harmonization took time to arrive. The responsible parties had to register at each one of the public treasuries where the activities were developed, obeying the circuits foreseen to these effects and obtaining a different registration number. In view of the need to inform new developments, they also had to do it in each Administration, regardless of the distance existing between this and their real domicile. At the time of paying, the individual had to go to as many banks as destination jurisdictions had the funds, because each one of them transferred the amount collected individually. Each tax administration acted independently before the taxpayer and there was no exchange of information among them, which made many taxpayers adapt the tax returns to their convenience, providing different data with respect to a same taxable fact.

As time went by the provincial Tax Administrations made progress in the control of these shared individuals, on the basis of successive collaboration agreements. They started with the use of a single registration number, identical tax return and payment forms, they unified the collection source and the channels to render the funds, they uniformed the forms destined to communicate highs, modifications and lows. Shortly thereafter they adopted a single annual tax return that was filed by the taxpayer at his home tax administration and circulated by the same to the rest of the involved jurisdictions. With this type of filing an end was put to the practice of some taxpayers of declaring different taxable bases, on a same operation, to the different provincial tax administrations.

However, the greatest progress made took place with the appearance of Information and Communications Technologies – ICTs –, which allowed the incorporation of other tools that improved the performance of the public treasuries and simplified the task of the responsible parties.

This technological leap was taken advantage of by the Arbitration Commission that, in 1995, put into operation a system it called SICOM, a replication and redesign of System 2000 of the Federal Public Revenues Administration. This collection system included, at the beginning, inter-jurisdictional taxpayers of greater fiscal interest located in the Autonomous City of Buenos Aires, who carried out activities throughout the whole country. These were approximately 1,700 controlled individuals who contributed 75% of the total country collection of the tax on gross revenues, settled under the Multilateral Agreement regime.

The SICOM Operational Unit, belonging to the Arbitration Commission, is an example of the joint work of 24 tax administrations that share a common taxpayer universe. It supported itself on the philosophy of the development of a fiscal vector that, at the beginning of the year, loads the identified periods with an obligation number that remains as pending until its payment in full. In this manner, at the end of the maturity day the taxpayers in arrears could be obtained and inform them to all the public treasuries involved for their demand for payment. The system was also in charge of distributing the funds and the data contained in the tax returns to each administration.

Currently, this is made possible "through a generation system, automatic data validation and capture, the operation of a comprehensive tax Collection and Control system, taxable bases, taxpayers and responsible parties that are under the Multilateral Agreement regime". In this manner, the system is capable of "contributing the information on compliance, behavior, progress, trends and forecasts that allow to count with evaluation elements for the creation of policies and legislation and a greater efficiency" of all the member tax administrations[18].

18 *Source: www.ca.gov.ar*

Other operational units arrived, along with SICOM, to the Arbitration Commission:

- **SIRCAR:** special system for Collection and Control of Responsible Parties as Collection Agents (Withholdings and/or Earnings) of the Tax on Gross Revenues - Multilateral Agreement, for taxpayers controlled by the SICOM System

- **SIRPEI:** system for the Collection of Earnings that must be carried out in concept of the Tax on Gross Revenues in the definite import activities to consumption of goods that enter into the customs territory. The administration of this system is carried out jointly with the Federal Public Revenues Administration – AFIP –, through the "MARIA" Information System, of the General Customs Directorate.

- **SIRCREB:** system for the Collection and Control of Banking Accreditations that enable the compliance with the collection regimes practiced by the banks, in their capacity of withholding agents for the Tax on Gross Revenues of the taxpayers included in the standards of the Multilateral Agreement, applicable on the amounts that are credited in accounts opened in financial entities.

In this manner, other duties of operational characteristics were added to the jurisdictional duties pertaining to the agency – referring to the resolution of concrete cases of distribution of the taxable base of the Multilateral Agreement regime and the list of General Interpretative Resolutions –, which benefitted the public treasuries and the inter-jurisdictional taxpayers throughout the country, facilitating compliance and control ensuring the collection of 24 jurisdictions, as is shown in the diagram below:

19 *General Resolution of the Arbitration Commission 09/2005*

Finally, starting on 2006[19], it is of mandatory use for all taxpayers of the Multilateral Agreement the so-called: Federal Collection System, "SIFERE". A home application software that allows the settlement of the Monthly and Annual Tax Returns of the Tax on Gross Revenues - Multilateral Agreement-, that has been developed in collaboration with the AFIP and operates on its SIAp platform (Integrated Applications System) available at www.afip.gov.ar

With the purpose of improving the quality of the information that was obtained at that time, the Arbitration Commission, through the mandate of the member Jurisdictions, entered into an Agreement with the Federal Public Revenues Administration in order to coordinate the implementation of this "Federal Collection System". A new home software was developed, which allows the settlement, payment and filing of monthly and annual Tax Returns for the Tax on Gross Revenues made by the taxpayers of said tax who pay taxes under the provisions of the Multilateral Agreement and that operates within the OSIRIS Collection System of the AFIP. This system is a clear example of how the tax administrations may collaborate among them[20]. It improves taxpayer service by providing an information system tool that allows electronic filing of Tax Returns though the AFIP website, using the tax key assigned by it – in the framework of General Resolution No. 1345/02 (AFIP) and its modifications -[21].

4. CONCLUSION

Tax decentralization in federal countries, and in those that are not, poses diverse challenges for their tax administrations. In Argentina, the tax on gross revenues – tax on economic activities –, is applied in its 23 provinces and in the Autonomous City of Buenos Aires. That implies that there are taxpayers that are liable in several public treasuries at the same time, simultaneously. These are the "inter-jurisdictional" taxpayers, who respond to an atypical legal tax obligation: a passive individual in front of several active individuals of the same government level, who aspire to a portion a common taxable base. In the last thirty years, some regulatory solutions have been applied to these cases, very successfully. However, what is really noteworthy is that it has been made possible for sub-national tax administrations and the Federal Public Revenues Administration to work in a coordinated fashion for the benefit of the public treasuries and of the taxpayers in the setting of an agency called Arbitration Commission. Perhaps this model may be useful for its application in other CIAT member countries, in similar situations.

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20 *By the autor: Necesidad impostergable de administración tributaria integrada. Periódico Económico Tributario del 29/03/04, nº 297. Ed. La Ley. Buenos Aires*

21 *This is not the only case of collaboration between the Tax Administrations of Argentina. AFIP has signed several agreements with the provinces and some municipalities. Some of them are not expensive and, in others, AFIP contributes resources in the framework of Provision 513/08 that in its article 1st establishes: "It is set in up to an annual THREE PERCENT (3%) of the resources indicated in sub-paragraph a) of article 1st of Decree No. 1399/01, the amount that may be subject to programs aimed at the development of projects that include plans, tasks, execution of works and the carrying out of activities related to the application, collection, supervision and execution of tax, customs and social security liabilities and the control of international trade, that are carried out jointly or in which there is the participation of national, provincial, inter-provincial, municipal, agencies or agencies of the Autonomous City of Buenos Aires, linked to the tax administration, with border control, with the registration of assets or of physical persons or bodies corporate". www.infoleg.gov.ar*

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Industry Sector Analysis of Dominican Republic

Marvin Cardoza Espinoza

SUMMARY

This article presents an overview of the industries sector in the Dominican Republic, the evolution of total sales and sales levied with the value added tax, incentives laws and tax payment. This last part of the analysis, draws attention to the need to differentiate taxes that are actually paid by the companies from the taxes that are withheld by these but are actually paid by end consumers and/or employees.

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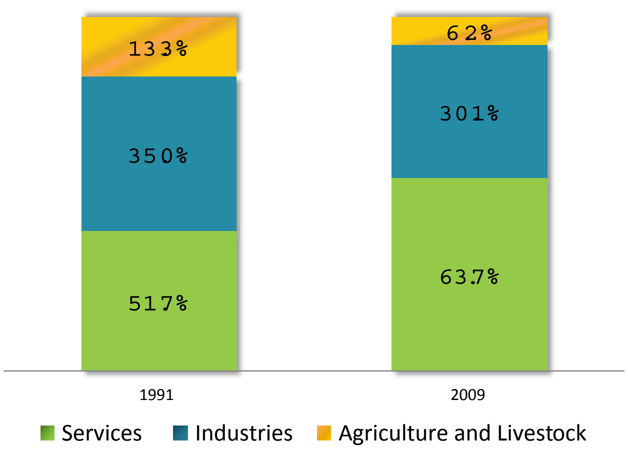
INTRODUCTION

Contents:

The Dominican economy is formed by three sectors: Services, Industries and Agriculture and Livestock. Of these, the Services Sector generates the most jobs, wealth and the largest tax collection payments.[1] Second in order, in terms of reported production and taxes, it is the Industries Sector and finally the Agriculture and Livestock Sector. (**See Graph 1)**

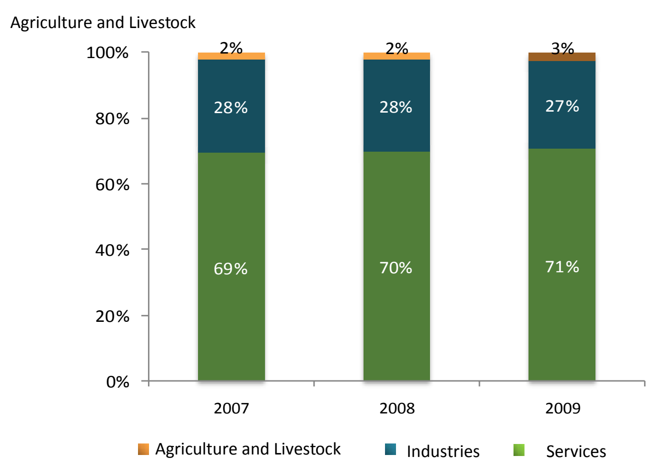
Currently, this distribution in the composition of the Dominican economy is maintained, through sales in the formal economy, as well as taxes reported, the amount of registered taxpayers and jobs generated. (**Graphs 2, 3 and 4**)

Graph 1
Domestic Production Composition
1991,2009; % of Nominal GDP



Source: BCRD

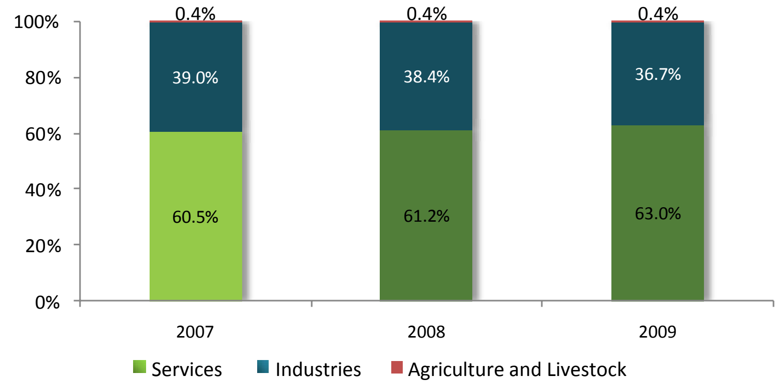
Graph 2
Sales Participation Reported at DGII
According to sector; in percentages;
2007-2009 Agriculture and Livestock



Source: Department of Economic and Tax Studies, DGII

1 *It is important to clarify that the Services Sector includes Commerce as a Sub-activity.*

Graph 3
Tax Revenue, According to Economic Sector
2007 – 2009; in percentages

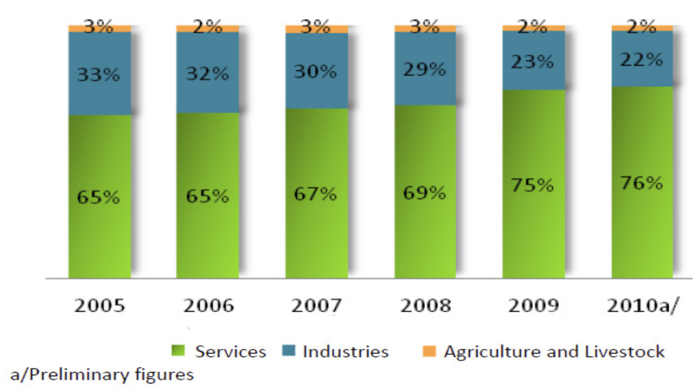


Source: Department of Economic and Tax Studies, DGII

In 2009 the DGII registered 123,758 active taxpayers[2], of which 13,697[3] belong to the industries sector, representing 11.1% of the total taxpayers and 86.8% in Services. In Agriculture and Livestock only 2.1% of the taxpayers are located.

Regarding jobs in the formal sector, measured by employees to whom the employer reported the payment of salary[4] and social security, currently the industries sector holds second place with 301,952[5] employees. If its evolution is analyzed during the 2005-2010 period, it is observed that in spite of being in second place, regarding the other sectors, a decline in the amount of employees takes place, declining from 33% in 2005 to 22% in 2010.

Graph 4
Participation of Formal Employment;
According to economic sector; 2005-2010

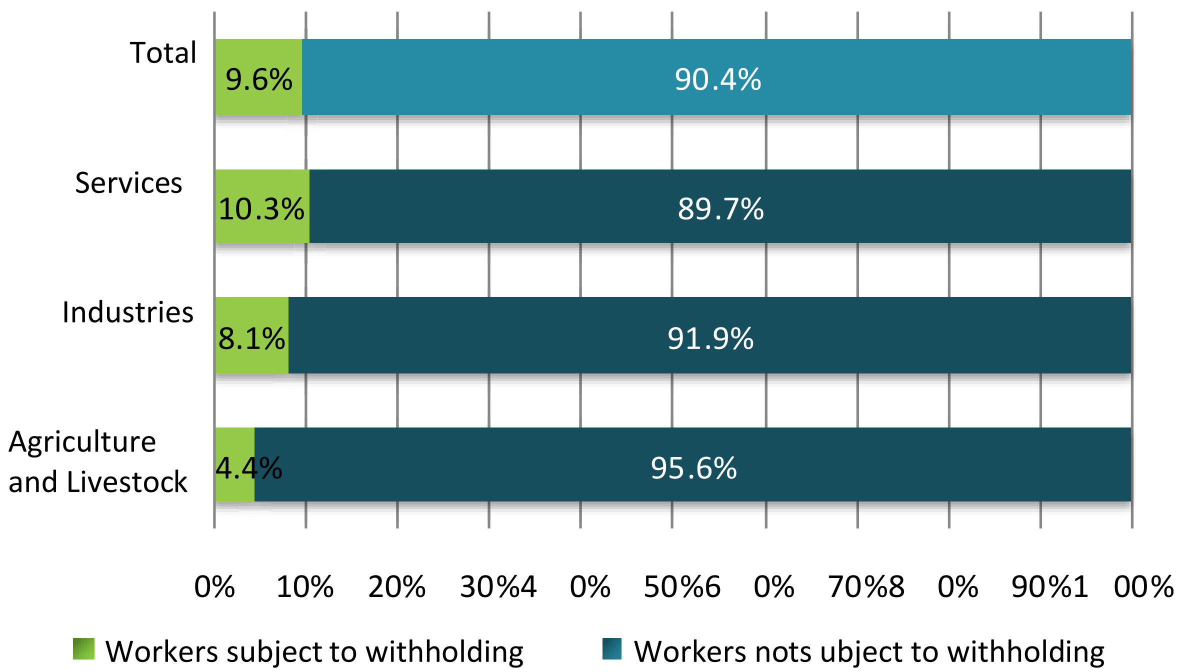


Source: DGII according to TSS data

2 *Includes companies, freelance professionals. Does not include salaried staff.*
3 *Of these taxpayers, 4,756 (35%) appear as Individuals and 8,941 (65%) as Bodies Corporate.*
4 *The amount of salaried staff is obtained from payroll reports presented by the companies before the DGII and the Social Security Treasury. The same month (June) each year was taken as a reference; assuming that the amount of employees remains constant throughout the year.*
5 *It is important to clarify that in this figure individuals with multiple jobs are repeated and by counted more than one time.*

The income tax structure (ISR) of individuals of the Dominican tax system, provides for a stretch of income exempt from tax payment[6] Due to this, for 92% of the employees working in the industry sector no tax withholding is made from their accrued wages, therefore the tax obligation falls on the remaining 8 %. This is in agreement with the entire national economy, where only around 9.6% of the total employees of the formal sector pay Income Tax. (**See Graph 5**)

Graph 5
Income Tax Salary Withholdings;
According to economic sector; 2009



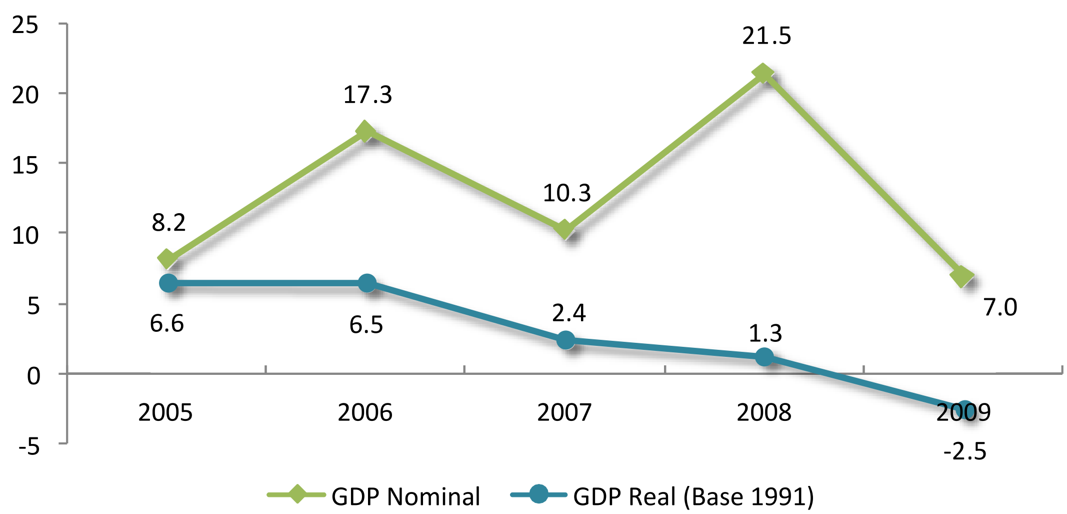
Source: DGII

6 *Article 327 of the Tax Code, exempts from the payment of Income Tax salaries and income lower than a amount that is published by the DGII and updated annually for inflation. For 2010 income lower than RD$29,110.5 monthly, or RD$349,326 annually, are exempted.*

1. INDUSTRIES SECTOR: ACTIVITY DESCRIPTION

The industry sector has averaged 2.9% annual real growth in the period 2005-2009 showing positive growth every year, except for 2009 which presents a negative real growth of 2.5%. This decline follows the pace of the economic slowdown attributed in part to the global financial crisis. (**See Graph 6**)

Graph 6
Annual GDP Growth of Industries Sector
2005-2009, in percentages



Source: Central Bank of the Dominican Republic

The industries sector, according to the National Accounts System of the Dominican Republic is composed of four branches of productive activities, the ***Explotation of mines and quarries, local manufacturing, manufacturing of free zones and construction***. As regards the payment of taxes, the activity of manufacturing free zones is not relevant since the Dominican law exempts them from the payment income taxes and consumption taxes; they only pay deductions to employees, but 95% of wages lie below tax exemption.

The industry that most contributes is Local Manufacturing, which takes into consideration industrial work done in factories, workshops, and small family businesses. See annex for the detail on these activities.

In 2009 this activity sector accounted for 70% of GDP in the industry sector and total income declared by the companies in the industry sector. The second branch in importance is Construction, 18% in the GDP and 14% declared income, followed by Free Zones and the exploitation of mines and quarries. (**See Table 1**)

Table 1
Composition of the Industries Sector in Sales and Nominal GDP
According to activity; year 2009

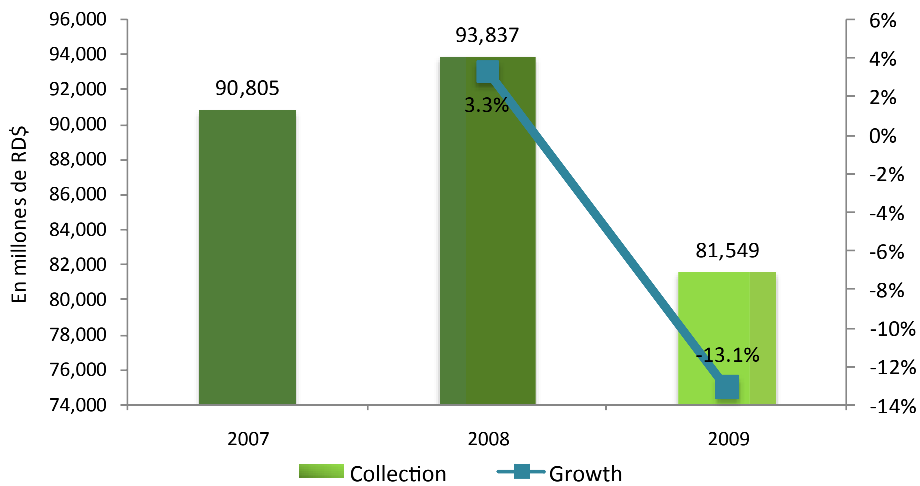
Sub-activities	Sales Participation Industries Sector	GDP Participation
Construction	14%	18%
Mines and Quarries Exploitation	1%	1%
Manufacturing	70%	70%
Elaboration of Milling Products	2%	1%
Elaboration of Sugar	3%	1%
Elaboration of Beverages and Tobacco Products	11%	6%
Manufacturing of Oil Refinery Products	12%	1%
Remaining Manufacturing Industries	42%	62%
Free Zone Manufacturing	15%	11%
Total	100%	100%

Source: DGII, BCRD

2. COLLECTION ANALYSIS: TOTAL AND TAX OPERATIONS, INCENTIVES LAWS AND TAXES PAID

To assess tax collection reported from companies in the industry sector, this presented a 3.3% growth in 2008, declining by 13.1% in 2009. This reduction goes hand in hand with the slowdown experienced by the Dominican economy during said year, fiscal measures taken to deal with the crisis as Act No. 182-09 modifies the payment of withholdings to the State and its dependencies from 5% to 0.5% and the increase of tax exemption of enterprises benefiting from the Pro-industry regime.

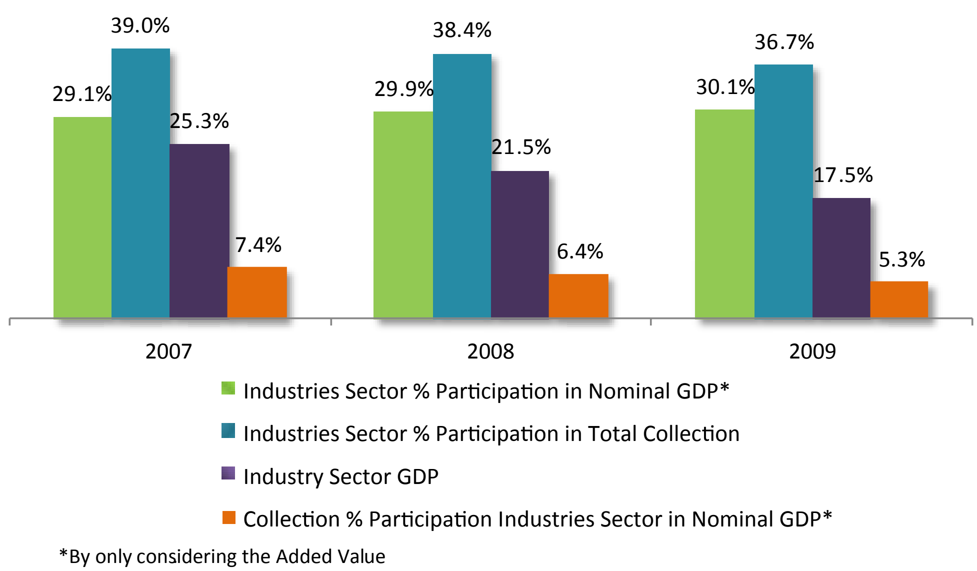
Graph 7
Industries Sector: Tax Collection
2007 – 2009



Note: Include collection by DGII, DGA and TN of the Industries sector.
Source: Department of Economic and Tax Studies, DGII

The participation of the industry sector in tax revenues is related to participation in the economy, measured by GDP. In 2009, its contribution to revenue was 36.7% and averaged 38% in the 2007-2009 periods. (**See Graph 8**)

Graph 8
Industries % Participation in the Nominal GDP and Total Collection
2007-2009, in percentages



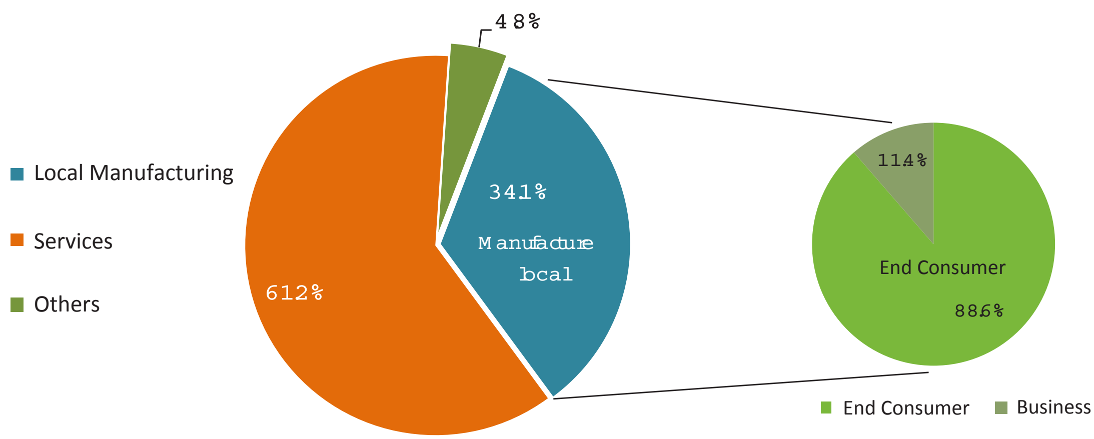
Source: Central Bank of the Dominican Republic and DGII.

However, to make an objective tax analysis it is necessary to differentiate taxes that are actually paid by the companies of taxes that are retained by these but are actually paid by end consumers and/or employees.

In the case of taxes levied on the consumption of goods and services[7], the so-called indirect taxes, the burden falls directly on consumers. Same happens with the taxes on wages that are paid by employees working in enterprises, and the dividends distributed to shareholders, among others, whose burden does not fall on the company. On the other hand, there are taxes on the income earned by companies and the payment of taxes on assets that directly affect the business.

As shown in **Graph 9**, taxes reported by companies belonging to the local manufacturing[8] sub-activity accounted for the 34.1% of the total tax revenue. However, only 11% was effectively paid by enterprises, while the remaining 89% was retained by the companies but actually paid by end consumers and/or salaried employees.

Graph 9
2008 Collection Participation by Economic Activity
In percentages



Note: The "Others" category includes Agriculture and Livestock, Industrial Free Zones, Construction and Mine and Quarries Exploitation.

It is important to highlight that 6 companies dominate around 70% of the collection reported by Local Manufacturing. Said companies belong to the Manufacturing of Oil Refinery Products (40%), Elaboration of Beverages (23%) and the Elaboration of Tobacco Products (6%) sub-activities. (**See Table 2**)

7 *The ITBIS, Selected Spirits and Tobacco are included, Selected Hydrocarbon, Telecommunications, Insurance Consumption Taxes, on the use of goods and licenses, among others are included.*

8 *Local manufacturing is the largest activity in the industry sector, measured through tax revenue reported during 2008.*

Table 2
2008 Distribution of Tax Revenue according to Economic Activity (In percentage)

Economic Activity	Total (1)+(2)	Paid by: Business (1)	Paid by: Salaried Staff and/or end consumer (2)
Agriculture and Livestock	**0.4%**	**0.1%**	**0.3%**
Industries	**38.4%**	**6.1%**	**32.4%**
Construction	**2.1%**	**0.6%**	**1.5%**
Exploitation of Mines and Quarries	**2.1%**	**1.6%**	**0.5%**
Free Zone	**0.2%**	**0.0%**	**0.2%**
Local Manufacturing	**34.1%**	**3.9%**	**30.2%**
Conservation, Production and Meat Processing	0.3%	0.1%	0.2%
Edition, Recording, Printing	0.6%	0.2%	0.4%
Elaboration of Vegetable and Animal Oils and Fats	0.2%	0.0%	0.1%
Elaboration of Sugar	0.2%	0.0%	0.1%
Elaboration of Beverages	7.7%	0.6%	7.1%
Elaboration of Cacao, Chocolate and confectionery	0.0%	0.0%	0.0%
Elaboration of Plastic	0.6%	0.1%	0.6%
Elaboration of Milling Products	0.1%	0.0%	0.0%
Elaboration of Bakery Products	0.1%	0.0%	0.0%
Elaboration of Tobacco Products	2.1%	0.3%	1.8%
Elaboration of Diary Products	0.2%	0.1%	0.2%
Manufacturing of Cement, Lime and gypsum	1.2%	0.3%	0.8%
Manufacturing of Soap andDetergents	1.5%	0.2%	1.3%
Manufacturing of Furniture and Mattreses	0.2%	0.0%	0.2%
Manufacturing of Ceramic Products	0.1%	0.0%	0.1%
Manufacturing of Oil Refiner Products	13.5%	0.8%	12.6%
Manufacturing of Wood, Paper and Carton Products	0.3%	0.0%	0.2%
Manufacturing of Glass Products	0.1%	0.0%	0.1%
Manufacturing of Pharmaceutical Products	0.4%	0.1%	0.2%
Manufacturing of Textile Products and Apparel	0.2%	0.0%	0.2%
Manufacturing of Chemicals	0.5%	0.2%	0.4%
Iron and Steel Basic Industries	1.8%	0.2%	1.6%
Other Manufacturing Industries	2.2%	0.5%	1.7%
Servicies	**61.2%**	**15.9%**	**45.2%**
Public Administration	**4.0%**	**1.2%**	**2.8%**
Home Rentals	**1.6%**	**0.8%**	**0.8%**
Commerce	**23.7%**	**3.5%**	**20.3%**
Communications	**7.2%**	**2.6%**	**4.7%**
Electricity, Gas and Water	**1.5%**	**0.7%**	**0.7%**
Hotels, Bars and Restaurants	**3.3%**	**0.9%**	**2.4%**
Financial Intermediation, Insurance and Others	**11.2%**	**3.8%**	**7.4%**
Services Free Zone	**0.1%**	**0.0%**	**0.1%**
Teaching Services	**0.2%**	**0.0%**	**0.1%**
Health Services	**0.4%**	**0.2%**	**0.2%**
Transportation and Storage	**3.8%**	**0.6%**	**3.3%**
Otros Servicios	**4.3%**	**1.8%**	**2.5%**
Total	**100.0%**	**22.1%**	**77.9%**

Note: Does not include Third party funds, surcharges or compensation interest.
Data prepared by the Economic Studies Department of the DGII based on information from DGII, DGA and TN

On the other hand, the sales reported for the industry sector has shown positive growth during the 2005-2009 terms, with the exception of the year 2009 where it grew 10%. The subsector that represents the largest amount of sales in Manufacturing, is the Manufacturing of oil refining products, however, none of its operations are levied by the ITBIS, although they are levied with luxury tax. Companies with the Elaboration of Beverages subsector hold the second place because of its sales, and approximately 85% of these are levied by ITBIS. In the Other Manufacturing Industries, the activity with the largest amount of sales was the Elaboration of Other Foods Products; here, around 60% of sales are taxed, and at the same time holds third place in the sales of the Manufacturing subsector. (**See Table 3**)

Table 3
Main Activities of the Manufacturing Subsector
Taxed and ITBIS Exempted; 2009 in total sales percentage

Activity	Total Sales	Proportion of Taxed Sales	Proportion of Exempted Sales
Manufacturing of Oil Refinery Products	63,063	0.0%	100.0%
Manufacturing of Beverages	52,516	84.3%	15.7%
Elaboration of other Food Products N.C.P.*	20,955	57.3%	42.7%
Basic Steel and Iron Industries1	9,104	67.5%	32.5%
Manufacturing of Cement, Lime and Gypsum1	6,266	75.3%	24.7%
Manufacturing of Chemicals	15,666	45.1%	54.9%
Elaboration of Sugar	15,211	2.3%	97.7%
Conservation, Production and Meat Processing1	4,890	3.8%	96.2%
Manufacturing of Pharmaceutical Products	14,226	15.1%	84.9%
Others	122,839	60.3%	39.7%
Total Manufacturing	354,736	47%	53%

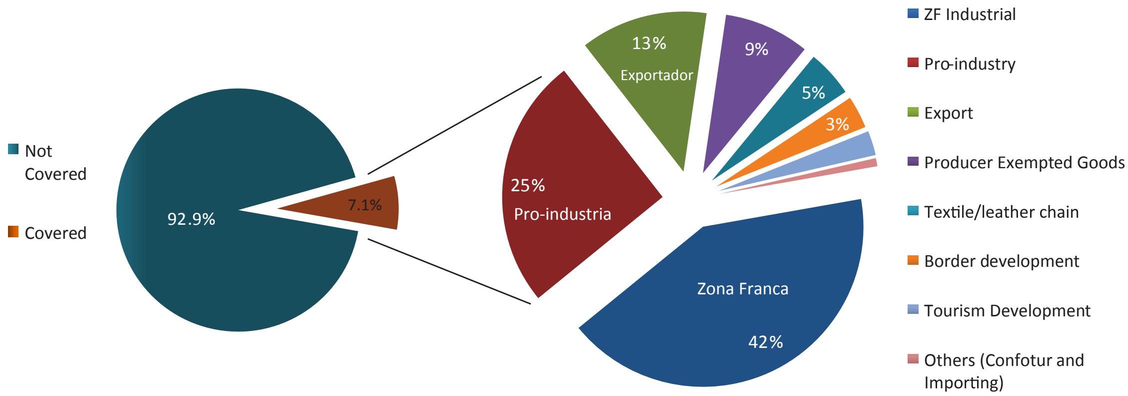
*Classified in "Other manufacturing industries".
Source: DGII

3. INCENTIVE LAWS

The Dominican Tax System has a series of laws that grants incentives to various sectors in order to encourage domestic production and/or promote the development of economic activities or areas of the country. In this regard, some enterprises of the industries sector have the possibility of benefiting from any of these laws under special regimes. These regimes are: Pro-Industry, exporters, Confotur, frontier development, tourism, industrial free zones, textile and/or leather chain, importers and producers of exempted goods sector development.

Of the total number of companies registered in the industry sector in 2009 that were economically active before the DGII only 7.1% were covered by incentive laws[9]. The regimes that register the greatest number of taxpayers are industrial free zones with 42%, Pro-industry with 25%, and exporters with 13%. Producers of exempted goods 9% and 11% are registered in 5 other regimes. (See Graph 10)

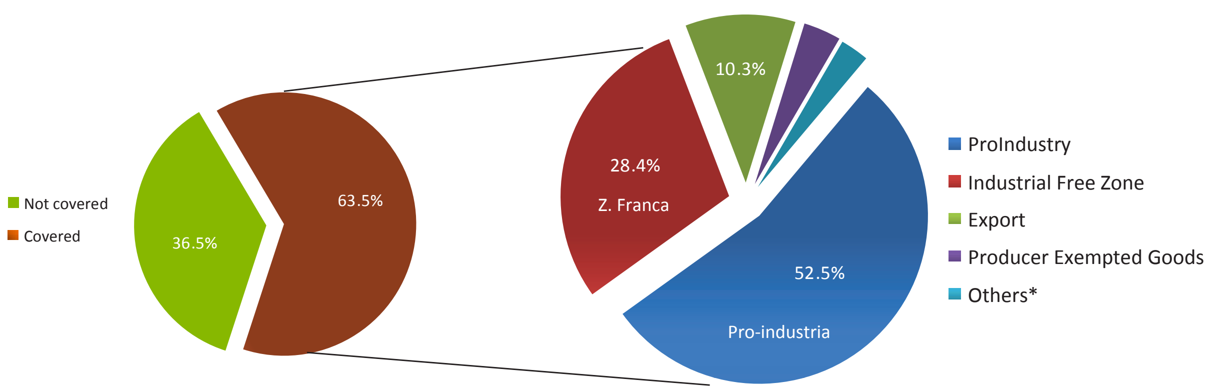
Graph 10
Amount of Companies of the Industries Section under and not under special regimes
According to the type of regime; 2009; in percentages



Source: Department of Economic and Tax Studies, DGII

However, these few businesses accounted for 64% of declared gross revenue from the industry sector. Of this total 53% belongs to Pro-industry, 28% to industrial free zones, 10% are exporting, among others. (See Graph 11)

Graph 11
Industries Sector
Proportion of gross revenue declared from companies covered and not covered under special regimes
According to the type of regime; 2009; in percentages



* Other includes Border Development, Tourism Development, Textile/Leather Chain, Confotur and Imports.
Source: Department of Economic and Tax Studies, DGII

9 *Economically active companies are those that made any type of payment or tax return before the DGII during the determinate term.*

On the other hand, in what refers to fiscal sacrifice resulting from the application of these regimes, as it is set in the 2011 Income Budget and the Public Expenditure Law[10] of the estimated total, the companies of the Free Zones are the most benefited, meaning a sacrifice in the amount of RD$ 4,221.3 million, representing 0.2% of GDP. Meanwhile, the estimate for undertakings benefiting from Pro-industry is 0.08% of GDP, and 0.03% of GDP to companies belonging to border development. Total tax expenditure estimated for that year was 5.2% of GDP, this includes other variables which do not affect the industry sector. (See Table 4)

Table 4
Fiscal Sacrifice per Regime
Estimated 2011

Regime	%PIB
ITBIS	3.22%
Others 1	.50%
Free Zone	0.20%
Proindustry	0.08%
Tourism	0.06%
Boder Development 0	.03%
Textile and/or Leather Chain 0	.00%
Total	**5.17%**

Source: Revenue Budget and Public Expenditure Law, 2011

4. CONCLUSIONS

When assessing the composition of the Dominican economy the importance gained by the services sector is clear, becoming largest generator of wealth for the country for several years. Furthermore, the industry sector occupies the second position in terms of production and tax collected, being local manufacture of greater importance in this line.

Of the total number of companies registered in the industries sector, only 7.1% are covered by incentive laws. However, these few businesses accounted for 64% of declared gross revenue from the industry sector. Of this total 53% belongs to Pro-industry, 28% to industrial free zones, 10% are exporting, among others.

With regard to the composition of tax revenue, this sector reported 38.4% of the revenues collected in 2008. However, it is important to differentiate taxes actually paid by the companies, from taxes that are retained by these but really fall on end consumers or employees, as seen, this represents the bulk of the collection.

10 *The 2011 tax expenditure is estimated based on the revenue for the 2009 period, declared during 2010.*

ANNEX
Details of Sub-activities that form Manufacturing

Subactivity	Participation in total manufacturing, according to revenue
Free Zone	15.5%
Construction	14.1%
Manufacturing Oil Refinery Products	12.1%
Elaboration of Beverages	10.1%
Other Manufacturing Industries	9.9%
Basic Iron and Steel Industries	3.7%
Manufacturing of Cement, Lime and Gypsum	3.1%
Manufacturing of Chemicals	3.0%
Elaboration of Sugar	2.9%
Conservation, Production and Meat Processing	2.9%
Manufacturing of Pharmaceutical Productos	2.8%
Elaboration of Plastic	2.6%
Manufacturing of Soaps and Detergents	2.5%
Elaboration of Vegetal and Animal Origin Fats and Oils	2.5%
Edition, Recording, Printing	2.1%
Elaboration of Milling Products	1.8%
Elaboration of Dairy Products	1.7%
Manufacturing Wood, Paper and Carton Products	1.3%
Exploitation of Mines and Quarries	1.3%
Elaboration of Tobacco Products	1.2%
Manufacturing of Furniture and Mattresses	0.8%
Manufacturing Textile Products and Apparel	0.7%
Elaboration of Bakery Products	0.6%
Manufacturing of Ceramic Products	0.3%
Manufacturing of Glass Products	0.1%
Total	**100.0%**

Note: This Table was made by taking total declared revenue and/or operations reported during the 2009 period.

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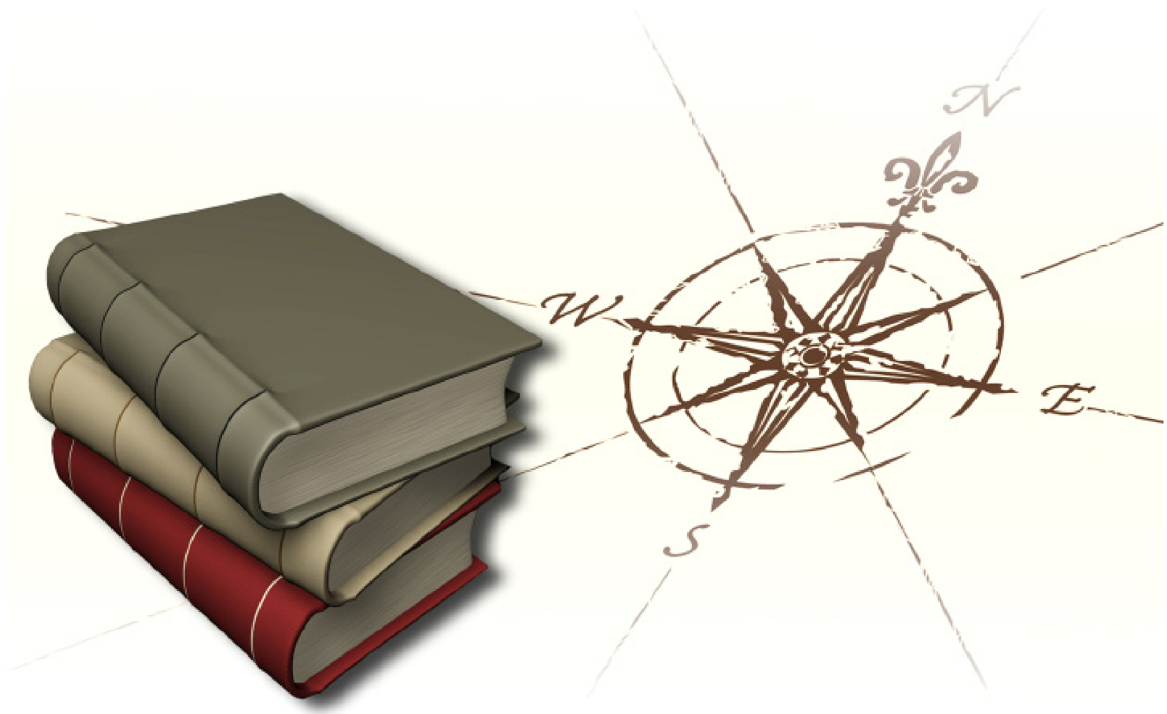
Constitutional Guidelines of the Brazilian Tax System

Denise Lucena Cavalcante



SUMMARY

The constitutional guidelines of the Brazilian tax system highlight the fundamental rights of the citizen-taxpayer in the Constitution. In Brazil constitutional guidelines are very important in the fight to control state excesses by limiting taxpaying powers and insistently repeating the set of fundamental rights and guarantees of the citizen-taxpayer. Today one of the great challenges of Brazil is to economically develop a federated system and actually have fiscal justice regarding so many inequalities.

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INTRODUCTION

Contents:

The article highlights the Brazilian Tax System as the constitutional guidelines emphasizing the need of this system to adapt to new paradigms of the Law in the 21st Century. In Brazil, the Constitutional Tax System made great progress with the provision expressed in the "limitations to the taxpaying power", strengthening the citizen-taxpayer rights at constitutional level. In this "principle logic" era reaffirmation of the principles expressed in the constitutional text focusing on the materialization of these specific rules, or in simple and far-reaching[1] steps must be sought.

1. BRAZILIAN FISCAL FEDERALISM

Brazil is characterized by its federative form of State, consisting of the indissoluble alliance of the Federal Union, 26 State-members; 5,564 Municipalities and the Federal District, integrating all the Federal Republic of Brazil[2] .

Entities of the Federation are equipped with autonomy, which allows sovereignty to the Federal Republic of Brazil to act internationally.

When the autonomy of federated entities was established, it meant that they do not have a hierarchical relationship between themselves[3] , being able to have their own administration and management, however, economic dependence on States and poorer municipalities seriously compromise such autonomy, since there should be no talk about autonomy without the adequate financial capacity.

1 *Please be advised that all quotes from Brazilian and Portuguese authors are a free translation of the author.*

2 *As provided for in the Federal Constitution: "Art. 1º. The Federal Republic of Brazil, formed by the undivided union of the States and Municipalities of the Federal District, becoming a Democratic State un the Rule of the Law and its main principles are:*
I – Sovereignty:
II - Citizenship;
III – The dignity of the human being;
IV – Social values of work and prívate initiative;
V – Political pluralism.

3 *In this regard, Roque Carrazza states: "Individuals working a hierarchical relation between the central government and the local governments work in contradiction. What there truly is among these political entities, are autonomous and exclusive fields of action, outlined strictly in the Magna Charta, that no Law One of the great challenges of the Brazil is exactly to economically develop a federated, system before so many existing inequalities and a geographical dimension accentuated by such differences."* ***(Curso de direito constitucional tributário. São Paulo: Malheiros, 1996, p. 96).***

Brazil versus the large regional differences, financial autonomy is still fragile, having huge inequalities between federated entities and the nation.

One of the great challenges of Brazil is to economically develop a federated[4] system, amidst so many existing inequalities and a geographical dimension accentuated by such differences.

The Brazilian Federal fiscal system requires having the conditions for the States and municipalities to have not only political autonomy, but also, mostly, financial autonomy, reaching independence as provided by for Paulo Bonavides[5] :

> In the Federal State, a number of States that are associated with a view to a harmonious integration of their destinations, have no external sovereignty and from the point of view of internal sovereignty are partly subject to a single power, the federal power, which partly preserves its independence. Moving freely in the area of competition constitutional that was noted for self-organization effects. Since they have this capacity for self-organization, which means the power to found their own constitutional order, the State-members acting outside of any submission to a higher power and being able in the table of Federative relations demand from the Federal State compliance with certain obligations, and become political organizations that have undeniable State nature.

In the Brazilian context there is a large economic submission of the States and Municipalities to the Federal Union, since the Union not only holds the greatest part of the tax collection, but also, conditions funds to review and this is compulsory for States and municipalities, which are submitted to new rules causing a visible aggression to the Federative principle.

The provision of the original Constitution's drafters determined in article 160 of the Brazilian Constitution the ban of constitutional review vetoes, which later through Constitutional Amendment, then such veto was restricted, allowing withholding and blocking in the case of debts of State bodies in the following terms:

> **Article 160.** The withholding or any restriction on delivery and the use of the attributed resources, in this section, the States, the Federal District and the municipalities in the same, additional and relative tax increases.
> Single paragraph. The veto laid down in this article does not prevent the Union and the States to condition the delivery of their resources:
> I. to the payment of their credits, including their autarchies;
> II - to comply pursuant to Article 198, § 2, II and III[6]. (Single paragraph and letter paragraphs added by Constitutional Amendment No. 29, 13 September 2000).

This constitutional device is still today point of criticism, as it enables the withholding of resources belonging to federated entities, and has no restrictions in the case of debts. The fact of having debts by itself cannot justify withholding and blocks, mainly in the Brazilian context where almost all municipalities are Social Security debtors.

Besides economic discrepancies between Brazilian federated entities, there are still economic differences in the population. Therefore, the difficulties in managing the fifth

4 *Federalism is a clause stipulated in art. 60, § 4°, letter paragraph I, of the Federal Constitution: "The amendment proposal leading*
5 *BONAVIDES, Paulo. Ciência Política. 7. ed. Rio de Janeiro: Forense, 1988, p. 207-208.*
6 *This article is about the application of the mandatory percentages for health.*

largest country in the world with 15,700 km of land borders, with a population of over 195 million are quite evident.

Just to give you an idea of the economic distortion which prevails in Brazil, of its vast population, we can say that about 25 million Brazilians are income tax taxpayers, i.e. just over 10% of the population this characterizes the poor distribution of income per capita in the country[7].

Difficulties are many in this country of continental proportions, reason why the originating the Constitution's drafters in 1988 determined as one of the fundamental principles provided for in the Federal Republic of Brazil is the quest to reduce social and regional inequalities, as provided for in the Federal Constitution:

> Article 3. The following are key objectives of the Federal Republic of Brazil:
> I - Build a free, fair and mutually supportive society;
> II - Ensure national development;
> III - Eradicate poverty and marginalization and reduce social and regional inequalities
> IV - Promote the welfare of everybody, without prejudice of origin, race, sex, color, age, and any other forms of discrimination.

This constitutional provision is important, since it exerts greater legislative pressure on public policies recognizing the establishment of behaviors that are geared towards minimizing socio-economic problems which cause regional inequalities.

Therefore, regarding so many discrepancies between the formal text and social reality, the Constitution exerts an important role in the constant struggle to control excesses originating from poor understanding of the State sovereignty, by limiting the power to pay and insistently repeating the list of the fundamental rights and guarantees of citizen-taxpayer.

Hence the relevance of the so-called **Constitutional Tax Law** and not **Tax Constitutional Law**, as well highlighted by José Osvaldo Casás[8] the constitution always has to be the base of all and any study of the rules of taxation.

In this regard Rodolfo Spisso[9] states that all juridical analysis must as from the constitutional perspective:

> "Therefore the tax institution as well as other legal institutions that make up our system cannot be sufficiently understood and explained if it is not from the point of view of the constitutional perspective. The constitutional program illuminates and conditions so the concrete legal institutions, to meet justice criteria should not be only in the service of their specific purposes and objectives, but also to serve the purposes and constitutional objectives. Hence, the

7 *Brazil is a country that has the weight of being the most unfair country of the world, having the worst income distribution. Injustice is not a consequence of poverty [sic] – Brazil is the 11th economy of the world, in terms of gross production - , but a terrible distribution. Injustice is not a consequence of the contrast between the rich and the poorest of the poor, between the wealth pole – similar to countries of the developed world – and the poverty pole, similar to the poorest countries of the world" (SADER, Emir. Perspectives. Colecció Os porquês da desordem mundial. Rio de Janeiro: Record, 2005, p. 129).*

8 *"The environment of our legal sector, pursuant to the best traditions of the Latin taxation doctrine – American and European – it finds it most correct characterization when called "Tax Constitutional Law", and not as "Constitution Tax Law". (...) In the vast spectrum formed by "Constitutional Tax Law" two sections clearly standout; one developed as from the dogmatic part of the constitutions of States under the Rule of Law or "Constitutional Law of Freedom," which comprises a system of citizen rights and guarantees acting as a limit and the exercise of the State's regulatory-taxation power (...)."(CASÁS, José Osvaldo. **Derechos y garantías constitucionales del contribuyente.** Buenos Aires: Ad Hoc, 2002, p. 119).*

9 *SPISSO, Rodolfo R. **Derecho Constitucional Tributario**. 2. ed. Buenos Aires: Depalma, 2000, p. 3.*

need for the analysis of the constitutional plan or program to build in the future one of the basic points in the doctrinal elaboration of scholars of any legal science. From that perspective, the Constitution before us as an exclusively non-regulatory instrument of the cardinal principles of the organization and functioning of the Government, but essentially, of the restriction of power in the protection and guarantee of individual liberty."

Regarding this peculiarity, we share the thought of Humberto Ávila when he affirms that Brazilian Tax Law is essentially Constitutional Tax Law[10].

2. BRAZIL's TAX SYSTEM IN THE CONSTITUTION OF 1988

Brazil stands out for having in its constitutional text an extended chapter on the National Tax System[11].

It may be affirmed that the Brazilian Constitution, due to its extension and details has a regulatory orientation, adopting here the term used by Domingo García Belaunde[12]:

> And the point is the following, or a principled (or analytical) Constitution is drafted or a comprehensive Constitution (or rules based) is preferred. The idea that causes the first is that the Constitution, without being a long text, must be sober in its exposure, containing only the most general principles in what refers to the fundamental rights and the means to protect them, as well as the precise mechanisms for the behavior and control between the powers. Other aspects shall be treated in laws or constitutional statutes (as stated by Alberto Borea O., in this same paper) and which amendment must have a special procedure. Otherwise it falls in all our republican tradition, of very tight and detailed texts which age over time. It must be emphasized that this fundamental idea that a Constitution can be a memory of grievances or a political catechism."

The Brazilian Tax System in the 1988 Constitution is excessively detailed and often runs the risk of containing elements that are materially spurious, as stated by Portuguese Constitutionalist Paulo Ferreira Cunha[13].

This is the manner in which it is discussed in Chapter I, of Title VI, of the Brazilian Constitution: Taxation and Budget, with its 19

10 *ÁVILA, Humberto.* ***Sistema constitucional tributário****. São Paulo: Saraiva, 2004, p. 110.*

11 *"The national tax system is the set of positive principles and standards, which ápex is the Federal Constitution, ruling the tax rights and duties of the taxpayers as well as Public Power. The duty of paying taxes is fundamental regarding the rights stipulated in the CF (health, education, housing, freedom), because collection is the logic background of the exemption, effective public means of fundamental rights." (WEISS, Fernando Lemme.* ***Princípios tributários e financeiros****. Lumen Juris: Rio de Janeiro, 2006, p. 140).*

12 ***Constitución y Política.*** *3. ed. N. 2. Lima: Biblioteca Peruana de Derecho Constitucional, 2007, p. 107.*

13 *"The 1988 [Brazilian] Constitution is one of the most progressive constitutions of the world, in spite of the fact that its detailed nature makes it contain materially spurious elements. However, it is a framework in the constitutional construction and specially concerned about citizens, this is why it is called the "The Constitution of the Citizens." (CUNHA, Paulo Ferreira.* ***Direito constitucional geral.*** *Guid Juris: Lisboa, 2006, p. 225).*

(nineteen) articles and over 100 (one hundred) letter paragraphs and lines stipulating on the National Tax System.

Many constitutional devices could be justified if we consider that the Brazilian Constitution was enacted in 1988, i.e. over twenty years after the National Tax Code – CTN -, which was enacted by law No. 5.172, 25 October 1966. Being the CTN earlier than 1988 Constitution it appointed it as a complementary law, pursuant to article 146 of the Constitution that determines that only Complementary Laws[14] may confer General Tax Law Standards.

The National Tax System is divided into six sections in the Federal Constitution of Brazil as follows:

Article 145 to Article 162:

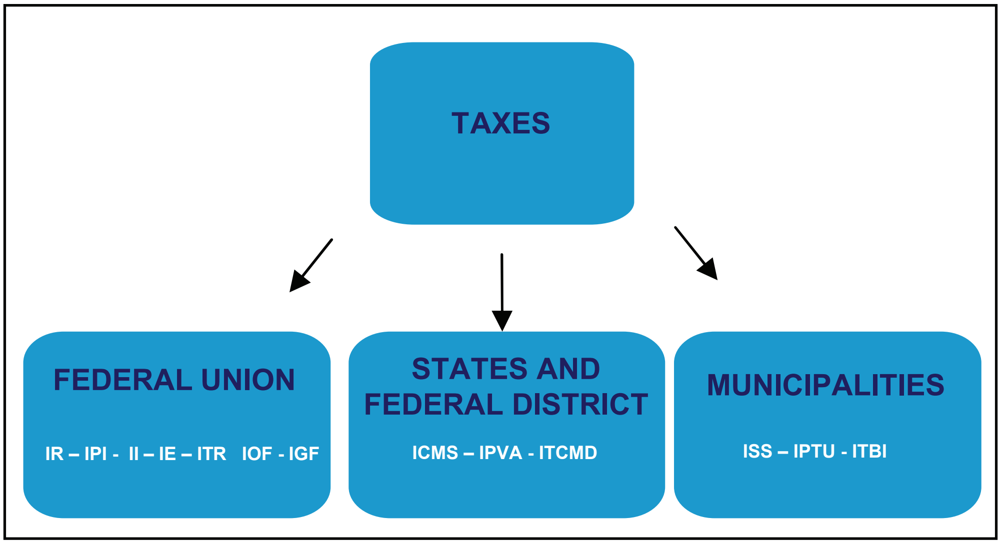
- Of General Principles;
- Of Limitations of the Taxpaying Power;
- Of the Taxes of the Union;
- Of State Taxes and the Taxes of Federal District;
- Of Municipal Taxes;
- Of the Distribution of National Treasuries.

In relation to the distribution of the tax, the Constitution's drafters established which taxes each entity of the Federation may establish, this is why in Brazil they say "the constitutional discrimination against competence" is rigid, not allowing other State bodies to establish new taxes[15], excepting only the "residual jurisdiction" of the Federal Union.

14 *In the Brazil laws can be complementary or ordinary. The general rule is ordinary law, the law complements the exception, therefore, when necessary, depending on the subject, the constituent expressly determines. José Afonso da Silva clearly states: "Regarding the latter [Supplementary law] it seems to say that they only differ from the procedure for the drafting of ordinary laws in the requirement of a majority vote of the Houses, for approval (article 69), thus formed by ordinary procedure with special quorum"." (Curso de direito constitucional positivo. 32. ed. São Paulo: Malheiros, 2009, p. 531).*

15 *"The abovementioned exclusive powers involve, on the one hand, the statement of the tax power its holder, and on the other, involves a denial of this same power. In fact, based on its sovereignty, the State can do it. Meanwhile, the Constitution limits this special power since what it shares among the partial government orders that form the Federation. Such is the fact through the assignment of determinate economic fields for each one. Therefore, the competent legislator has the possibility of establishing the tax within the limits of its field. If, meanwhile, beyond any form or of capturing manifestations of diverse richness attributed thereto, there will be constitutionality by invasion of competition. Therefore, the importance of researching if the facts stated and selected by the tax law are within the field reserved to the competition of the taxpayer entity or even if the tax assessment criteria does not denaturalize it [sic]." (SOUZA, Hamilton Dias de. A competência tributária e seu exercício: a racionalidade como limitação ao poder de tributar. In Princípios e limites da tributação. Coord. Roberto Ferraz. São Paulo: Quartier Latin, 2005, p. 260).*

The following graph summarizes the current taxes in Brazil[16]:



It must be clarified that in Brazil taxes represents the genre, whose species are: taxes, rates, improvements contributions, coercive loans and social security payments.

Social security payments in the Brazilian tax law deserves to be highlighted, being still today of great relevance in tax collection, representing a high percentage of the total revenue, which alters their previously extra-fiscal nature for predominantly tax if a distinction can still be made.

16 *In order to clarify the acronyms used, the text of the Federal Constitution is transcribed as follows:*
Of the Taxes of the Union
Art. 153. *The Union must impose taxes on:*
I – the import of foreign products (II);
II – the export of national or nationalized products (IE);
III – income and salaries of any nature (IR);
IV – industralized products (IPI);
V – credit, Exchange and insurance operations, or pertaining to securities or unregistered securities (IOF);
VI – rural territorial property (ITR);
VII – huge fortunes, as provided for in the suplementary law (IOF).
Total expenditure collected in the above;
Of the taxes of the States and the Federal District
Art. 155. *The States and the Federal District shall establish taxes on:*
I – transmission causa mortis and donation, of any asset or right (ITCMD);
II – operations relating to the circulation of goods and on the provision of inter-state and inter-municipal transportation services and communication services, even when operations and benefits originate offshore (ICMS);
III – property of motor vehicles (IPVA).
Of the taxes of the Municipalities
Art. 156. *The municipalities must establish the tax on:*
I – property and urban territorial tax (IPTU);
II – transmission inter vivos, at any title, for a good and valuable consideration, of real estate, by nature or physical action or real rights on real estate, excepting guarantees, as well as the assignment of preemptive rights (ITBI);
III- services of any nature not covered by Article 155, II, defined by the supplementary law (ISS).

3. OF THE CONSTITUTIONAL TAX PRINCIPLES

The principles laid down in the Brazilian Constitution reflect historical-political changes in the Brazilian law, when establishing definitively in 1988 democracy in the Brazil. Despite many policy forecasts, although they still not have enjoyed full effectiveness, already represent a big step forward in the rules laid down in the chapter relating to the National Tax System. The Brazilian lawyer must effectively make these rules to be in agreement with reality, as Paulo Bonavides[17] teaches:

> In the entire minimal effectiveness over reality is established - the minimum which the jurist should possibly turn into a maximum - clearly that the constitutional problem takes nowadays new dimension by postulating the need to place in global terms, in the realm of society. That society, invaded of state interferences, does not dispense, therefore, the recognition of forces acting powerfully in the same, capable of quickly and frequently changes, the meaning of constitutional standards, which are malleable and adaptable insofar in a satisfactory manner, to the fundamental and pressing demands of the social environment.

The Constitution's drafters by establishing so many guidelines stipulate the commitment of the transformation of Brazilian society through a new Constitutional[18] order, in counterpoint to the socioeconomic "disorder" still prevailing in the country[19].

Hence, at the beginning, a first reading you have the feeling that many standards are redundant or obvious, while what the Constitution's drafters intended was essentially to protect the fundamental rights of the citizen-taxpayer by limiting the powers of the State to strictly legal links.

Constitutional limitations to the taxpaying power are treated as General Principles (Section I) from Article 145 to Article 149-A, of the Federal Constitution.

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17 *BONAVIDES, Paulo. Curso de Direito Constitucional. 11. ed. São Paulo: Malheiros, 2001, p. 79.*

18 *Ives Gandra da Silva Martins rightly states: "The 20 years of the 7th Brazilian Constitution show that the legal regime established by the same resulted in an institutional stability never achieved by the previous constitutions. (...) In other words: the democratic system operated perfectly, so I believe this was due to the fact that the 1988 Constitution formed a balance of powers, unknown for example, by our neighbors (Venezuela, Ecuador, Bolivia), whose constitutions, newer than ours, were not able to establish. In effect, in these countries, the constitutions barely give precedence to the Executive Power – they are almost dictatorships - turning the other two (2) powers (legislative and judicial) subject and subordinate to the Executive. This may have been the great merit of Supreme Law of 1988, which, notwithstanding the 62 amendments (56 in ordinary proceedings and six (6) in the so-called process review which is called "revisional") and 1,600 draft amendments in the works, in Congress, maintains democratic stability thanks to the stability of the institutions. With these specificities, the effectiveness of the Constitution is unequivocal. In the tax field, there are still indisputable impasses, which have led to successive amendments." (Efetividade da Constituição em matéria tributária. In* ***Revista Brasileira de Direito Tributário e finanças públicas****. São Paulo: Magister e CEU. Vol. 12, jan./feb., 2009, p. 23).*

19 *On this subject, read: SADER, Emir.* ***Perspectives****. Colection Os porquês da desordem mundial. Rio de Janeiro: Record, 2005.*

These principles[20] represent on the one hand, the fundamental guarantees of the citizen-taxpayer and on the other, a stop to fiscal power.

The Brazilian Tax System recognizes the following general tax law principles in the Constitution[21]:

1) Tax capacity (Art. 145, § 1º)
2) Legality (Art. 150, I)
3) Equality before the law (Art. 150, II)
4) Non-retroactivity (Art. 150, III, a)
5) Precedence (Art. 150, III, b)
6) No seizures (Art. 150, IV)
7) Freedom of movement (Art. 150, V)

In addition to the principles specified, the Constitution's drafters also established in the Brazilian Constitution immunity concerning taxes, this immunity also represents a constitutional limitation on the taxpaying Power.

Tax immunity means the impossibility of the Union, of the States and the Municipalities of establishing taxes on property, income or services in the cases provided for in the Constitution. This is the case of a constitution guarantee, in the following terms[22]:

"Constitutional impact represents a guarantee for citizens when duly provided. There being a limitation standard which determines that people, goods and services should not be taxed, such norm will be generating laws [sic], which is the guarantee for the non-collection of taxes.

"Contrary to the incidence of the norm, once it happens rights are born for the Treasury, precisely the right to establish a credit, the rule that prevents the incidence or the advanced vetoed thereof, any interference in certain cases, also creates rights for the citizen only and not for the Treasury."

As mentioned, immunity is restricted solely to taxes, and these are one of the tax species.

In the 21st Century principles have grown and guide the Law in a more direct

20 *"As Jean Boulanger taught, principles are an essential element for the fertilization of the positive legal order. They contain, in a virtual state (à virtualité l´état), a large number of solutions required in real life. Once stated and applied by the case-law, the principles are the material thanks to which the doctrine can build legal constructions with trust. This French author concludes that: `Le constructions juridiques ont les príncipes pour armature´ - the conception of the law as a normative system fenced bu principles requires a legal order vision different from the one built in the past. To accept the fact that the legal-positive order is articulated around principles, which confer organic planning on the actual operation of the law, have as a consequence a profound alteration in the way of thinking and applying the law." (PONTES, Helenilson Cunha.* ***O princípio da proporcionalidade e o direito tributário****. São Paulo: Dialética, 2000, p. 28).*

21 *OF THE LIMITATIONS OF THE TAXATION POWER (Constitution):*
Article 150. *Without detriment of other guarantees assured to taxpayers, the Union, States, Federal District and the municipalities are barred from:*
I – requiring or increasing taxes if not provided for by law;
II - introducing unequal treatment between taxpayers who are in the same situation, any distinction is prohibited due to of professional occupation or function they exercise regardless of the legal name of performance, titles or rights;
III – collecting taxes:
a) in relation to generating events which occurred before the start of the validity of the Law that introduced or increased the same;
b) in the same financial year in which the law has been published or on which it was instituted or increased;
c) observing line "b" (Including Constitutional Amendment No. 42 of 19.12.2003) after ninety days have elapsed as of the date on which the law establishing or increasing the same has been published;
IV - using tax to make seizures;
V - setting limitations on the transit of persons or goods by means of inter-state or inter-municipal taxes, excepting the collection of tolls for the use of roads kept by the Public Power.

22 *RODRIGUES, Denise Lucena.* ***A imunidade como limitação à competência impositiva.*** *São Paulo: Malheiros, 1995, p. 21.*

manner, exceeding the phase of the strict application of the rules. This is perceived in jurisprudence-based decisions and is no longer limited to the strictly application of the rule.

The argument defended is that new paradigms prevail in this era, where the idea of justice, than the mere application of the generic law, whether good or bad must be sought more. In this context, we can affirm with certainty that the "bad-law" must be purged from the system through the constitutional force of the general principles of Law.

In the words of Paulo Ferreira da Cunha, it would be the guardianship of the specific case and not of the law in general[23]:

> "The law of the concrete. The Law in addition to the guardianship of the concrete case than a general law (Perelman, Müller). We would dare to say that the topical-problematic thought should be taken, because of judicialism and not because of regulations and, even because of legla pluralism (of course pluralism in the sources considered) and not because of legal monism – mostly in the form of legal positivism of the dura lex sed lex and, even worst in its very Portuguese version, <son ordes>, with or without the follow-through of the argumentandum baculinum... Post-modern law also gives priority to the compliance with a minimum set of laws, against the regulatory jungle, which makes frivolous or trivial the norm: and a bad norm, as a bad coin, expels the good one."

These ideas are very important for the Tax Law, since this is one of the strictest branches of the Law, because it is always related to property conflicts between the Treasury and citizen-taxpayer.

The tax law must also adapt to the new paradigms of post-modernity, minimizing its coercive and bureaucratic aspect, and often threatening, as stated by Brazil's "Receita Federal" which symbol today is the figure of the "lion" as a representative of this body. The lion symbol is completely incompatible with the current democratic State of Law, apart from damaging the image of the Treasury, which insists on the propagandist figure of the seventies, when military dictatorship still reigned in Brazil.

The major changes in the Brazilian Tax System should begin in small details (it is suggested, of course, the extinction of the inappropriate "lion" symbol), starting from bureaucratic public attention services at the treasury until the reaffirmation of the tax constitutional principles.

23 *Geografia constitucional – sistemas juspolíticos e globalização. Lisboa: Quid Juris, 2009, p. 314.*

4. TAX REFORM IN BRAZIL

A comprehensive tax reform is currently being discussed in Brazil, which is in process in the National Congress through Proposed Constitutional Amendment n. 233 - PEC n. 233/2008. However, in spite of the significant alterations planned, more than 60 (sixty) alterations in constitutional devices are already in place in the National Tax System through 10 (ten) constitutional amendments implemented after the enactment of the Constitution in 1988, which are:

1. EC n. 3, of 17/03/1993
2. EC n. 20, of 15/12/1998
3. EC n. 29, of 13/09/2000
4. EC n. 33, of 11/12/2001
5. EC n. 37, of 12/06/2002
6. EC n. 39, of 19/12/2002
7. EC n. 41, of 19/12/2003
8. EC n. 42, of 19/12/2003
9. EC n. 44, of 30/06/2004
10. EC n. 55, of 20/09/2007

So many alterations have basis in the Brazilian Constitution which has an explicit estimate on the need for the periodic evaluation of the National Tax System functionality, and whereas the principal guidelines for the system can be found in the constitutional text, almost all alterations only can be made through constitutional amendments. Article 52 thus provides:

> **Article 52.** Federal Senate of the State is exclusively in charge of:
>
> XV – periodically evaluate the operation of the National Tax System, in its structure and its components and the performance of the tax administrations of the Union, States and the Federal District and the Municipalities. (Text included by Constitutional Amendment Nº 42, of 19.12.2003).

So many alterations still did not attain the main goal of meeting the contemporary needs of the country, within the same, the implementation of an efficient system that makes tax justice more visible; the creation of a State structure compatible with the changes made and the specific conditions to address the mass fiscal "litigiousness" which prevails in Brazil.

Considering the amount of distortions that prevail in the Brazilian Tax System, the alterations of the PEC n. 233/2008 have as main objectives:

1. simplification of taxation, reducing and riding the legislation of bureaucratization;
2. end of the tax war;
3. correct distortions in the tax structure that harm investment and efficiency;
4. tax exemption with focus on taxes that harm growth;
5. improvement of the Regional Development Policy;
6. improvement of the quality of federal relations.

5. DISTRIBUTION OF THE TREASURY

The technique adopted in Brazil to better distribute tax collection among the entities of the Federation was the constitutional distribution of tax administrations.

Collection coming from taxes is not sufficient to ensure the necessary autonomy to States and municipalities, causing a situation of economic submission thereof in relation to the Federal Union, responsible for most of the collection and subsequent distribution to the tax administrations.

In order to consolidate these imbalances in collection, the Constitution established in Articles 157-162 the provision of constitutional transfers, which consists of set of Federal treasuries collected by the Union.

The proportional division of the tax administrations gives tax collection between federated entities should be a mechanism to reduce regional disparities, in an attempt to promote the socio-economic balance between federated entities, but ahead of political interference and the centralized economic strength of the Federal Union, it is still far from being a fair system.

Major transfers of the Union for the States, Federal District and the municipalities, provided for in the Constitution, include: the Participation Fund of the States and of the Federal District (EPF); the Participation Fund of the municipalities (FPM), the Compensation Fund for the export of industrialized products – FPEX; the Assistance and Development Fund for Fundamental Education and Valorization of the Teachers' Union - FUNDEF; and taxes on the Rural Territorial Property - ITR.

6. FINAL CONSIDERATIONS

The purpose of this study was to approach the current National Tax System pursuant to the constitutional guidelines, emphasizing due to its applicability in specific cases, and in the need this system has to adapt to the new legal paradigms of the 21st Century.

When a certain legal structure of a country presents itself, it must give an overview of institutions of that embody the Law set out in rules, making clear the reality coming from specific cases.

In el Brazil, the Constitutional Tax System made great advances with the provision stated in the "Limitations to the Taxpaying Power", reinforcing in the constitutional scope the rights of the citizen-taxpayer.

In this "principle-logic" era to look for a reaffirmation of the principles expressed in the constitutional text, focusing on the materialization of these in specific or simple measures as well as far-reaching, such as the de-bureaucratization of the attention to the citizen-taxpayer; in the need of the personnel providing attention to the public of being cordial; in the development of collective guidelines to clarify new rules; simplified and available electronic attention; in short, concrete actions and rights to increasingly facilitate the citizen-taxpayer routine.

What is important in this contemporary context is to make Tax Justice a fundamental principle adapted to reality[24].

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RODRIGUES, Denise Lucena. A imunidade como limitação à competência impositiva. Mallheiros: São Paulo, 1995.

24 *As Klaus Tipke says well: "Justice is primarily assured through equality before the law, and in the tax law it is through the equality in the distribution of the tax burden. Who wishes to check if principle of equality is respected or undermined requires a comparison term adapted to reality. It is obtained as from principles adapted to the reality in which positive law should be ideally based on. Who wishes to find the suitable principle adapted to the reality should be familiar with this reality." (TIPKE, Klaus. Tax Moral of the State and the Taxpayers. Translated by Pedro M. Herrera Molina. Madrid: Marcial Pons, 2002, p. 30).*

SADER, Emir. Perspectivas. Coleção: Os porquês da desordem mundial. Rio de Janeiro: Record, 2005.

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Paper on Information Exchange between Argentina and Canada

Sonia Ivone Chapelet

SUMMARY

This paper describes the practical and theoretical aspects of the exchange of information between Argentina and Canada, as a result of research carried out in 2009 which discussed the relevance of information exchange treaties and agreements, the ability to establish fair taxation conditions, and its importance in the fight against evasion.

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INTRODUCTION

Content:

Introduction

1. Analysis of the convention between Canada and the Argentine Republic for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on Capital.
2. Information exchange between Canada and Argentina.
3. Information exchange clause in the convention between Canada and the Argentine Republic for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital.
4. Modifications made to article 26 in the current OECD model convention - comparison with article 26 in force between Canada and Argentina.
5. Application of the manual for the exchange of information of the OECD.
6. Exchange of information on request - OECD guide.
7. Obstacles to cooperation between administrations, presented by article 26 of the greement currently in force between Argentina and Canada.
8. Conclusion.

9 Bibliography.

The relevance of treaties to avoid double taxation and information exchange agreements between two or more countries lies in the ability to try to establish fair taxation conditions between foreign and national taxpayers eliminating double taxation, and fight evasion and the unfair competition that it represents. This functionality translates into a social purpose in spite of being treated in the economic field, since all economic circumstances, will largely define the social aspect of a country through the means that its people posses and how they live and develop.

We find its role in the current globalized world in the ability to strengthen markets, which have the ability to achieve the proper distribution of resources and the correct measurement of those when referring to tax facts affecting more than one country, thus strengthening the tax administration through the possibility of acting beyond its geographical borders.

These aspects of double taxation treaties and especially the exchange of information has been widely analyzed by different agencies, for example the technical resolution of the 36th General Assembly of the Inter-American Center of Tax Administrations, CIAT in Canada in 2002, where the central theme "Opportunities to improve tax compliance through interaction and cooperation," concluded that international cooperation should be promoted by holding international treaties. For its part the Organization for Economic Cooperation and development (OECD) created the global forum for cooperation and fiscal transparency to work permanently in the advancement and improvement of international relations for tax purposes, recognizing the need for the countries to establish fiscal policies to ensure legitimate market conditions in the international competition faced by companies.

Through personal interviews with officials of the tax administrations and finance ministries as well as other public departments involved in the negotiation of international treaties and

in the implementation of the same in Argentina and Canada, performing also consultations in educational institutions libraries and documentation in national archives relating to treaties, a fairly detailed picture of the operations of this important tool for international cooperation in the field of the protection of the base and tax sovereignty was obtained.

1. ANALYSIS OF THE CONVENTION BETWEEN CANADA AND THE ARGENTINE REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL

The relevance of treaties to avoid double taxation and information exchange agreements between two or more countries lies in the ability to try to establish fair taxation conditions between foreign and national taxpayers eliminating double taxation, and fight evasion and the unfair competition that it represents. This functionality translates into a social purpose in spite of being treated in the economic field, since all economic circumstances, will largely define the social aspect of a country through the means that its people posses and how they live and develop.

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Canada - Argentina Relation

In Latin America and the Caribbean, excluding Mexico, Argentina is 7th commercial partner of Canada, also Canada ranks 7th as the country with the most direct investments in the same region. The exports of goods produced by Canada towards Argentina grew 482% between 2003 and 2008.

Canada and Argentina have a treaty to avoid double taxation on income and capital which includes a clause on information exchange that apart from being the most effective weapon against double taxation, is basically a contract providing how the tax base is divided between two Nations and comes to provide a clear scenario for the legal and tax scope for the companies of each country wishing to extend their borders, thus becoming a catalyst instrument for trade between the two Nations, promoting further investments of capital abroad since this agreement remains in the long term, ensuring the rules of the game for investors.

On the other hand, although it is not the specific purpose of this treaty, to provide means to ensure fiscal transparency and fight evasion, is a first major step towards achieving this goal, in its information exchange clause.

2. INFORMATION EXCHANGE BETWEEN CANADA AND ARGENTINA

In Argentina, the Federal Administrator of Public Revenue (AFIP) has the power to sign international treaties in the field of information exchange and mutual administrative assistance since they are considered "simplified agreements" and do not require the intervention of other governmental powers or ratification by Congress. This power was granted by Decree 618/97 in its article 9, according to the provisions in force in international law.

The procedure is initiated in AFIP DGI, in the Directorate of International Affairs. Currently the policy of this Government is to subscribe as many as possible information exchange agreements, consistent with fiscal transparency practices that the Organization Economic Cooperation and Development is promoting to be followed worldwide.

Argentina, from the Directorate of International Affairs, started in 2009 tasks and negotiations in order to know the position of the Canadian Government regarding the signing of a specific agreement for mutual administrative assistance and the exchange of information.

In Canada, instead, negotiations and preliminary talks for the signing of information exchange agreements are conducted by the Ministry of Finance with the collaboration of the Canada Revenue Agency, subsequently requiring the approval of Parliament so that this Treaty comes into effect as a Law.

From the information gathered in the Ministry of Finance of Canada it was known that Canada does not expect to conclude new agreements for the mutual assistance between tax administrations or information exchange with those countries with which it already has an international convention or treaty with an information exchange clause, since their efforts are working at the signing of agreements with those countries with which there is still no kind of international standards in the fight against double taxation or tax evasion such as information exchange.

Canada's interest focuses on the signing of treaties following the model treaty for exchange of information, created by OECD, being at this stage sufficient to establish agreements for the exchange of information at the request of the parties. Even the possibility of automatic or spontaneous exchange is still not considered, as it currently only performs these practices with its No. 1 business partner, the United States, in attention to the relevance of the relations between both countries.

Already in 1971, Canada set as its primary goal to create the most extensive network of international treaties that was possible. This ultimately led to the achievement of a strong economy, whose advantages would benefit all Canadians.

This view is based on the idea that a strong international tax system, transparent and fair improves the competitiveness of the country to attract investors in high value added activities, innovation and skilled employment which is what is considered relevant and necessary at this time in Canada.

In its budget for the year 2007, where the central idea consisted in achieving justice in international taxation, a panel of experts on taxation was established to work towards that purpose.

This panel worked taking into account the work and the experience of the Global Forum on Transparency and exchange of information of the OECD, of the G7 and G20 groups by issuing a final report in 2008 entitled "Enhancing Canada´s international tax advantage"-improving the international tax advantages of Canada.

The main goal of the panel was to support the commercial advantages of Canada, by establishing certain objectives that should be covered by international tax policy.

These objectives are:

1. Canada's international tax system for investment and national businesses abroad must be competitive when compared with the systems of Canada's major trading partners.

2. Canadian and foreign investments in Canada must have equal treatment, protecting the tax base and measurement thereof in relation to income from Canadian source.

3. Must include tools that provide safety and protection to the Canadian taxable base.

4. Tax legislation must be easy to interpret, meet, implement and manage, by taxpayers as well as of the Revenue Agency.

5. It is also important to regularly compare and analyze the tax systems of the most relevant trading partners to the Canadian system, that is, resort to benchmarking.

6. Any important change in international tax legislation should be widely consulted and studied.

Furthermore, Canada considered that being one of its objectives to attract foreign investment to the country, special care should be taken to establish international tax policy, which would position them regarding their competitiveness.

For the tax system to create this competitiveness, it should achieve neutrality in: the export of capital, the import of capital or the holding of capital, these objectives are jointly unattainable, but these neutralities are obtainable through the signing of treaties to avoid double taxation with other countries, by adding this action to the establishment of other factors in the fiscal and commercial policy, they would only have decide which of the three neutralities is the one that best suits national economic policies.

It was also felt that while Canada needs direct in its investment country, this objective can be reached in the long term through Canadian investment abroad, since it is shown that countries tend to repatriate the profits of their foreign investments, therefore a better option for Canada may be to seek more prosperous markets in the short term, which strengthen long term domestic capital stock, and once again international treaties are promoting these movements of capital and on the other hand ensure that Canada protects its tax base by having all the information necessary for the activities that national companies abroad either directly or through its subsidiaries carry out. At this point the study panel reached an agreement that the risk of creating a competitive tax environment to generate the export of capital and employment is less than the risk of losing investment because the system is not competitive.

Alongside the promotion of investment, this international tax system must also protect the tax base, which is achieved by setting anti-evasion standards, such as the exchange of information.

In its race to establish the largest network of international treaties, Canada has reached 86 international treaties in the tax area, this being the most among developed countries. With this Canada ensures that if one of the main concerns in the election of the bases for the taxation system was to level the playing field for foreign and Canadian companies carrying out activities on Canadian soil, then, this network of international treaties is at the forefront in achieving this goal.

With the passing of time, it is clear that Canada worked not only at improving and expanding its network of treaties, but it also complied with improving its tax system, from being fiscally the most expensive of the Group of seven, in 1994, to currently being the country with the lowest tax cost of the same group, achieving to recapture investment and create jobs for its country.

This network of international treaties is vital, in addition to having necessary information in the feedback of the country's international tax policy. Information on taxpayers, their economic acts, capital movements, the generation of the income they produce and in general any matter which affects the foreign source tax base of the country or the Canadian source of non-national residents is the raw material to establish the bases and principles of the tax system.

If the Government relies on information provided exclusively by taxpayers it faces the problem of lack of quality information and the lack of obligation in providing such information. This situation is faced by all countries, therefore, the efforts of the tax administration and the Ministry of Finance are not sufficient, and the Panel considered that the actions to optimize collection must be redoubled and use of information from taxpayers in the area of international taxation, by establishing an Information Management System in order to obtain and efficiently process the same.

3. INFORMATION EXCHANGE CLAUSE IN THE CONVENTION BETWEEN CANADA AND THE ARGENTINE REPUBLIC FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL

The Treaty between the Governments of Argentina and Canada to avoid double taxation on income and capital is currently in effect and was signed under the law No. 24.398 (according to Argentine law), gaining the acceptance of the Canadian Parliament with the corresponding Royal consent, 1994-06-15. The agreement was based on the OECD model treaty to avoid double taxation with respect to taxes on income and capital, in its version of the year 1977.

The tool that the concerned Administrations of Canada and Argentina have available for the exchange of information, is only article 26 of said Treaty with some aggregates, which try to solve the shortcomings detected in the model followed, as set out below, and which were taken from the United Nations model Convention:

Regarding the exchange of information according to article 26 of the OECD model, the Contracting Parties added a paragraph according to which the states must intensify their efforts to obtain information, when the same them is required, although they do not need it for their own purposes, providing the same in the same manner and extension in which it was collected according to its administrative rules and practices, this addition responds to the United Nations model Convention.

Article 1 of the OECD model to avoid double taxation, regarding the exchange of information was excluded from the application of the article, therefore the limitation of the exchange of information relating to resident individuals in any of the contracting countries is removed, extending the same to persons of third countries on the sole condition that the requesting country possess sovereignty to demand taxes to that person in the terms of the Convention, i.e. by the taxes referred to therein, and is aware that another contracting country is able to provide such information.

Article 26 establishes mutual assistance between tax administrations with certain limitations and at the request of the parties. Presenting some disadvantages, since the Treaty in force followed the OECD model before the changes made in 2000.

The information to be sent or requested is limited in the following aspects:

1. The Contracting Parties may only request information necessary for the implementation of the Convention or domestic laws concerning taxes covered by the agreement which are only income and capital tax.

   This “necessary” limitation prevents States from carrying out “fishing expeditions” practices when requesting information, with the respective workload for the state which receives and processes this request without knowing the existence of taxable events. This limitation is important in avoiding fishing expeditions, but harmful from the point of view that a state may not have a presumption as sufficiently certain or verifiable of the existence of the omitted tax base, and if this limitation exists, it is unable to obtain the confirmation or rejection of suspected tax evasion, since article 26 does not contemplate spontaneous exchange when the administration detects circumstances that may be of interest to the other state.

2. Information remittance is limited by restrictive of reciprocity clause, according to which neither of the two contracting countries is forced to make efforts which exceed or are contrary to the normal administrative practices or its legislation to obtain information, emerging in this manner a limitation in practice where none of the two countries will obtain information exceeding the one it can provide, either in quantity of information or relevance thereof for tax purposes.

3. Information disclosing commercial, industrial or professional secrets, trade procedures or contrary to public order may not be provided.

4. The information collected can only be used for the purposes of the application of the convention and shared with the competent authorities of the tax administrations. Therefore it cannot be used to expose other offences other than tax or to start another type of investigation out of tax audit.

4. MODIFICATIONS MADE TO ARTICLE 26 IN THE CURRENT OECD MODEL CONVENTION - COMPARISON WITH ARTICLE 26 IN FORCE BETWEEN CANADA AND ARGENTINA

If we look at the current drafting of article 26, in the 2008 version of the OECD model, it can be observed that some shortcomings presented in the application of the article as drafted in the agreement signed by Canada and Argentina, were solved, namely:

The limitation of requesting information "necessary" for the implementation of the convention or the domestic laws of the contracting countries of the taxes referred to in the Convention is deleted by incorporating in the new wording to the possibility of exchanging "ascertainably needed or relevant" information making exchange far-reaching, since the applicant country must only provide information data identified in the information exchange manual drafted by the OECD for the case of the exchange prior request for the purpose of verifying the possible relevance of the information and only in the case that it does have this minimum on the taxpayer to verify, the requested country may assume the existence of a case of fishing for information.

On the other hand, by adding the provision of relevant information for the administration, the management and implementation of the internal laws of the contracting countries, grants the necessary tool to assist in the collection of taxes and the determination of the tax base.

Finally, with regard to the limitations of the scope, the clause in effect between Argentina and Canada provides that with regard to the exchange of information, the provisions of Article 1 of the Convention, shall not be applied, i.e. information can be exchanged on taxpayers who do not reside in any of the contracting countries, but does not mention any exception regarding the article 2, as the new wording does, therefore, the only information that can be exchanged is regarding the application of the Convention itself or the internal laws of each contracting country corresponding to taxes achieved by the Convention and while these laws are not contrary to the Convention.

The new wording of article 26 removes the application of article 2 of the Convention concerning the exchange of information, being covered almost all applicable taxes in each of the contracting countries at all government levels, so the information may be shared with different levels of the public tax administration, in both the implementation of the internal laws of the country that are not contrary to the Convention held.

However, it maintains the ban on using information in other areas and for other purposes than the collection of taxes for which the information was requested.

On the limit given by the requirement of reciprocity between countries, it remains in the current writing, as well as the limitation regarding commercial and industrial secrets and information contrary to public order or public policy.

Enforcement and compliance with Article 26 in its practical aspects

Inquiries were carried out at Canada Revenue Agency, and the Federal Administration of Public Revenue of Argentina, and the following information was obtained:

In Canada international information requests received or sent to or from other countries are handled by Canada Revenue Agency at the "International and Large Business Directorate", there are no internal rules for the standardization of the process to make requests and send information, therefore, Canada follows the stipulations of the Manual for the Exchange of Information compiled by the OECD in its " Exchange of Information on request" module.

In the case of Argentina, until July 2010 there were no internal rules to standardize the procedure for the request or transmission of information. However, the allocation of responsibility for compliance with requests or transmission of information was established by means of internal provisions, i.e. the competent authority in each situation was clearly established. There is also Opinion 16/94 of 01/26/1994 of the Legal Directorate of the Federal Administration of Public Revenue whereby the conventions held by Argentina, in effect at that time and, which involved the exchange of information were analyzed, establishing the precautions to be taken so that information would be valid for tax assessments.

The above-mentioned Opinion proposes that the recommendations of the Manual for the Exchange of Information issued by the OECD in the compliance and preparation of requests for information be considered. This Opinion also mentions the lack of regulation as regards the delegation of authority to perform the procedure, at that time the regulations of Decree 1326/87 only recognized the Minister of Finance as the competent authority. Currently the legal framework thereon was completed through an internal arrangement AFIP DGI and General Guidance of July 23, 2010, 894/2010 laying down the procedures and powers of each area involved in the exchange of information. This Guidance follows the guidelines of the Manual for the Exchange of Information issued by the OECD.

The procedures for the exchange of information in Argentina are the responsibility of the Federal Administration of Public Revenue. With respect to the authority responsible for performing tasks related to article 26 of the Treaty to avoid double taxation, it is in the head of the Deputy Director General of the Office of Examination, in his/her absence or inability to comply with the tasks, he/she should be replaced by the Chief of the Department of International Operations who can comply with all tasks relating to the exchange of information, except in the case an automatic exchange of information, although it is not a practice that is currently practiced with Canada or in the case of requests transacted before the Ministry of Foreign Affairs, International Trade and Culture.

In cases in which information exchange is automatic, and the Deputy Director General of Examination needs to be replaced in his/her tasks, the Chief of the Directorate of Strategic Information for Examination will carry out these tasks, but as already mentioned, this practice is not covered by any international standards.

We see that both countries perform a delegation of the competent authority that comes to solve one of the most significant inconveniences for the exchange of information and is availability and processing for the information, and such responsibility is at the head of those who handle daily information on taxpayers, thereby ensuring that the procedure is carried out in an effective and timely manner.

With regard to the implementation of the manual on the Exchange of Information designed by OECD, which attempts to standardize the formalities for referral and request of information and the contents of these requests, it contains the necessary examples of prior information to forward requests to be answered by the requested country.

It must be taken into account that the manual for the application of the provisions concerning the exchange of information for tax purposes of the OECD was updated in 2006, and tailored based on article 26 of the model Convention revised by the Committee on fiscal affairs in 2004, which differs from article 26 of the Convention signed by Canada and Argentina, this situation was considered in the drafting of the manual through clarifications and additional recommendations for the cases of treaties signed with earlier versions of the article under analysis.

To comply with the requirement for information, the Tax Administration of Canada exclusively applies the stipulations in article 26 of the Convention and section 241 of its Profits Tax Act, according to which in Canada there is a restriction on the disclosure of information on taxpayers, having to respect tax secrecy, excluding from the application of these rules when there is an international treaty in force stipulating the remission or request for information.

The same rules apply in Argentina, however, except for the observance of tax secrecy due to the application of an international treaty and only insofar as this measure is established by these legal framework, it would be unable to provide any type of tax information, since in the specific case of the Treaty between Canada and Argentina, article 26 provides that information must comply with certain limitations as discussed previously.

In the practical order, once made a request for information is made under the terms of the article 26 and determining that once it is appropriate, both Argentina and Canada, will transact the same performing a verification procedure according to its internal rules of audit and taxpayers investigation, performing the procedures necessary to comply with the request at the earliest possible date and staying within their usual tasks.

It is important to point out that once the exchange of information is done, there is no legislation to cover the obligation by any of the contracting countries to inform the informed subject about exchange performed, and therefore, such notification usually does not take place.

Despite the constraints which may arise with regard to information obtained or provided by virtue of the Convention, there is also the possibility of providing or request information, through the good offices of the Ministry of Foreign Affairs, International Trade and Culture, in this case information only may be furnished by the Deputy Director General of Examination.
Therefore, since there is the full capacity of states to provide or request information as a tool of international cooperation through a request made between ministries of Foreign Affairs through diplomatic channels, what is the meaning of the signing of treaties for the exchange of information? This is to establish information exchange as a routine, normal and standardized practice that does not require sporadic and unusual procedures that delay the results sought by the requesting party, removing from the exchange according to Convention the power that it has as a transparency and cooperation tool, when the relevance in time and quality of the information provided is respected.

It is also important to consider the assistance given through the application of article 26, where there are fiscal offences in this case, when a required state provides information on a taxpayer who has a fiscal offence cause, it will be done in accordance with its national domestic legislation, basing the same for the purpose of collecting information, on the evidence and the necessary documentation to resolve the cause initiated by the requesting party.

5. APPLICATION OF THE MANUAL FOR THE EXCHANGE OF INFORMATION OF THE OECD

General Aspects

The exchange of information between Argentina and Canada is mandatory due to the application of article 26 of the Convention, once one of the countries requests information, the other must substantiate its refusal or send the requested information. This means that if information was denied without sufficient substantiation, this means non-compliance with international rules and is punishable in accordance with international law, in this case in particular the Vienna Convention would apply.

Regarding the taxes on which the information is exchanged, the same focuses on the profit tax, assets tax, currently the alleged minimum profit tax and tax on personal property not incorporated into the economic process and tax income in the case of Argentina and on income tax in the case of Canada.

Regarding the periods covered by the information, the internal rules of each country must be taken into consideration regarding the limitation of the powers of the State Treasury to audit and enforce taxes.

Regarding the reciprocity clause, which establishes that a country cannot request information that would it not be able to deliver according to their own legislation and administrative procedures and a requested country is not required to provide more information than that that can be obtained from the other country according to the regulations of that other country, the fact arises that in the practice it is of difficult compliance, since the required party does not have knowledge of the type of information that is impossible to obtain from the requesting party, according to its internal rules and vice versa. This is solved by including a declaration of compliance with the reciprocity clause in the request for information, in which the country requesting the information declares that it can obtain this type of information requested regarding taxpayers carrying out activities in its territory, with which the required party will be knowledgeable of the compliance with the reciprocity to send information and that it may not refuse to grant the same once this requirement has been fulfilled and being forced to act as if it were their own fiscal interests and tax base.

As regards the information contrary to public order and the preservation of commercial, professional and industrial secrecy, there are no special considerations. This has no disadvantages regarding banking secrecy rules since both countries contain provisions thereon in its tax legislation with which there is no information can be denied because a country invokes a breach of banking secrecy.

Information exchanged can only be uses for tax assessments and tax purposes. On the other hand Argentina and Canadian law does not have provisions that require informing subjects on what is covered by the exchange of information held.

Regard communications to perform once the exchange is made and to give the information, there are internal information requirements to certain national bodies operating in other offences, such as money laundering, financing of terrorism, etc. A specific example in Argentina is that it is mandatory to inform the Financial Intelligence Unit when detecting possible money laundering or financial crime, this is the case of an impediment to compliance with the internal standards by means of the implementation of an international treaty since the information obtained can be used exclusively for the determination of the tax and may not be shared with other persons other than the competent authorities in the administration of taxes.

Regarding the costs of the exchange of information the Convention does not consider which of the parties assume the same, therefore in practice the tax administrations solve the situation by mutual agreement, finding ways to reduce costs for both parties.

6. EXCHANGE OF INFORMATION ON REQUEST - OECD GUIDE

Prior to referral of the request for information on a person or company under verification, the country that performs the same must exhaust the means to obtain information in its own country at a reasonable cost either through public information on the Internet, information that diplomatic missions may have in the country or anything that may be obtained through the base developed by the OECD as reference guide on sources of public information abroad available at www.oecd.org/taxation for the competent authorities of the public revenue administrations.

Having fulfilled this preliminary step, a written request containing at least the information described in the Manual for the Exchange of Information of the OECD, “Exchange of information on request” module. It must also include a statement concerning the reciprocity clause as set out in the general part of the manual.

When the requested country receives the request, it acknowledges receipt and verifies that it complies with all legal requirements, it is forwarded by the competent authority, including all the information needed to be answered and the information requested falls within the provisions of the Convention. If the request is not valid for the requested country, the applicant must be informed, stating the reasons by which it is considered that the request cannot be answered. If on the other hand, the application complies with all the formalities and requirements to be answered, it must be investigated promptly.

Once a request for information is accepted and transacted it must be answered with the greatest urgency by attaching further information or documentation, which has not even been requested, however, it is considered of relevance pursuant to the statements of the request filed by the requesting country.

Deadlines for processing are not set in the Convention, however, the OECD exchange of information guide suggests it should be answered within 90 days of the receipt, by informing the requesting party when this term is not sufficient. On this regard, the internal regulations regarding checks must also be observed, taking into account the date in which the information will no longer be useful to the applicant country, if such date was informed in the request for information. In the same order, IG 894 establishes that Argentina shall observe the time limits laid down in specific agreements for the exchange of information which have a term of 3 and 6 months depending on if the information is available or not internally.

There are no internal rules in Canada to comply with the procedure for the exchange of information, the time limits to comply are not clearly established, Argentina now has IG 894/2010, however, no information was obtained to indicate that there are problems or inconveniences caused by delays in the processing of applications, therefore, the objective of collaboration and international transparency between administrations prevails.

7. OBSTACLES TO COOPERATION BETWEEN ADMINISTRATIONS, PRESENTED BY ARTICLE 26 OF THE AGREEMENT CURRENTLY IN FORCE BETWEEN ARGENTINA AND CANADA

To file a request for information, the requesting country must do so in an ongoing investigation or audit to the taxpayer in question, having a nexus with the request to carry out and acknowledge of the existence of taxable economic facts abroad. That is, there must be prior knowledge of the existence of tax base and only the request of information will help establish the measurement of this basis, so if there are taxable facts unknown by the requesting country and which do not come to light in the course of the investigation carried out by the requested country, and the latter proceeds to report this as a measure of good collaboration practice, these facts will be left out of the assessment. From this point of view the exchange of information on request is useful for reaching the correct measurement of the tax base, not to determine basis of the same, i.e. the facts and the amounts subject to taxation.

The “necessity” of information must be proven, currently and according to the final wording of Article 26, requests are more broad, being the requirement for the validity of the request that the information is “ ascertainably relevant”, however, the OECD model for a request foresees that the information be provided on the concept that the requesting state considers that it has the right to tax, therefore, only additional information to protect the measurement of the tax base will be obtained, if the requested country sends additional information it finds in the course of the processing of the request received, but if the applicant does not have a fairly concise idea of the taxes and concepts that the audited taxpayer is omitting to declare, the request not may be transacted.

Although more expensive, it would be extremely useful, and would truly fulfill the objective of transparency and international cooperation, that among the contracting countries there is the possibility of accessing databases or information about companies or people in a contracting country which carry out transnational activities of any kind or receive income due to any concept, in another contracting country. This would give strong tools to decide what companies to examine and on what taxpayers and concepts to make specific requests for information.

Another aspect to consider is that you only can request information for assessments on income tax, personal property or the alleged minimum profit (in the case of Argentina) tax, or corporate tax or individual income tax (in the case of Canada).

8. CONCLUSION

There is awareness of collaboration which leads to the administrations to communicate with each other results based on the Exchange of information, for the feedback of the procedure between Argentina and Canada and to make the necessary improvements throughout time.

Both countries have significantly advanced in achieving the guidelines recommended by the OECD for the achievement of fiscal transparency and international cooperation as see for example in the case of Argentina which has issued internal regulations during last year and has clearly established the procedure for the exchange of information. However, in order for information exchange to efficiently achieve its objectives, the signing of specific agreements for the exchange of information is necessary, as well as having rules requiring the spontaneous reporting of cases is detected during an examination, the existence of tax facts that are relevant for other country regardless of the tax involved.

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Control of Expenses Computed by Permanent Establishments under the OECD Model Agreement

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SUMMARY

This paper is concerned with the different aspects to be considered when controlling expenses computed by permanent establishments under the OECD model agreement and the taxation consequences arising from their examination, specifying each regulation governing the matter and considering especially the current observations and reserves of such international body's member countries.

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INTRODUCTION

Content:

The globalization of the world economy has been one of the main consequences of the large-scale development of the goods and services trade among different countries, as a result of which companies, in trying to internalize their investments, have streamlined methods intended to channel their operations through diverse corporate structures, among which are: agencies, branches or any other type of permanent establishments.

A permanent establishment is defined as "an effective extension, in another country, of the business activity of the headquarters, which may or may not be related to the place of operations[1]. It is within this scenario that permanent establishments have arisen as a complex legal institute rooted in different company groups having their own ways to carry out activities; and this is not alien to the difficulties deriving from the international double taxation on their income, for many countries strive to impose their tax jurisdiction to assess income deriving from such international operations.

It is apparent that permanent establishments still spark concern to most tax administrations and have resulted in a complex treatment of computed expenses, especially when the same are associated to the income earned by such establishments from a foreign source.

Alternatively, the OECD model agreement, which suggests rules to avoid or mitigate the international double taxation, has reportedly and visibly predominated between the States as the main source for agreements concerning this matter. However, it is with reference to such model agreement that member countries have made observations and raised objections with the consequence of limiting its application in many cases and causing tension with the local laws of each State. This paper will try to elucidate this issue.

1 *FAÚNDEZ, Antonio, Agencias y otros establecimientos permanentes, in Manual de consultas tributarias, n° 389, (Santiago, 2010), p. 21; SAME AUTHOR, Establecimientos permanentes: aspectos tributarios (Santiago, 2009), p. 34; SAME AUTHOR, Beneficios atribuidos a establecimientos permanentes, in Revista de Derecho de la Empresa, 21 (Santiago, 2010), p. 101.*

1. IDENTIFYING THE PROBLEM

The countries that have celebrated international double taxation agreements within the scope of the OECD model agreement abide by the regulation on expenses computed by permanent establishments included in paragraph 3° of section 7, which provides: "To determine the permanent establishment's income, the deductible expenses shall be those incurred in carrying out the purposes of the business, including management and general administrative expenses incurred for such purposes, whether incurred in the State where the establishment is located or elsewhere". The cited section seems not to set a limitation on the manner the expenses are computed, which raises the first question as to whether such expenses should necessarily be tied to the taxable income or may be deducted even in the case where expenses are tied to non-taxed or exempted income.

As a consequence of the above, the application of internal regulation should be elucidated in the cases not regulated by the agreement, which on occasions become in conflict with the principles acknowledged internationally and incorporated into the cited double taxation agreements, as is the case, e.g., with the non-discrimination principles of agreements.

The above also includes the situation of expenses resulting from operations conducted between the permanent establishment and its headquarters, mainly in respect of the fact that they both constitute legally the same entity. Within the taxation sphere, the principle of considering the permanent establishment as separate from its headquarters should not be overlooked, but this also may bring doubts regarding the acts that fall within such limits.

2. PRINCIPLES TO BE CONSIDERED WHEN DETERMINING EXPENSES

The principles discussed below are vital to approach the control of expenses related to permanent establishments, the scopes of which, in my opinion, will be in constant conflict as a result of the rule antinomy, i.e., convention rules vs. local regulations.

1- The non-discrimination principle of agreements: ongoing tension with local laws?

The principle of non-discrimination of agreements provides that permanent establishments should not bear within the State in which they operate a less favorable taxation than that borne by companies of the same State for the same activity. Section 24, paragraph 3° of the OECD model agreement indicates that "the permanent establishments held by a contracting State in another contracting State shall not be subject in the second State to any taxation that is less favorable than that borne by the companies performing the same activities in the second State. This provision shall not be construed as obliging any contracting State to grant to the residents of the other contracting State the personal deductions, exemptions and tax reductions granted to its own residents in consideration of their civil status or dependant contributions".

The principle of non-discrimination of agreements is a manifestation of the arm's length principle of taxpayers, in respect of which the elements that are to be compared will link a permanent establishment with a resident of the State in which it operates. In this sense, the non-discrimination principle of agreements operates between taxpayers but not between States. According to GARCÍA[2], what should prevail in the resolution of this matter is not the elimination of the international double taxation borne by the permanent establishment but rather that the taxation in the relevant State should not be greater than that borne by a comparable establishment[3]. Now, in my opinion, comparative criteria should not be limited only to the type of activity carried out by the taxpayers, but should also take into account the income nature and the type of tax assessed on such activity, which should necessarily be considered in light of the local laws.

The OECD's comments on the model agreement indicate that the equalitarian treatment with relation to permanent establishments should operate in the following six areas: (i) tax liquidation; (ii) special treatment of dividends earned by permanent establishments; (iii) tax structure and rate; (iv) withholding of tax on dividends, interest and royalties for permanent establishments; (v) discount of taxes paid abroad; and (vi) extension to the permanent establishments of the benefits of double taxation treaties signed with third countries[4]. However, the scope of section 24 of the model agreement has not been unanimously accepted by OECD's member States, and reservations have been made to its application[5]. Notably, many countries which are not members of the OECD frequently consult these comments as a way to interpret their agreements, but the diverse reservations made by the member States to the cited section 24 clearly keep such countries at a distance from the interpretive scope of such comments.

These precedents lead to permanent tension between the agreements and the local laws and result in each country construing the non-discrimination principle and establishing comparative criteria based upon its own legislation. Such tension is inevitable if the agreement fails to specify the comparative criteria to be considered for the non-discrimination principle, and each State will fill any gaps in the agreement with its local regulations.

2. Jurisdictional factors determining the application of taxes to income attributable to permanent establishments

Outside the sphere of the OECD model agreement, the tax legal hypothesis described in each piece of legislation should be supported by principles tied to jurisdictional factors that determine the application of the income tax. These principles are related mostly to a State's territory or a taxpayer's residence.

In this sense, if the territoriality principle is applied as a jurisdictional factor, a distinction should be made between the national source income and the foreign source income. The national source income will consist of the income attributed to permanent establishments deriving from property located in the State where they operate or carry out activities. Alternatively, foreign source income will derive from property located or activities carried out in a country different from the country where such establishments operate.

The residence principle is a second factor that may influence the application of taxes. Broadly,

2 *GARCÍA, Francisco, La cláusula de no discriminación en los convenios para evitar la doble imposición internacional, in Fiscalidad Internacional, (Madrid, 2005), p. 927.*

3 *Ibid., p. 934.*

4 *Paragraphs 24 to 54 of section 24 of the OECD's comments.*

5 *Australia, Canada and New Zealand made objections to such section; the United States reserved the right to apply their taxes on branches; France reserved the right to apply the provisions in paragraph 1° to individuals only; the United Kingdom objected to the second phrase of paragraph 1°; Switzerland reserved the right to not include paragraph 2° in their agreements; Greece, Ireland, Luxemburg and the United Kingdom reserved the right to restrict the application of paragraph 6° to the taxes included in the agreement (OECD, Modelo de convenio tributario sobre la renta y sobre el patrimonio, in Instituto de Asuntos Fiscales, [Madrid, 2005], pp. 324-325).*

this principle states that the residents of a State will pay taxes on income of any precedence. The double taxation phenomenon may arise in the case that a resident earns income from a foreign source that is subject to taxes in the State where it is originated. This principle constitutes the primary basis for the application of taxes by States. Hence, in Chile this principle is acknowledged in section 3° of the Income Tax Act; in Peru, it is regulated in section 6° of the Income Tax Act; in Mexico, it is provided in section 1° of the Income Tax Act; in Argentina, in section 1° of the Income Tax Act; etc.

Now, in the sphere of the OECD model agreement, the residence principle constitutes the general rule for assessment used by the contracting State bound to assess income. The right of taxation is conferred exclusively upon the State where the taxpayer resides; this means that where income is earned by a taxpayer in a contracting State where they do not reside, such State may not impose a tax, but rather the right of taxation will remain in the contracting State where taxpayer resides, thereby avoiding the double taxation of income.

The exception to the rule lies in the source principle for cases expressly provided for in the model agreement. This is the situation of permanent establishments, where the income obtained in the contracting State where they operate, in accordance with paragraph 1° of section 7°, shall also be subject to taxes in such contracting State. Now, to avoid or mitigate the double taxation of income in this exceptional case, the model agreement provides in sections 23A and 23B that the State where the permanent establishment resides should allow a tax relief through two methods: exemption and charging expenses or credit[6].

Notwithstanding the above rules, the model agreement says nothing about the income obtained by a permanent establishment in a State different from that where it operates. In my opinion, paragraph 1° of section 7° of the model agreement only refers to profits earned by a permanent establishment in the contracting State where it operates, thus providing sufficient grounds to apply the internal regulation to the taxation of profits obtained by the permanent establishment in a State different from that where it operates. In this sense, to determine the rules for assessment of such income, we should resort to the territoriality principle previously discussed with relation to the income earned by a permanent establishment from a foreign source, although in this case in accordance with the national laws of each contracting State. In Chile, the Internal Revenue Service[7] has stated that the permanent establishment is considered non-resident, so it will pay taxes in the source State only in respect of income obtained in such State, and, therefore, it will not pay taxes in that State in respect of the income obtained in the other contracting State or a third State[8].

The criterion of considering the permanent establishment as non-resident in the country where it operates is widely accepted among countries, and is supported in the dependence on a non-resident. For control purposes, tax administrations generally require foreign companies operating with permanent establishments to fix a known domicile, which may generate some confusion at the time of rendering a resident of such State, and serious consequences at the time of liquidating a certain tax. For the same reason, the establishment of a known domicile for control purposes may only be effective in the event of an inspection. It is in this scenario that the legal basis makes sense,

6 *In Chile, pursuant to section 41C with relation to section 41A letter B of the Income Tax Act, the companies incorporated in the country which operate with permanent establishments located abroad may opt for the credit method, with certain limits established by the regulation.*

7 *Inspection body responsible for interpreting administratively the fiscal regulation through its National Director.*

8 *Official Letter n° 2.556 of the Internal Revenue Service, dated June 8 of 2004.*

of taxing permanent establishments only in respect of the income obtained in the contracting State where they operate, supported by the "dependence" on the headquarters' residence[9].

Alternatively, in the context of double taxation agreements, GARCÍA states that the failure to consider the permanent establishment a resident company of the relevant State originates from the impossibility to consider it a person of the contracting State[10]. This author bases his theory on the fact that a permanent establishment is not a legal person and, therefore, should not be considered a person of the State in which it operates and, consequently, it could not be considered a resident of such State.

Now, based on the above stated rules, the expenses should be determined which will be related to the income subject to the fiscal burden in the State in which the establishment operates, by applying the residence principle contemplated in the model agreement and the territoriality principle established in the national laws of each State, something we will discuss in the following paragraphs.

3. EXPENSES RELATED TO INCOME ATTRIBUTABLE TO PERMANENT ESTABLISHMENTS

Paragraph 3° of section 7° of the OECD agreement model provides that expenses tied to income attributed to a permanent establishment should be allocated to the pursuance of corporate purposes. But the cited rule fails to specify whether the expenses whose reduction is sought should or should not be tied to the income attributed to the permanent establishments bound to be subject to a certain fiscal burden[11]. On this regard, it is indispensable to discuss the concept of income attribution in order to determine later the taxable income.

1. Income attributable to permanent establishments

BETTINGER defines attributable income as "that resulting from any corporate activity, as well as that deriving from the sale of goods or real property by the headquarters within the national territory, or by another establishment held by the resident abroad, or directly by the resident, as per the case"[12]. In this sense, the income to be attributed to a permanent establishment will determine, on the one hand, the fiscal burden taxable in the country where it operates; and, on the other hand, it will be essential for the headquarters to invoke income intended to attenuate or reduce the international double taxation[13].

Paragraph 2° of section 7° of the OECD model agreement provides that in order to determine a permanent establishment's profits, the establishment must be considered a different

9 *FAÚNDEZ, Antonio, Op. cit. (n° 1) Agencias, p. 65-65.*

10 *GARCÍA, Francisco, El Establecimiento Permanente. Análisis jurídico tributario internacional de la imposición societaria (Madrid, 1996), p. 435.*

11 *In Chile, pursuant to section 31 of the Income Tax Act, the expenses that are deductible from the gross income are all those required to produce it, either paid or owed, and which are allocated to the business activity. The above cited rule should be supplemented with the provisions in letter e) of number 1° of section 33 of the same act, which also provides that the expenses should in addition be tied to the income subject to a fiscal burden. As a consequence, expenses tied to non-income revenues or exempted income are not considered expenses.*

12 *BETTINGER, Herbert, Efecto Impositivo del Establecimiento Permanente, (Mexico, 2008), p. 113.*

13 *FAÚNDEZ, Antonio, Op. cit. (n° 1), Beneficios, p. 102.*

and separate company from its headquarters[14]. However, such paragraph fails to specify the manner of determination of such profits. In the opinion of BAKER and COLLIER, which I uphold, the local laws need not be adapted in each jurisdiction to the concept of a separate company or the prudence principle; in other words, each jurisdiction should decide on its own how to determine a company's taxable profits and how income is attributed to a permanent establishment under the local laws[15]. Nevertheless, the provisions in paragraph 1° of section 7° should not be disregarded, which state that the profits subject to a fiscal burden shall correspond to the profits that may only be attributable to a permanent establishment, which implies that the State in which such establishment operates may not tax the profits obtained by the headquarters in the same State through other means.

The States have adopted three methods to determine the income attributed to a permanent establishment, namely: (i) the direct method, whereby the permanent establishment's profits are determined on the basis of its own income, regardless of the headquarters' total profits; (ii) the indirect method, whereby the company's total profits are considered in order to distribute them to the permanent establishment proportionately to certain auxiliary factors, as is the case of, e.g., Switzerland, where the total income of a company is distributed among several permanent establishments in proportion to their separate profits, calling this method "total distribution of income"[16]; and (iii) the mixed method, an application of both the direct and the indirect methods, but where either one prevails over the other.

The mixed method is applied in countries such as Germany, where the direct distribution method prevails over the indirect method[17]. It is also applicable in Chile, with predominance of the direct method, governed in section 38 of the Income Tax Act. This rule establishes that the Chilean source income of a permanent establishment is determined based upon its own income, regardless of the headquarters' total profits; however, rather than a prevalence of the direct method over the indirect method, the latter is applied by the tax inspection authority where the actual income cannot be determined through the former[18].

The expenses deductible by the permanent establishments should necessarily by tied to the income attributed in conformity with the methods discussed above; however, where the expense is tied to exempted or non-taxed income, it may be reduced if the relevant legislation expressly sets forth such limitation, a situation we will deal with in the next paragraphs.

14 *The doctrine has been split internationally into two theories: (i) the relevant business activity approach, in which the permanent establishment's income is determined by considering the business activity of the headquarters as a whole; i.e., as an "individual company" of which the permanent establishment is a part. In this way, upon determining the headquarters' global income, this income is attributed to the permanent establishment. And (ii) the functionally separate entity approach, where the income attributed to a permanent establishment is that obtained as a separate entity from the company to which it belongs. This criterion is adopted in the OECD's comments on the model.*

15 *Compare with BAKER, Philip and COLLIER, Richard, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 28.*

16 *Ibid., p. 37. A study conducted by Sven Olof Lodin and Malcolm Gammie, which proposes schemes for applying a common corporate tax system in the European Union and which is clearly reflective of an indirect method. This system is called Home State Taxation, and broadly provides that a corporation residing in a certain State should calculate the taxable base not only of such corporation but of all its branches situated in the States that abide by the system, in conformity with the fiscal regulation of the State of the corporation (RAVENTÓS, Stella, La Reestructuración Empresarial como Instrumento de Planificación Fiscal Internacional, in Centro de Estudios Financieros, (Madrid, 2005), p. 1.184.*

17 *NAUMANN, M., FÖRSTER, H. and ROSENBERG, O., Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 344.*

18 *On this regard, I suggest reading of Beneficios atribuidos a establecimientos permanentes, in Revista de Derecho de la Empresa, 21 (Santiago, 2010), by Antonio FAÚNDEZ.*

2. Deductible expenses under the OECD model agreement

The determination of the permanent establishment's expenses is regulated in paragraph 3°, section 7° of the OECD model agreement, which provides: "To determine the permanent establishment's income, the deductible expenses shall be those incurred in carrying out the purposes of the business, including management and general administrative expenses incurred for such purposes, whether incurred in the State where the establishment is located or elsewhere". This rule is supported by the principle of separate company established in paragraph 2° of section 7° discussed previously.

The first thing that should be noted is that paragraph 3° of section 7° of the OECD model agreement seems not to establish any limitations on the manner expenses are calculated, and includes the expenses generated in another State. This rule fails to specify whether the expenses tied to non-taxed or exempted income are to be considered expenses. In view of this omission, the provisions in paragraph 2° of section 3° of the model agreement should be taken into account, which state that in order that any contracting State should apply the agreement at a certain moment, any term or expression not defined therein shall have the meaning assigned by the State's legislation at that time, unless the context should imply otherwise. But the context of the rule of paragraph 3° of section 7° does not envisage any solution to the problem analyzed, leaving no other choice but to apply the internal legislation of the State in which the permanent establishment operates; and so where the internal laws so provides it, the expenses tied to non-taxed or exempted income shall not be accepted as expense[19]. The proposed solution resolves the determination of expenses in the same manner as that established for a company incorporated in the same State where the permanent establishment operates, which requires abiding by the non-discrimination principle of agreements.

Particularly in the case of Chile, pursuant to subsection one of section 38 of the Income Tax Act, the income of a permanent establishment is determined on the basis of the actual income obtained from its operations within the country; however, given that such establishment is considered non-resident, it will only pay taxes in Chile on Chilean source income, a situation regulated in section 3°. In this sense, the foreign source income of a permanent establishment operating in Chile will not be subject to taxes by reason of that establishment being non-resident, and for the same reason, under the letter e) of number 1° of section 33 of the Income Tax Act, expenses tied to non-taxed or exempted income shall not be charged.

Now, well, the accountability of the permanent establishment may reflect expenses originating in a country different from that where it operates, which could be allocated to the generation of income in the State where it carries out its business activity. In these cases, the taxpayer is responsible for providing due evidence of this circumstance as per the formalities and conditions established in the internal laws. The problem arises upon the accountability of expenses tied to both the headquarters and the permanent establishment, in which case such expenses should be separated or prorated. The OECD has stated that in respect of the general administrative expenses incurred by the company's headquarters, it may be fit to compute a proportional portion in accordance with the relation between the sales volume of the permanent establishment (or possibly its gross profits) and the sales volume of the company as a whole[20].

19 Supra cit. n° 11.

20 Subparagraph 16 of paragraph 3° of section 7° of the OECD model agreement. In Chile, the subsection two of section 27 of the Fiscal Code establishes the authority of the Internal Tax Service to separate or prorate expenses in the case that taxpayer fails to accompany documentation or provides incomplete information.

On the other hand, a great number of specific problems may arise in practice, but as a general rule the determination of profits attributable to a permanent establishment should always be based on such establishment's accountability, to the extent that it is representative of the real situation. On the contrary, if the accountability does not reflect the actual facts, then new accounts should be created or the original accountability should be corrected using the market normal values[21]. In this sense, the OECD has expressed that upon reviewing the headquarters' and the permanent establishment's accountability and finding that some items depict entirely artificial functions instead of actual economic functions of the different parts of the company, then such items may be disregarded and proper adjustments should be made[22]. This situation may occur, for example, where the sales made by a permanent establishment are accounted for as a primary activity implying insurance and freight expenses and it is determined in reality that they constitute only an intermediary activity, in which case they cannot be considered expenses.

3. Expenses related to operations between the permanent establishment and the headquarters.

Both doctrine and jurisprudence agree that the permanent establishment and its headquarters constitute the same entity for legal purposes, something that approximates reality if we consider that the former is an extension of the latter in terms of their economic activity. This varies when assessing each entity's taxation, in which case, pursuant to paragraph 2° of section 7° of the OECD model agreement, they will be considered two separate and independent companies. This separation has more often than not resulted in serious problems when delimiting businesses as a single entity for legal purposes and separate and independent companies for tax purposes.

The main consequence of considering the permanent establishment and its headquarters a single entity is the absence of legal obligations between them. As a rule, any contractual obligation presupposes the concurrence of two persons: one as creditor and one as debtor[23].

As a result, if the accountability of the permanent establishment records expenses reportedly tied to agreements celebrated with its headquarters, such entries should be corrected. This situation occurs, for example, where expenses are accounted for as a result of lease contracts between the permanent establishment and its headquarters.

The foreign jurisprudence reports cases in which the Courts have expressly rejected the deduction of certain expenses tied to agreements celebrated between the permanent establishment and its headquarters, as exemplified in a ruling issued by the Federal Court of Appeals of Canada, in declaring that the income from a rental paid by a permanent establishment in Canada could not

21 *Subparagraph 14 of paragraph 2° of section 7° of the OECD model agreement.*

22 *Subparagraph 12.1 of paragraph 2° of section 7° of the OECD model agreement.*

23 *Section 1.437 of the Chilean Civil Code provides: "Obligations may arise from the real concurrence of the will of two or more persons, as in the case of agreements or conventions; the voluntary action of a person that bound themselves, as in the acceptance of a inheritance or bequest and in all quasi-contracts; or as a consequence of any deed resulting in slander or damages to another person, as in torts and unintentional torts; or by operation of law, as between parents and children subject to parental rights and duties".*
In this same sense, the tax inspection authority of Chile (Internal Tax Service) in establishing interpretation criteria declared in the Official Letter Nº 800 of 2008 that: "[...] pursuant to the tax legislation and in light that the headquarters and its agency abroad are the same legal person, an agency abroad may not hold the capacity of creditor of its headquarters in Chile because any obligation presupposes the existence of different legal subjects under section 1.437 of the Civil Code. As a consequence, upon the headquarters in Chile and its agency abroad constituting the same legal person, the existence of credits and reciprocal obligations between both entities is not legitimate, and therefore, the tax adjustments for money correction provided for in section 41 of the Income Tax are not applicable..." Furthermore, the Internal Tax Service, in the Official Letter Nº 1.276 of 2007, stated: "[...] it is

be deducted at its headquarters based in the United States[24]. In the same sense, Swedish courts have established that foreign headquarters and a Swedish permanent establishment cannot enter into a loan agreement, and therefore, the permanent establishment cannot deduct interest paid to the foreign headquarters[25].

The OECD has indicated that in the case of payments made to the headquarters by its permanent establishments for interest on loans, the issue arises mainly for two reasons: (i) from a legal standpoint, the transfer of capital as interest payment and the commitment to reimburse it on a certain date is in fact a formal act inconsistent with the authentic legal nature of the permanent establishment; and (ii) from an economic standpoint, the internal debts and credits may be inexistent, because if a company is financed, only or mainly through equity capital, the deduction of interest that manifestly was not payable is not legitimate. While it is true that symmetrical charges or revenues do not misrepresent a company's global profits, it is not less true that partial income may be altered arbitrarily[26]. It further states that if the debts assumed by the headquarters on behalf of the company were used exclusively to finance their activity or, clearly and exclusively, the activity of a certain permanent establishment, the problem would only be a matter of undercapitalization of the effective user of such loans. In fact, the loans taken by the headquarters of the company will normally be used to cover their own needs up to a certain extent, while the rest of the borrowed funds will be allocated to provide the permanent establishments with basic equity[27].

Now, under certain circumstances, deducting expenses tied to certain operations carried out between the permanent establishment and its headquarters would in fact proceed, intended to materialize businesses bound to generate taxable income, as for example, the expenses incurred in transferring goods from the headquarters to the permanent establishment, which are intended for sale in the State where the latter operates. SKAAR[28] points out that the transfer of goods, services and intangible property between the departments of the same taxpayer will not be taxable; rather, the taxable event occurs when the goods or merchandise is transferred later by the permanent establishment to a third party. Likewise, VON UTHMANN[29] argues that in Sweden the transfer of assets from the headquarters to a permanent establishment, under the general internal principles and the fiscal credit of the relevant double imposition agreement, will not pay taxes

concluded that the shares that are to become part of the effective capital held by the foreign agency in the country for its business activity do not purport the sale of such securities, because the holder thereof remains being the same legal person. Such shares may only be allocated to the performance of operations in Chile, but the ownership thereof shall remain unaltered".
In Australia, in the Max Factor case, the Supreme Court ruled that an entity cannot earn profits from business conducted with itself. Likewise, in India, the courts have ruled that a permanent establishment and its headquarters are part of the same legal entity and cannot earn profits from each other (BAKER, Philip and COLLIER, Richard, Op. cit. [n° 15], p. 38.)

24 *Ruling issued in the matter of Cudd Pressure, 1999, 1 CTC 1 (FCA), cited by DARMO, Marc and SMIT, Carrie, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 236.*

25 *VON UTHMANN, Karin, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 640.*

26 *Subparagraph 18 of paragraph 3° of section 7° of the OECD model agreement.*

27 *Subparagraph 18.1 of paragraph 3° of section 7° of the OECD model agreement. It should be noted, however, that the OECD comments recognize special situations, in the case of interest payments made among the different parts of a financial company (e.g., a bank) for advances and similar concepts (other than provision of capital), based upon the close relationship between the granting and reception of advances and the corporate purpose of such companies.*

28 *SKAAR, Arvid, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 525.*

29 *VON UTHMANN, Karin, Op. cit. (n° 25), p. 639.*

until the assets are sold to a third party alien to the company.

However, in other legislations, such as in South Africa, there are special rules governing the transfer of assets between headquarters and permanent establishment, which are rendered by such legislation as a sale at market price and an immediate sale at such same value. This same rule applies inversely; that is, in the case of a South African permanent establishment that transfers an asset to non-resident headquarters[30]. In this State charging the expenses incurred in such operations would be legitimate.

4. CONCLUSIONS

The analysis of the formulated hypothesis shows that the OECD model agreement proposes a generic regulation regarding expenses that can be charged to income attributed to a permanent establishment, a situation that is complex given the innumerable situations that may arise from the operations conducted between a permanent establishment and its headquarters. In this scenario, the internal legislation will fill the gaps not allowed for in the relevant agreement.

The principles determinant of the jurisdictional factors in the taxation of income attributed to permanent establishments should be fully considered at the time of assessing expenses. The complexity will lie in the establishment of the boundaries of application of the agreement rules and the internal legislation, particularly where the permanent establishment intends to charge expenses tied to income obtained in a State different from the one in which it operates.

From the analysis of the above, within the context of paragraph 3° of section 7° of the OECD model agreement, it is not possible to specify whether the expenses tied to non-taxed or exempted income can be accepted as such, leaving no choice but to apply the internal legislation of the State where the permanent establishment operates; and in this sense, where the internal legislation so provides it, the expenses tied to non-taxed or exempted income may not be charged as such.

Alternatively, where expenses tied to both the headquarters and the permanent establishment are accounted for, such expenses should be separated or prorated. In the specific case of general administrative expenses incurred by the headquarters on behalf of the company, it may be appropriate to calculate a proportional part according to the relation between the sales volume of the permanent establishment and the sales volume the whole company. If upon reviewing the accountability of the headquarters and the permanent establishment there are items depicting purely artificial functions instead of the actual economic functions of the different parts of the company, then such items may be disregarded and the pertinent adjustments may be made.

Lastly, in view that the permanent establishment and its headquarters constitute the same entity, if the accountability of such establishment records expenses reportedly tied to agreements celebrated with its headquarters, then such entries should be corrected and the expense should be included in profits. Now, under certain circumstances, deducting expenses tied to certain operations between the permanent establishment and its headquarters would indeed proceed, specifically upon carrying out business with third parties, resulting in taxable income.

30 *HATTINGH, Johann y NEWTON, Basil, Cahiers de droit fiscal International: The attribution of profits to permanent establishments, V .91b, in International Fiscal Association, (The Netherlands, 2006), p. 578.*

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Environmental Towards Taxation

Edgardo Héctor Ferré Olive

SUMMARY

As a consequence of the global environmental deterioration, countries must develop mitigation strategies and discuss whether they can preserve the existing resources through the implementation of environmental taxes or control administrative mechanisms to provide a solution to environmental problems. This paper outlines such instruments and mechanisms within a sustainable frame by proposing the analysis of a green fiscal reform.

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INTRODUCTION

Content:

We are confronted with one of the greatest challenges of this century posed to humanity; the global climatic change is increasing mean temperatures, altering rainfall patterns, raising the sea level, reducing the surface covered by snow and glaciers, etc.

An international mitigation strategy is required that considers the magnitude of the economic costs implied and is related to the characteristics and alternatives of economic development in the next decades. [1]

Given the environmental deterioration occurred in the last years, the lack of environmental information available to the citizens and a lack of effectiveness of the regulatory mechanisms used to protect the ecosystem, it should be analyzed whether the implementation of environmental taxes is apt to preserve the existing resources and overcome the problems generated in the environment within a tax system that adopts them.

1. ECONOMIC AND SUSTAINABLE DEVELOPMENT

The Bruntland Report of the World Commission on Environment and Development (1987) incorporates the concept of sustainable development, which is such development that meets the present needs without compromising the ability of future generations to satisfy their own needs.

The guidelines set out in such report are the following:

- The pace for extracting renewable resources should always be less than the pace of natural regeneration.

1 *On this regard, the ECLAC believes that in the 21st Century the economies in Latin America and the Caribbean will be confronted with the challenge imposed by the climatic change, including the costs of adaptation and mitigation, while simultaneously deal with other pending issues, such as sustainable economic growth, job generation or poverty reduction. In "The economy of climatic change in Latin America and the Caribbean, 2009 Synthesis", United Nations, Economic Commission for Latin America, 2009, p. 9.*

- The waste flow should be kept below or on the same level as the assimilation capacity of the environment.
- The reduction in non-renewable resource inventory should be offset by an increase in renewable resources.
- The reduction in non-renewable resource inventory should convey an increasing efficiency of use.

This report further outlines two more concepts: intra-generational and intergenerational equity.[2]

On the issue of dealing with environmental problems a reference is made to the preservation of the rights and interests of future generations; but a problem that is to be discussed today, for it is one faced by current generations, is the social exclusion suffered in our planet.[3]

Sustainable Development is an economic development model that allows meeting the current needs without jeopardizing the satisfaction of the needs of subsequent generations. In the economic theory the market today brings producers and consumers face to face, without regard to the needs of future generations. Is it possible to establish an intergenerational solidarity based not on selfish but on supportive efforts?[4]

This requires the analysis of environmental economic aspects, the application of Economic Instruments and the treatment of environment-related taxes and rates.

Environmental concepts have been present in the study field of Economics ever since its inception as a scientific discipline.[5]

From an ecological viewpoint, with the Industrial Revolution humanity ceases to depend exclusively on solar energy to cover its basic needs (given the impact of such energy on the life cycle of agricultural products), and begins to develop manufacturing processes able to generate energy in fossil state (petroleum, coal, etc.) through a development and expansion process supported by the “classic” school of economic thought and Adam Smith’s division of labor.

The so-called “neoclassic” school arises in Europe in the late 19th Century with a view to adapting sciences to the methodologies used in physics and mathematics.

2 *On this issue, Garnica indicates that intra-generational equity is the fair distribution of both environmental income and costs, which leads to plan the redistribution of income and costs among a country’s population; whereas intergenerational equity is the fair distribution of environmental income and expenses among present and future generations. In Garnica, Juan F. “Tributos orientados a la protección del medio ambiente”, Doctrina Tributaria Errepar, Volume XXVI, July 2005.*

3 *Fazio, Horacio, “Racionalidad Económica, ética ambiental y generaciones futuras”, in “Ambiente, economía y sociedad”, FLACSO-LIBRONAUTA, Buenos Aires, 2001.*

4 *This intergenerational solidarity relates to the intertemporal choice faced by the regulator when determining the level of environment protection and the effects on consumption or the exploitation of natural resources. In selecting the optimal sequence of intergenerational consumption a fair treatment should be given to future generations by weighing their wellbeing. In Ianello, Pablo A. “ Elección intertemporal y el tratamiento igualitario intergeneracional”, Revista de Derecho Ambiental, N° 12, Lexis Nexis, Argentina October/ December2007, p. 173 through 177. One of these natural resources is water, which is a common or collective good and is part of the common heritage of humanity, of which current and future generations are its owners.*

5 *The first school of economic thought acknowledged as such was “physiocracy”, which considered that the only activity likely to generate wealth was agriculture, and that thanks to trade this wealth was transferred from agriculturists towards the rest of society. As indicated by Repetto, physiocracy emerged in France during the 17th Century, its main exponents being Richard Cantillon Francois Quesnay, Jean Vincent and Pierre Samuel du Pont de Nemours; in Repetto, Patricio Ernesto “La ecología en la Ciudad de Buenos Aires. Enfoques particulares de las Ciencias Económicas”, EDICON, published by Consejo Profesional en Ciencias Económicas de la C.A.B.A., Buenos Aires, 2007.*

An economist of this school, Arthur Pigou, developed the concept of "externality", which are the consequences – economic or extra-economic – of the exchange of goods or services in the market and which may affect third parties. These can be positive or negative: positive if, for example, the owner of a shop installs a lighting system that also benefits other nearby shops; and negative if a contaminant-producing factory is built in a tourist city.

The key aspects for discussion from the perspective of the environmental economy include:

Property rights:

This is a very interesting analysis, since natural resources and waste are, on principle, nobody's property. If privatization is sought, its application is more complex because nobody will want to own waste with no economic value; but what can be achieved is that the person generating the waste may become the owner thereof and be held responsible for its disposal.[6]

Externalities:

It is a concept of utmost importance in environmental economy. Externalities are the consequences – whether economic or extra-economic – of the exchange of goods or services in the market which may affect third parties, and which may be positive or negative.

For the purposes of the environmental effects of economic activities, the concept of externality conveys not an economic but a political valuation; it is a decision made by the government rather than a valuation based on the costs and benefits of the different economic agents operating in the market.

The problem is how to assess these externalities and how to charge them.[7]

As to their valuation, one possibility is to apply the "polluter pays" principle (PPP). In the case of the contaminating company, the economic value of the environmental externalities generated by a factory that contaminates a town would be the economic cost of reestablishing such contaminated town to its original state, or maybe to a condition of minimum pollution, the limits of which should be applied through the adoption of a political decision. Such cost entails establishing a system of monthly payments equal to the externality valuation, which the government will invest in sanitation works.

Sometimes these costs cannot be calculated and other times the presence of contaminating activities forces the need to change the industrial model of a country, which entails incalculable decontamination costs.

Externalities may be collected through fines, monthly payments or an eco-rate, but if its cost cannot be borne by the society, the activity should be then closed down.

Eco-rates or ecological taxes:

Eco-rates are taxes levied on economic activities that generate negative environmental

6 *On this regard, Perez states that the studies conducted by Coase on the social costs show that if transactions are made free of cost and the appropriation rights are clearly established, a redistribution will take place whose result will be that of maximum efficiency. These "appropriation rights" are the English translation of the term "property rights" and have a wider meaning than "ownership right". Perez gives the example of a company authorized to dispose of its waste onto the river, in which case it is not being granted a property right over the river but an appropriation right, and the awarded company should perform in the most efficient manner. In Perez, Daniel G. "La reforma fiscal verde y los tributos argentinos", Universidad de Buenos Aires, Facultad de Ciencias Económicas, Centro de Investigaciones Tributarias, Director: Luis Omar Fernández, 2009, p. 20.*

7 *Delacámara, in an externality valuation analysis, states that many decisions are adopted by considering the economic aspects but fail to allow for the knowledge, valuation or accountability of the associated externalities. In Delacámara, Gonzalo "Guía para decisores. Análisis económico de externalidades ambientales", United Nations, ECLAC, Draft Project, 2008, p. 15,*

externalities. The purpose of their application is to assess them and to bring market competitiveness to other activities or technological alternatives less harmful to the environment. Eco-rates may be final, in which case tax collection promotes alternative technologies via subsidies, by applying an eco-rate not intended for collection purposes but as incentive for clean economic activities.

Subsidies:

Subsidies for clean technologies or those substituting renewable resources for non-renewable resources are the quid pro quo for eco-rates. Therefore, if there is a positive externality (e.g., the installation of renewable energy that saves fossil or non-renewable fuel) the society can reward such externality by means of an aid or subsidy.

2. ECONOMIC INSTRUMENTS

The use of economic instruments by the State in environmental matters should lead to a rational utilization of natural resources. An efficient management of environmental resources is based on the internalization of prevention, control and damage costs deriving from pollution.

Such internalization may be done in two ways:

a) through administrative regulation (“command and control”) or
b) through instruments based on market mechanisms (“incentive-based”) [8].

As indicated by Macón[9] , there are three classes of instruments intended to reduce contamination – i.e., externalities – to a level compatible with a healthy life: “administrative mechanisms”, “private transactions” and “fiscal mechanisms”.

The administrative mechanisms entail the identification of causes and the application of fines, which may lead to closure. It is criticized because these mechanisms reduce or eliminate the economic activity and solve the issue of contamination in a non-rational way. The financial mechanisms are those adopted by the Organization for Economic Cooperation and Development (OECD) through the “polluter pays” principle.

The economic instruments are market-based and constitute political tools that affect the behavior of economic agents with a view to meeting environmental policy targets or modifying certain behaviors by issuing notices in the market, instead of issuing regulations on the control of the level or form of contamination.

8 *These instruments are mentioned in the Agenda 21 , UN’s Conference on Environment and Development, Brazil, 1992, Chapter 8,subsection C “ Effective use of economic instruments and market and other incentives”, items 8.27 through 8.40. In the European Union, these are outlined, among others, in the Fifth Environmental Action Programme of European Communities (1993), item 31 “Wider range of instruments” , and the Sixth Action Program (2001), item 2.3 “Encouraging the market to act in favor of the environment”. They are also found in the Mercosur Frame Agreement, Act Nº 25841, which sets out actions to foster the internalization of environmental costs through the use of management economic and regulatory instruments.*

9 *Macón, Jorge “Economía del Sector Público”, Mc Graw –Hill Interamericana, Buenos Aires, 2000, pp.. 43 et seq. Other authors, such as Magadán Díaz, Marta and Rivas García, Jesús in “ Fiscalidad y medio ambiente en España”, Septem Ediciones, Oviedo España, 2003, p. 8, state that within the frame of a theoretical analysis of Environmental Taxation there are three ways to overcome or internalize the externalities: through taxes, by defending property rights, and lastly, through administrative rules or regulation.*

The theory indicates that where adequately established, the economic instruments allow achieving any level of pollution control at the lowest global cost to society.

With relation to the externality, this can be internalized by making it part of the process originated by it. If negative, it will be included in the costs to be borne by whoever generates it; while if it is positive, it will be included in the amounts to be received by the beneficiary.

When analyzing environmental pollution from the economic perspective there are divergences between social and private costs, which are called external economies or diseconomies (externalities), as outlined by Pigou.[10]

Therefore, the costs incurred should be borne and accounted for by the manufacturing companies, considering the total costs and the existence of positive and negative externalities, and procuring an optimal allocation of resources and equating the private costs with the social costs (borne by the community).

If this situation is not achieved, then the State should step in.

CLASSIFICATION OF ECONOMIC INSTRUMENTS

The following are the main categories of economic instruments:

a) Taxes on emissions and effluents
b) Waste treatment and disposal rates
c) Ecological taxation (fiscal instruments or eco-taxes)
d) Penalties for non-fulfillment
e) Taxes on proceeds
f) Refundable deposits
g) Tradeable emission rights or certificates
h) Tradeable rights for resource use
i) Rates on the use of natural resources or environmental enjoyment
j) Performance bonds

An alternative to the economic instruments is the establishment of a direct regulation of command and control, used where high levels of environmental protection are required in the short term, or where strict controls are needed.[11]

This regulation may include:

- specific targets for contaminating emissions
- product industrial standards
- mandatory product labeling
- use of specific technologies to control or minimize damages to the environment

The public administrations order the performance of these procedures by way of laws, which are controlled subsequently to assure their compliance. One disadvantage with regard to the pursuance of a better quality and protection of the environment is their lack of flexibility. They further oblige the industry to meet the obligations required by the regulation without considering the costs that are to be borne.

The administrative control sets limits to the quantity and quality of effluents or emissions or disposals onto the environment. This control can be effective at first to raise awareness in the population regarding the reduction of pollution, waste or a better understanding of the need to preserve the environment.[12]

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10 *Pigou, A.C. "La economía del bienestar ", p. 146 et seq. Madrid, 1946, Ediciones Aguilar. This author gives the example of a locomotive whose sparks harm the harvests of agriculturists living near the railway. This means of transport does not suffer or accounts for the damaged caused, so the social cost of the train is different and greater than the private cost, thereby giving rise to a negative externality.*

11 *Yabar Sterling, Ana and Herrera Molina, Pedro "La Protección Fiscal del Medio Ambiente ", Chapter II, "Instrumentos Jurídico-Públicos de Protección del Medio Ambiente", Marcial Pons , Ediciones Jurídicas y Sociales S.A., Madrid- Barcelona, 2002, p. 127 through 183.*

12 *Rosembuj, Tulio "Los tributos y la protección del medio ambiente", Marcial Pons , Ediciones Jurídicas, S.A., Madrid, 1995, p. 49.*

The economic instruments comprise emission taxation, pollution rights, refundable deposit systems and subsidies, among others.

The Organization for Economic Cooperation and Development prefers the use of economic instruments because they are an ongoing incentive to reduce pollution and they allow polluting agents to save costs, since they can look for different options to reduce contaminating action and are more flexible than regulatory or administrative (command and control) solutions.

In this sense, environmental taxes can play an important role, either by creating new taxes or modifying existing ones, considering the tax problems that may arise from the neutrality thereof.

3. TAXES AND RATES

The rate is intended to finance the cost of a certain public service and the tax entails a generic impact with no pre-established amount.

Environmental taxes are such special taxes, rates and contributions whose structure establishes an incentive for environmental protection, or else offset the damages caused to the environment by the persons bearing the tax burden.

The ideal ecological tax will not generate zero collection. The lack of collection is equal to the total absence of taxable behavior and this should not be pursued through a tax but through prohibition, penalties and administrative control.

There are different classifications of environmental taxes, namely:[13]

- cost-covering rates
- user rates: intended to cover costs of environmental services and anti-pollution control measures (waste rate)
- cost recovery rates: used to finance related environmental expenses (disposal rates or rates on noise pollution generated by aircraft)
- incentive-oriented taxes, which try to change the behavior of producers and consumers (tax on fertilizers or water contamination)
- environmental taxes, intended to increase collection (tax assessable on carbon dioxide emission)

The tax classification (taxes, rates and contributions) differs from the concept of environmental tax.

The taxes are based on the economic capacity and the rates on the equivalence principle, but both environmental taxes and rates abide by the "polluter pays" principle which, under the German doctrine, is a manifestation of the equivalence principle.[14]

The difference between the ecological rate and the tax is that the latter is not intended to cover the cost of a public service associated with environmental property, but to reduce or prevent emissions damaging the environment; the tax is not compared against the price but against the regulatory prohibition.[15]

13 *Magadán Díaz, Marta and Rivas García, Jesús " Fiscalidad y medio ambiente en España", Septem Ediciones, Oviedo España, 2003, p. 8.*
14 *Herrera Molina, Pedro M., VI Congreso Nacional del Medio Ambiente, Grupo de Trabajo 25, Fiscalidad Ambiental, Spain, 2002..*
15 *Op. cit. in 12 , p. 86*

The adequate fiscal precept is the tax; the rate can be used for authorizations, permits, emission controls or individualized services.

The management of waste for environmental tax purposes cannot be effected with the rate because the same fails to apply the twofold collection-behavior change mechanism, which is consistent with another tax precept that is the special negative tax or contribution.[16]

ENVIRONMENTAL TAXES

For the purposes of discussing their main aspects, they are classified as:

a) Excise taxes
b) General taxes on consumption and inputs
c) Taxes on emissions
d) Differential taxes, subsidies and incentives
e) Green Certificates
f) Emission Permits – Tradeable Licenses
g) Refundable deposits

a) Excise taxes

These special taxes apply to contaminating goods, whether in the industrial, consumption or waste stage.

It applies to pesticides, lubricants, sulphur contained in fuels, fertilizers, batteries, non-returnable packaging.

Product taxes assess "inputs" of manufacturing processes – raw and intermediate materials for production – or final consumption goods.

The advantage of applying this type of tax lies in their reduced administrative costs.

The disadvantage of applying it is that the ecologic valuation will depend on the complex relationship between the product consumption and the environmental problem.

Ecological taxes may be applied to this type of products to modify relative prices and reduce their consumption or encourage their substitution. The effectiveness of these taxes will depend on demand elasticity and product substitution.

b) General taxes on consumption and inputs

Where the goal is to tie indirect taxation to the environmental result, a tax on value added pollution may be suggested, tied to the pollution, to increase the product's cost and discourage the demand for consumption of non-eco-friendly goods and services.

The end of this type of tax is to reduce the global pollution in the ozone layer.

As regards the competitiveness of products manufactured in countries adopting this tax on added pollution, the assessment applies to the products produced in the country and is exempted for export purposes.[17]

An excise tax on consumption is the carbon tax, which assesses the carbon content of fossil fuels, intended to replace current taxes on fuels and energy use, and which assesses fuels but proportionately to their carbon content (this carbon tax is tied to the "greenhouse effect").[18]

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16 *Op. cit. in 12, p. 205. Chico de la Cámara explains that this special negative contribution has been used in the scientific doctrine with two completely different meanings: a) to refer to assumptions where the Administration agrees to the creation of disadvantageous situations prejudicing a group of individuals, and b) when the public body demands this contribution to finance public service works, establishments or expansions aimed at correcting or reducing the environmental contamination originating in the advantageous situation – "private benefit" – enjoyed by some individuals with respect to the rest of the society. In Chico de la Cámara, Pablo "Un apunte sobre la naturaleza jurídica y la valoración constitucional de las contribuciones especiales medioambientales", Yábar Sterling and Herrera Molina, Obra Colectiva, 2002, p. 243 through 245.*

17 *Op. cit. in 12, p. 111*

18 *Macón, Jorge "Economía del Sector Público", Ediciones Mc Graw –Hill Interamericana, Buenos Aires, 2000, p. 43 et seq.*

The tax on consumption brings about problems in the distribution of the fiscal burden and increases the regressive nature of the tax system.

The OECD recommends consumption taxation but indicates that not all contaminating "inputs" can be taxed, and renders the VAT not an ideal mechanism because passive taxpayers do not consider it a cost on production factors.[19]

These taxes assess the use of certain pollution-generating inputs and attempt to modify the economic agent's behavior by encouraging the use of less contaminating inputs.

This is limited by the fact that one input may cause contamination in one case but not in all cases, affecting the business costs groundlessly, since in practice it is very difficult to distinguish a tax on a product according to its destination.[20]

This type of encumbrance can be applied in an anti-contaminating tax system if the tax can be differentiated according to its destination and where the number of taxpayers causing contamination is so high that they can be adequately controlled (by taxing the consumption of non-renewable fuels).

c) Taxes on emissions

In this type of taxes the taxable event is the emission of contaminating substances or gases.

The disadvantages arising from the application of this type of tax are:

- that these systems have no relation with the effective tax systems, and
- that they are difficult to control, because they require monitoring.

They are based on the quantity and/or quality of the discharges contaminating the environment. They are set as per the volume of emissions and the degree of ecological damage, and are called "Pigou taxes".

These assessments can be uniform or differ as per the quantity of treated effluents.

The degree of environmental damage is measured in contaminating units and the revenues resulting from this charge are allocated to actions intended to maintain or improve the water quality and to cover administrative costs incurred.

They are compatible with the "polluter pays" principle, but assessing their taxable base is difficult.

There are two alternatives when it comes to quantification:

a) assessing the damage to the community through contamination (medical, cleaning, expenses, etc.), or
b) in terms of opportunity costs, getting the producer to pay the cost incurred by the community to eliminate all their waste.

d) Differential Taxes-Subsidies-Incentives

d.1) Differential taxes

Differential taxes are used as incentives in the transportation area. High taxes are imposed on contaminating vehicles to encourage purchase of clean cars. They are used in many countries to differentiate the price of gasoline, charging a higher price for gasoline containing lead.

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19 *OECD, "La fiscalidad y el medio ambiente. Políticas complementarias", Madrid, 1994, p. 109. Rosembuj, Op. cit. in 12, p. 258, believes that this critique is not well grounded. This tax can be used for environmental purposes considering the final consumption of contaminating goods or services with a global application and proven administrative management mechanisms.*

20 *Macón, Jorge "La política fiscal en el contexto de la contaminación ambiental", published in IMP. 1980- A. 141 and in "Impuestos-Doctrinas Fundamentales 1942-2002", Editorial La Ley, Buenos Aires, 2002, p. 395 through 403.*

These taxes are part of the tax systems, are used as incentive and apply the PPP principle.

d.2) Subsidies

The difference between a tax and a subsidy is that where the former is applied to the company, the company experiences an increase in costs and a reduction in output. Whereas with the subsidy, it can be additional revenue with no effect on pollution or it may cause its increase. Therefore, subsidies should be granted on condition that contamination is reduced.

Subsidies are a financial aid intended to modify the contaminators' behavior or to finance companies making changes in their production process in order to meet environmental requirements.

Subsidies are also granted for the development of non-contaminating technology.

But the problem is that subsidies tend to impede transparency of the relative prices of products. The alternative of obtaining revenue by reducing other taxes creates the risk of posing a conflict between the ecological effectiveness of taxation and the fiscal benefits.[21]

The OECD believes that the use of subsidies should be justified and that observance of the "polluter pays" principle should be controlled, and indicates that subsidies lack the effectiveness of taxes to grapple with the damages caused to the environment.

According to Macón[22], this modifies the principle formulated by the OECD, from a "polluter pays" to a "polluted pays" principle. And according to the tax in question, even contaminated and not contaminated people alike may have to pay.

These subsidies offered to companies may consist of a tax reduction – maybe in the form of a special deduction of the income tax on the portion of the cost of depurating equipment – in return for avoiding pollution.

d.3) Incentives

Tax stimuli are economic incentives of a fiscal nature. These incentives may be used to finance directly the technological restructuring of a business intended to protect the environment.

The incentives may be loans having special terms for borrowers or reduced interest rates in comparison with market values, tax exemptions or incentives and rewards for the disposal of waste or residues.

They are targeted at modifying the behavior of contaminating agents, but are criticized because they affect the fairness in the application of taxes, the application of the "polluter pays" principle and fail to contribute to tax harmonization.[23]

e) Green Certificates

Green certificates are tradeable titles that evidence that taxpayer is using clean energies, such as the generation of power from a renewable source.

This brings about two effects:

- the environment is protected and the exhaustion of non-renewable resources is avoided
- renewable energy sources contribute to mitigate the climatic change because they do not give off greenhouse gases to the atmosphere

21 *OECD, "La fiscalidad y el medio ambiente. Políticas complementarias", Madrid, 1994, p. 110.*

22 *Macón, Jorge "Economía del Sector Público", Ediciones Mc Graw –Hill Interamericana, Buenos Aires, 2000, p. 46. Op. Cit. in 18 . As stated by Valls, "... the amount of the subsidy should be high enough so as to dissuade the beneficiary from continuing to damage the environment, but low enough so that the community should not be paying more than the effective worth of the environmental protection achieved"; in Valls, Mario Francisco. Manual de Derecho Ambiental. Ugerman Editor, Buenos Aires, 2001, p. 95.*

23 *Alurralde, Aldo M., Mordini, José S., Catinot, Silvia G. "Ecotributos e incentivos tributarios". Ediciones La Ley, Periódico Económico Tributario 122, 2004.*

This system of green certificates operates when energy consumers (companies or individuals) acquire a certain quota of renewable energy. These certificates also make for a production "input" in that the use of energy in the processes is supported, whichever their source, up to the value assigned in the certificates.

f) Emission Permits. Tradeable Licenses

At the Kyoto meeting, held in Japan in December 1997, 162 countries agreed to reduce the emissions of carbon dioxide and other gases causing the greenhouse effect. This "Kyoto Protocol" provides that industrial countries should reduce their emission levels by 5.2% in the period 2008-2012, down from the levels recorded in 1990. This goal has not been consistent, for the European Union set a reduction goal of 8%, while Japan and the United States agreed to reduce emissions by 6% and 7%, respectively.

This Protocol implies that countries should assess the cost of its application and determine the policies applicable to comply with it. There is no international consensus on the policy options intended to achieve the goals and meet the established terms, but authorities will have to choose between two economic instruments: ecological taxes (or eco-rates) or tradeable licenses as supplement to most traditional policy instruments such as direct intervention and regulation (called "command and control measures").

Most countries have more frequently resorted to taxes than to licenses to control pollution. In Europe projections are being made using eco-rates, but an increasing interest is observed in experimenting with tradeable licenses, especially in light of the emission goals set by the Kyoto Protocol.[24]

For the post-Kyoto period (from 2012), the aspects discussed in the Climatic Change Summit in Copenhagen (COP 15, 2009) should be considered, as well as those that will be discussed in the coming Conference (COP 16, 2010) to be held in Mexico.

g) Refundable Deposits

The consumer pays a deposit upon making the purchase. On returning an empty packaging to a recovery or waste center, the deposit is reimbursed to them, which constitutes the subsidy.

This restitution is aimed at reducing environmental damage that would otherwise occur with illegal waste or disposals.

The OECD defines this system as a deposit (tax) charged for a potentially contaminating product, which is to be refunded upon returning the packaging to a shop or waste treatment or recycle point. It may apply to bottles, used lubricants, car batteries, mercury batteries, etc.

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24 *Norregaard, John- Reppelin Hill, Valérie "Control de la contaminación mediante el uso de impuestos y licencias negociables ", in Temas de Economía, and based on "Taxes and Tradeable Permits as Instruments for Controlling Pollution: Theory and Practice." International Monetary Fund, Washington, 2000. Acquatella outlines the economic fundamentals of flexibility mechanisms for the international reduction of emissions within the frame of the Climatic Change Convention, conducting an analysis of the estimation of the costs and the reduction of emissions to meet the goal of the Kyoto Protocol (p. 11), the economic fundamentals of the international market (CDM: clean development mechanism) (p. 15) and the political aspects of CDM negotiation (p. 27). This author's analysis of the political aspects is very interesting, and particularly the United States' and the European Union's position regarding the principle of "complementarity" (this criterion requires that a percentage of the total emission reduction undertaken by the countries listed in Annex B of the Kyoto Protocol be performed in their own territories, and the rest may be carried out "complementarily" through flexibility mechanisms); in Acquatella, Jean "Fundamentos económicos de los mecanismos de flexibilidad para la reducción internacional de emisiones en el marco de la Convención de Cambio Climático (UNFCCC)", ECLAC, Environment and Development Series N° 38, Santiago de Chile 2001.*

Table 1 shows some environmental incentives and taxes applied in the European Union.[25]

TABLE 1. Environmental incentives and taxes applied in European Union Countries

Environmental incentives	• Corporate income tax • Individual income tax
Fuel taxes	• Value added tax • Excise tax on consumption • Other taxes
Energy product taxes	• Tax on the sale of vehicles • Annual tax on holdings • Fiscal treatment of company automobiles and expenses incurred in commuting to the workplace
Agricultural input tax	• Tax on fertilizers • Tax on manure • Pesticide retail sale • Tax on excess animal fertilizers • Tax on fertilizers and pesticides
Special taxes on other goods	• Lubricant oils • Beverage packaging • CFCs • Electric shavers • Disposable photographic cameras • Disposable glasses, plates and cutlery • Polyethylene used as raw material to manufacture plastic bags • Common light bulbs • Batteries • Sand and gravel
Other environmental taxes	• Airport rates and other rates on civil aviation causing environmental impacts • Monthly payments for water supply and water disposal services

Source: *Magadán Díaz, Marta and Rivas García, Jesús I. "Fiscalidad y medio ambiente en España", Septem Ediciones, Oviedo, 2003, Chapter 2 "La Fiscalidad Ambiental en la Unión Europea", Table 2.1, p 21.*

25 *On this regard, the particular tax measures adopted by the different countries to protect the environment should be assessed. The 2008 CIAT Technical Conference in South Africa featured several presentations concerning the extra-fiscal functions of taxation and their repercussion in tax administrations, delivered by speakers from the Netherlands and Germany. The Netherlands apply taxes on ground water, drinking water, waste, coal, energy, air passengers, packaging, mineral oil consumption and automotive vehicles. The ecological incentives relate to deductions in energy investments, environmental investments, green investments and the application of differentiated environmental tax rates.*
Germany applies taxes on vehicles, ecological taxes (energy treatment), air traffic and consumption. Incentives concern the application viability of different VAT tax rates on energy products or energetically efficient products, and certain fiscal benefits and exemptions; in Inter-American Center of Tax Administrations (CIAT), Technical Conference on "Emerging topics in the agenda of tax administrations", Johannesburg, South Africa, 2008, published in AFIP's Tax Bulletin N° 136, November 2008, p. 2031 through 2088.

4. ASSESSING THE ENVIRONMENTAL TAX

Any tax of an environmental nature should influence the behavior of economic agents and the payment of the tax should be tied to the environmental problem.

One aspect to be considered is that in regulating an environmental tax there are political-institutional aspects that should be coordinated to enforce it. This will entail coordination between the environmental authorities, which should identify the environmental problem and determine which correction is pursued with the tax.[26]

The tax policy and administration will decide on the feasibility of the application and administration of the tax.

An outline of an Environmental Taxation Code Model for Latin America[27] indicates the guidelines to be considered to establish Environmental Taxes, defining the proposal along several subsections:

1. The concept of environmental tax and aspects to be considered for the taxable event.
2. Compensation of damages caused as a result of the taxable event (obligation to correct).
3. The treatment of cases of absolute prohibition, because prohibited conducts harmful to the environment cannot be taxed.
4. Consideration of the cases where acts or facts negatively affecting the environment or demanding environmental guardianship occur as a result of acts of God or force majeure ("non taxable assumptions").
5. The creation of an environmental tax, and the projects for the establishment of this type of taxes, should include (under penalty of nullity, by law exclusively, of the provisions setting the amount of the environmental tax) an environmental technical economic study intended to justify the quantification criteria used.
6. This technical economic study will serve as quantification parameter for the collection of the environmental tax, which may not exceed in aggregate the largest amount among the damage caused, the cost that taxpayers should have borne to avoid the damaged caused and the cost of public environmental guardianship activities. Should this criterion not be applicable, the individual impact of pollution must be determined, for which purpose environmental progressiveness criteria may be used.
7. In establishing the environmental taxes, the different government levels should abide by the taxation consistency principle (the failure to fulfill this requirement will result in the nullity, by law exclusively, of the provisions setting the amount of the environmental tax).
8. Once this legislation is in place, the local provincial or municipal governments should sanction their own legislation regarding specific environmental taxes.

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26 *The tax authority may determine that the application of a tax is not feasible (on the grounds that it constitutes a high administration cost in comparison with tax revenues, or that it poses a conflict with another tax base) and thus rule out its application. In Motta, Ronaldo Seroa da "Tributación ambiental, macroeconomía y medio ambiente en América Latina: aspectos conceptuales y el caso de Brasil", ECLAC, Development Macroeconomics Series N° 7, Chile, 2001, p. 42.*

27 *Instituto de Estudios Fiscales (IEF), España. "Modelo de Código Tributario Ambiental para América Latina", Directors Miguel Buñuel González and Pedro M. Herrera Molina, Doc. N° 18/03, 2001. This document of the IEF features an introduction to the method and plan and a synoptic chart describing the current situation of the countries analyzed in the document, including references to the Taxation Code Model for Latin America and CIAT's Taxation Code Model. The countries analyzed are Argentina, Brazil, Colombia, Costa Rica, Chile, Spain, Mexico and Panama.*

5. THE ENVIRONMENTAL FISCAL REFORM

In the path towards a sustainable development, the economic and environmental policies should be integrated with an environmental fiscal reform targeted at such direction.

The environmental policy and the fiscal framework should be coordinated, even though studies conducted by ECLAC[28] indicate that most Latin American countries lack an operating platform favoring the coordination of policies and the joint development of economic instruments between environmental and fiscal authorities.

The persons responsible for making decisions on the proposal of an environmental fiscal reform may opt among three types of environmental decisions[29], which can be supplemented with one other:

- **The elimination of subsidies:**

Subsidies affect the financing of resources allocated to the environment and their elimination or reduction (as applicable) allows obtaining a twofold benefit upon generating revenues that may be used to cut down the rates of other taxes that distort the economy.

Some of these subsidies make up the deduction of taxes in transportation expenses and the tariffs of subsidized energy; these tax measures applied in the energy sector lead to high consumption rates and increased pollution.

- **The restructuring of existing taxes:**

Fuel taxes were created originally with a view to generating tax revenues for governments. In OECD countries, taxes account for 80% of the fuel price. The idea has been to index the tax on the level of fuel pollution. The market has responded with the creation of cleaner fuels (lead-free gasoline).

- **The introduction of new environmental taxes:**

Some OECD countries have created new product taxes, assessments or rights on, e.g., residues, batteries, packaging, pesticides, fertilizers, detergents and oils. The purpose is to reduce their consumption and minimize their impact on the environment.

The application of the Ecological Fiscal Reform is based on three objectives[30]:

1. The incorporation of environmental provisions into the tax system, with a view to modifying, if not suppressing, the tax structures that in continuing to grant benefits to contaminating taxpayers foster behaviors prejudicial to the natural environment.
2. The establishment of environmentally-friendly tax precepts.
3. A design of high value taxes (income tax, VAT, corporate tax) inspired by a philosophy of natural environment protection based on the concept of sustainable development.

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28 *Acquatella, Jean "Construcción de una plataforma operativa para lograr mayor coordinación entre la política ambiental y el marco fiscal: El rol conjunto de las autoridades ambientales y autoridades fiscales". ECLAC, Workshop on Fiscal and Environmental Policy, Santiago de Chile, 2003.*

29 *Barde, Jean Philippe "Reformas Fiscales Ambientales, una revisión de la experiencia en países de la OCDE", in "Impuestos Ambientales. Lecciones en países de la OCDE y experiencias en México", Instituto Nacional de Ecología. Mexico, December, 2002.*

30 *López Guzmán, Tomás J., Lara de Vicente, Fernando and Gómez Puerto, Ángel B, in "Medio Ambiente y Reforma Fiscal: una Propuesta Autonómica", Revista Interdisciplinar de Gestión Ambiental (Editorial La Ley), N° 73, Spain, 2005.*

Likewise, Gago Rodríguez, Labandeira Villot and Rodríguez Méndez[31] point at three phases in the design of green tax reforms:

1. a comprehensive review of the effective fiscal system, with a threefold objective: substituting, under the fiscal neutrality principle, taxes on environmentally harmful activities for taxes penalizing labor; introducing new ecological arguments or elements in indirect taxation – in particular that assessing energy -, and eliminating fiscal incentives – deductions, exemptions, early amortization, etc. – that foster activities inconsistent with a natural environment concept.
2. the creation and introduction of new ecological taxes in the indirect taxation field – for example, taxes on fertilizers or used oils-; and
3. simultaneously with the two first phases, a third phase that would consist in incorporating offset and mitigation policies for the groups most largely affected by the green fiscal reform.

Table 2 contains an outline made by these authors which delves deep into the analysis, with an initial phase of review and adaptation of the fiscal system in force, a second and third phase of incorporation of new environmental taxes and other environmental policy fiscal instruments, and a fourth phase of precautionary and offset measures.

Under such analysis, each tax authority should evaluate (if it is to make such decision) how to apply a fiscal reform, the objectives of such reform and the design phases of the green fiscal reform.

31 *Gago Rodríguez,A., Labandeira Villot, X and Rodríguez Méndez, M "Experiencia, efectos y pautas de diseño de reformas fiscales verdes: una puesta al día", Hacienda Pública Española, Monografía 2001, p. 323 through 342.*

TABLE 2 – Contents of a General Framework of a Green Fiscal Reform

Initial Phase: Review and adaptation of the effective fiscal system. • Traditional direct taxation: proposals of possible reductions in types in the Individuals Income Tax, Corporations and Social Security Contributions. • Traditional direct taxation: review of the current system of reductions and incentives to adapt it to the eco-friendly concept. • Indirect taxation on hydrocarbons: adaptation of special taxes in force to gradually transfer them to the relevant polluting factor.
Second Phase: Incorporation of new environmental taxes. • Incorporation of new environmental taxes on energy, completing the existing special taxes. Will consist of one or several taxes directly related to the level of emissions, which will assess the use of fossil fuels as "inputs" (gas, coal, gas oil, heating) and nuclear and electrical energy. • Incorporation of new environmental taxes on the use of other products, as "inputs", with negative polluting effects (fertilizers, pesticides, etc.). • Incorporation of new environmental taxes on waste generation (taxes on dump sites) and on liquid disposal emissions. • Incorporation of new specific environmental taxes applied to such consumption having negative effects on the environment (batteries, plastic bags, etc.).
Third Phase: Incorporation of other environmental policy fiscal instruments. • Exemptions awarded to products or consumption having positive environmental impacts. • Tax base reductions for energy-efficient behaviors. • Tax rate deductions for the investment in sanitation installations and energy-efficient equipment and the acquisition of energy-friendly buildings and homes.
Fourth Phase: Precautionary and offset measures. • Gradual establishment of new taxes, with progressive expansion of taxable bases and increased tax types over time, fixing an annual rate and a maximum term for adaptation. • Decreasing discounts awarded to the production sector during a maximum period and conditioned by the burden increases resulting from the incorporation of new environmental taxes. • Redistributive mechanisms (increase in minimum living wages, raise in the exempted minimum salaries, reduction in minimum marginal types, etc.) to offset the negative impact of new environmental taxes in equity terms.

Source: Gago Rodríguez, Alberto; Labandeira Villot, Xavier and Rodríguez Méndez, Miguel, in "Imposición Ambiental y Reforma Fiscal Verde: tendencias recientes y análisis de propuestas", Seminario de Economía Pública, Instituto de Estudios Fiscales, Spain, March 2002.

6. CONCLUSIONS

- The analysis of the economic and ecological aspects allows us to conclude that the environmental economic analysis (property rights, externalities, application of administrative mechanisms or economic instruments) constitutes a key element to protect the environment.

- In a period of economic and industrial activity restructuring it is not possible to end drastically with environmental pollution and deterioration, given the high cost implied and the unemployment it would lead to. The application of tax exemptions, relief or reductions to polluting companies would be very important in the process of business reconversion in order to avoid significantly higher costs.

- Eco-taxes should be created to achieve environmental control as a preventive measure (use of ecologic taxes as incentives to curb pollution).

- They could be applied as economic instruments in the form of encumbrances over polluting products, emissions or effluents, or else differential taxes. They should be implemented by law and be equalitarian among passive taxpayers sharing the same situation with regard to the environment, either damaging or protecting it. They should be proportional, progressive and fit for the ability-to-pay-taxes, following the equity principle.

- The amounts collected through eco-taxes should be invested exclusively in environmental political expenses, mainly in sanitation works for the environment; that is, the funds contributed by the "polluter payer" should be used in cleaning activities and not to finance occasional budget deficits.

- Environmental taxes are intended to influence the behavior of individuals. Many times environment-related taxes are firstly created for fiscal reasons and subsidiarily to help foster an adequate environmental behavior. It is of utmost importance to the environment that the instruments should influence the behavior of economic agents and tie the tax payment to the environmental problem.

- Attention should be paid to legislative coordination in environmental taxation matters on the federal, regional, provincial and municipal levels with relation to the preservation and restoration of nature.

- An environmental fiscal reform should be aimed at a sustainable development; it may be targeted at eliminating subsidies, restructuring existing taxes and introducing new environmental taxes.

- The administrative mechanisms or economic instruments should establish an environmental taxation framework that allows for a sustainable development at all times.

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Notes on the Electronic Invoicing in Mexico

María Enriqueta Mancilla Rendón

SUMMARY

This document describes the way a taxpayer in Mexico must incorporate the electronic invoice in its activity, how it is generated, whether through their own means or through a service provider. In both cases the electronic invoice (or digital tax receipt) must meet the fiscal requirements established by law and must be generated and submitted using a Digital Seal Certificate authorized by the Tax Administration Service. It is an innovative IT tool that enables the communication between the tax authority and the taxpayer.

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INTRODUCTION

Content:

The neo-liberalism economic model has put forward the need to harmonize the behavior of businesses that participate in the economic activity and the tax administrations. The new world order demands treating tax and IT issues jointly aimed at achieving a reciprocal communication between the business activities and the tax office. The internationalization of the economy was accompanied by a technological innovation that State Tax Administrations incorporated into their internal procedures. Information technology changes have resulted in the passage from paper-based invoices to the issuance of digital tax receipts, such as the e-invoice, a digital tax document that benefits the administrative processes of taxpayers, saves costs, fosters the use of information in real time and enables an effective control by the Tax Administration. The Tax Administrations of several countries are using electronic invoicing to reorganize tax collection. In the European Community and in Latin America, particularly in Mexico, the Tax Administration has strengthened its technological platforms to implement the use of digital tax receipts, one of them being the electronic invoice, which is increasingly being used by an ever greater number of taxpayers under the effective tax provisions.

1. THE TAX ADMINISTRATION SYSTEM AND THE ELECTRONIC INVOICE

The result of the efforts of individuals and institutions, the electronic invoice in Mexico has been in use since the 90s. Electronic invoicing was driven by the private sector, which looked for a legal mechanism to approve its use, resulting in the creation of an electronic invoice committee composed of associated companies[1].

The electronic invoice is one of the so-called digital tax receipts (CFD, in Spanish) established by the Tax Administration Service (SAT, in Spanish) in conformity with the tax regulations. A digital receipt is any data message containing information or text generated, sent or filed through digital, optical or any other technological

1 *http://www.amece.org.mx*

means. A tax receipt is generated and stored through electronic means and has a high degree of integrity. Incorporating a digital tax certificate as a control instrument enhances communication between issuers, recipients and the tax administration, and provides sufficient and relevant information.

A CFD warrants that the information is protected against changes or alterations. A digital receipt enables checking the issuer's and the recipient's identity. Upon validation of the folio, the approval number and the digital seal certificate effectiveness, the digital receipt warrants inviolability and protection against forgery and duplication.

The current electronic scheme provides greater security than does the paper invoice, so an increasing number of taxpayers have opted for it since 2005. At 2009 year end, 26,512 issuers had opted for these receipts, generating 278.7 million digital tax receipts, up by 272 per cent from those generated in 2008. In the first year of application, in 2005, 139,509 receipts were issued and went up substantially in 2006 to 3,567,689 million receipts; to 15,516,665 million in 2007 and to 74,949,018 million in 2008. By July of 2010, 35,593 taxpayers had opted for the CFD scheme, of which 22,772 were individuals and 12,821 corporates.

The Tax Administrations of several countries are using the electronic invoice to reorganize tax collection and cross-check information. In the European Community, the countries that implemented this mechanism are Portugal, Spain, France, Italy, the Czech Republic, Germany, Finland and the United Kingdom[2]; in Latin America: Argentina, Brazil, Chile, Colombia, Costa Rica and Guatemala. In Mexico this scheme started out optionally on March 31 of 2004, but during the subsequent fiscal years the regulation established three invoicing modalities: authorized printer, self-invoicing and digital tax receipts, which will be mandatory as from January 1 of 2011.

2. ELECTRONIC INVOICING FISCAL FRAMEWORK

The Code of Commerce sets forth the obligation to carry and maintain an adequate accountability system. The system may be carried through the instruments, resources and record and processing system that best fit the taxpayer's characteristics, and allows identifying individual operations and their characteristics, as well as tying such operations to the original evidentiary documentation. The applications must accumulate in a way that enables the preparation of the business' financial information.

The Federation's Fiscal Code[3] implies the obligation to issue certificates for performed activities by means of digital documents processed at SAT through the website. The digital tax receipts must bear the digital seal of the issuing taxpayer, which must be underpinned by a certificate issued by the SAT, whose owner should be the individual or corporate issuing the receipts. Taxpayers who acquire, use or enjoy property, or use services, should request the relevant digital tax receipt, which shall fulfill the requirements of fiscal documents.

The Second Resolution Amending 2009's Miscellaneous Fiscal Resolution[4] describes the administrative rules that group together

2 *http://ec.europa.eu*
3 *Section 29 of the Federation's Fiscal Code, 2010.*
4 *Chapters I.2.11 and I.2.12; Chapters II.2.8 and II.2.9. The Official Gazette of the Federation of June 11, 2010*

and enable the fulfillment of tax obligations. Such administrative rules establish the way tax receipts should be issued to the general public, the storage of receipts and the issuance of digital tax receipts for sales made and services provided by taxpayers engaged in different activities. The resolution explains the procedure for issuing digital seals and the manner of contracting the services of one or more digital tax service providers responsible for generating and sending the digital tax receipts.

The Miscellaneous Fiscal Resolution[5] sets forth the obligation to report to the SAT the issued CFDs, and describes the electronic means and the technical features of the file containing the monthly report on issued digital tax receipts; the standards and technical specifications to be fulfilled by the IT applications for the generation of passwords for the Advanced Electronic Signature (FIEL, in Spanish); the CFD's standards; the description of how to generate digital seals for digital tax receipts; the use of the enveloping facility (Addenda) and the use of the "Complemento-Concepto" facility.

2.1 Taxpayer's Obligations

The taxpayer has the ability to issue their own invoices through their own means or through a service provider authorized by the tax authority.

If taxpayer decides to issue the receipts through their own means, they must have an accounting electronic system apt to issue the series of folios assigned by the SAT and record the accounting automatically, and each folio should have the date, time, minute and seconds of the invoice generation; and the advanced electronic signature (FIEL) along with the digital seal certificate. By July 2010 there were 13,338 taxpayers who decided to issue their digital tax receipts through their own means.

The electronic accounting system of the taxpayer issuing their own digital tax receipts should be apt to generate automatically the monthly report of issued electronic invoices and a monthly report containing the taxpayer's FIEL signature.

The taxpayers who wish to issue electronic invoices through their own means may at the same time issue e-invoices through a provider authorized by the CFD, but the administration and control of digital seal certificates is the responsibility of the issuing taxpayer.

In addition to reporting monthly the used folios to the SAT, the taxpayer should keep the e-invoices updated through electronic means and allow the authority to inquire information on the e-invoices. An issuing taxpayer who operates with the general public should issue global invoices through a federal generic taxpayers' registry XAXX010101000. If taxpayer issues e-invoices to foreign persons they should use the generic registry XEXX010101000.

When taxpayer opts for a CFD service provider authorized by the SAT, the provider generates and processes the digital tax receipts outside the fiscal domicile of taxpayer, without implying thereby that the accountability is carried outside the fiscal domicile. Currently, 22,255 taxpayers have opted to print their digital tax receipts through a service provider.

A digital tax receipt provider authorized by SAT must be an artificial person legally incorporated who is obliged to report financial information during the time it remains an authorized provider. It must have the FIEL number and issue its own digital tax receipts. Must provide evidence that it has the technological capacity and the infrastructure that allow it to provide the service of digital tax receipt generation and issuance, and should have contingency plans

5 *The Official Gazette of the Federation of December 21, 2009. Annex 20.*

in place to guarantee the operation and backup of information relative to the digital tax receipts issued. Also, it must provide the issuing taxpayer with a tool that allows taxpayer to inquire the details of their digital tax receipts.

The service provider should provide, within the first five days of the subsequent month, the file containing the details of the electronic invoices issued by the taxpayer, both active and cancelled invoices by series number and the federal registry of the taxpayer who hired its services. It must provide the SAT with the access tool to inquire issued invoices and keep this information for at least five years. The service provider should administer, control, assign and protect through its system the folios delivered to the taxpayer.

The taxpayer should furnish to SAT the evidence that their tax receipts fulfill the fiscal requirements, along with the certificate of compliance with such requirements. They must assign the folio of the tax receipt and incorporate SAT's digital seal. The taxpayer may themselves authorize providers of digital tax receipt certifications to carry out the validation, folio assignment and seal incorporation. The SAT may revoke the authorizations to providers if they fail to meet any obligations.

Taxpayer has the duty to provide their clients with the print of the digital tax receipt when so requested, and keep the specifications laid down by the authority. The taxpayer will establish controls for payment registration, whether payments are made in whole or in part, in compliance with the specifications required by the tax authority on IT matters.

As with the service provider, the taxpayer should forward monthly to the SAT the information relating to issued tax receipts along with the assigned folios; should this obligation not be fulfilled, the SAT will authorize new folios.

Based on the digital receipts, the taxpayer may carry out deductions or credits, and must check with the SAT that the name, corporate name and the registration code with the Federal Taxpayers' Registry of the person that appears in the receipts are correct, as well as the authenticity of the security device and the consistency with issuer's data in the receipt.

The taxpayers having a fixed shop are obliged to record the value of the acts or activities carried out with the general public, and issue the receipts with the fiscal requirements when the purchaser of the goods or the user of the service request the receipt in order to make deductions or credits.

The receipts must expressly state if the consideration was paid in full or in partial payments. If paid once in full, the receipt must indicate the total amount of the operation and, when applicable, the amount of transferred taxes broken down by tax rates. If in partial payments, the receipt should indicate, in addition to the total amount of the operation, whether payment will be made in partial payments and, as per the case, the amount of the partial payment covered at that time, and the tax amount transferred to such partial payment, by tax rate.

The digital tax receipt of the partial consideration should meet the following requirements:

I. Must contain the printed name, corporate name, fiscal domicile and federal taxpayer's registry code of the issuing taxpayer. Taxpayers having more than one shop or establishment should indicate in the receipt the domicile of the shop or the establishment where the receipts are issued.

II. Must contain the folio number assigned by SAT or the digital tax receipt certificate provider, and the digital seal.

III.- The place and date of issue.

IV.- The federal taxpayers' registry code of the recipient.

The taxpayer can print the receipts on their own or through a third party where the amount of operations is not in excess of $2,000.00, and must have a security device in place. If taxpayer fails to use the security devices for a term of two years, they must destroy them and notify thereof to SAT. Digital tax receipts must have the digital seal certificate of the issuing taxpayer.

2.2 Fiscal Requirements of Digital Tax Receipts

Taxpayers should issue their digital tax receipts in compliance with established fiscal requirements; issued receipts should contain:

I. The printed name, corporate name, fiscal domicile and the federal taxpayers' registry code of issuer. Taxpayers having more than one shop or establishment should include in the receipt the domicile of the shop or establishment where the receipts are issued.

II. The folio number assigned by the SAT or the digital tax receipt certificate provider and the digital seal.

III. The place and date of issue.

IV. The federal taxpayers' registry code of the recipient.

V. The quantity and class of goods and the description of services.

VI. The unit value expressed in numbers and the total amount expressed in numbers or letters, as well as the amount of taxes to be transferred under the fiscal provisions, broken down by tax rate, as per the case.

VII. The number and date of the customs document, as well as the name of the customs that processed the import in the case of first-hand sale of import goods.

VIII. The security device attached where taxpayer performs operations whose amount is not in excess of $2,000.00 and issues the receipts on their own or through third parties. The security devices not used by taxpayer for two years must be destroyed and the SAT should be notified thereof.

IX. The certificate of the digital seal of the issuing taxpayer.

In Mexico, where the receipts fail to meet any of these requirements, the purchases and expenses are not deductible and taxes cannot be credited.

3. DIGITAL SEAL CERTIFICATES

The digital seal certificate is an electronic document used by the Tax Administration Service (SAT) to validate the link between a subject's identity and their public code. The purpose of the SAT in issuing the digital seal certificate is to digitally sign the digital tax certificates. Through these certificates, the taxpayer signs electronically the original chain of the receipts they issue, guaranteeing the origin and authenticity of the digital tax receipt. The digital seal allows proving the authorship of the digital tax receipts issued by individuals and corporates.

The taxpayer is responsible for maintaining an advanced electronic signature certificate in force (FIEL) and request from the SAT the certificate to use the digital seals. The taxpayer may request a digital seal certificate only if they hold the FIEL obtained through the Request for Digital Certificates (SOLCEDI, in Spanish). The taxpayer may use one digital seal certificate for all their shops or establishments or else request a digital seal certificate for each one of their establishments.

To be valid, the certificates issued by SAT[6] must include a legend explaining that they are issued as such; the single identification code of the certificate; indicate that it was issued by SAT and provide an electronic address; the name of the certificate holder and their federal taxpayers' registry code; the effective term of the certificate, specifying starting and expiration dates; the technology used to create the advanced electronic signature contained in the certificate; and the certificate holder's public code.

3.1 Original Chain Generation

The original chain is the sequence of data composed of the information contained in the digital tax receipt in accordance with the regulations and the sequence specified in the administrative regulations.[7]

The sequence is presented in the following order:

1. Receipt data (version, series, folio, date, number of approval, year of approval, receipt type, form of payment, payment conditions, subtotal, discount, total).
2. Issuer's data (RFC and name and corporate name of issuer).
3. Issuer's fiscal domicile (street name, external and internal number, colony, locality, domicile reference, municipality, state, country, postal code).
4. Domicile where receipt is issued.
5. Recipient's data.
6. Data of recipient's fiscal domicile.
7. Data of each item in the receipt (quantity, measurement unit, identification, description, unit value, amount, number of customs document, issue date of the customs document, customs issuing the document, number of real property account).
8. Data of tax withholding (tax type, amount, total withheld taxes).
9. Data of tax transfers (tax type, rate, amount, total transferred taxes).

Example of original chain

||2.0|ABCD|2|03-05-2010T14:11:36|49|2008|INGRESO|UNASOLAEXHIBICIÓN|2000.00|00
.00|2320.00|PAMC660606ER9|CONTRIBUYENTEPRUEBASEISPATERNOSEISMATERN
OSEIS|PRUEBASEIS|6|6|PUEBLACENTRO|PUEBLA|PUEBLA|PUEBLA||MÉXICO|72000|
CAUR390312S87|ROSA MARÍA CÁLDERON URIEGAS|TOPOCHICO|52|JARDINES DEL
VALLE|NUEVO LEÓN|MEXICO|95465|1.00|SERVICIO|01|ASESORIA FISCAL Y ADMINISTRA
TIVA|2000.00|IVA|16.00|320.00||

6 *Section 17-G of 2010 Federation's Fiscal Code.*
7 *Item C of Annex 20.*

3.2 Digital Seal

The digital seal is an electronic message that evidences that a digital document was received by the relevant authority. This seal identifies the office that received the document and will purport, unless proof to the contrary, that the digital document was received on the date and time specified in the acknowledgement of receipt mentioned above. Upon taxpayers forwarding a digital document to the fiscal authorities, they will receive an acknowledgement of receipt containing the digital seal of the original chain (or digital tax receipt) to be sealed digitally.

The digital seal authenticates the authorship of the digital tax receipts issued by taxpayers. It is the electronic message that gives proof of the issuer of a digital tax receipt and warrants its authenticity and integrity. The authenticity and integrity of a digital tax receipt bearing a digital seal is verifiable through reference to the original document using the author's public code.

Example of digital seal:

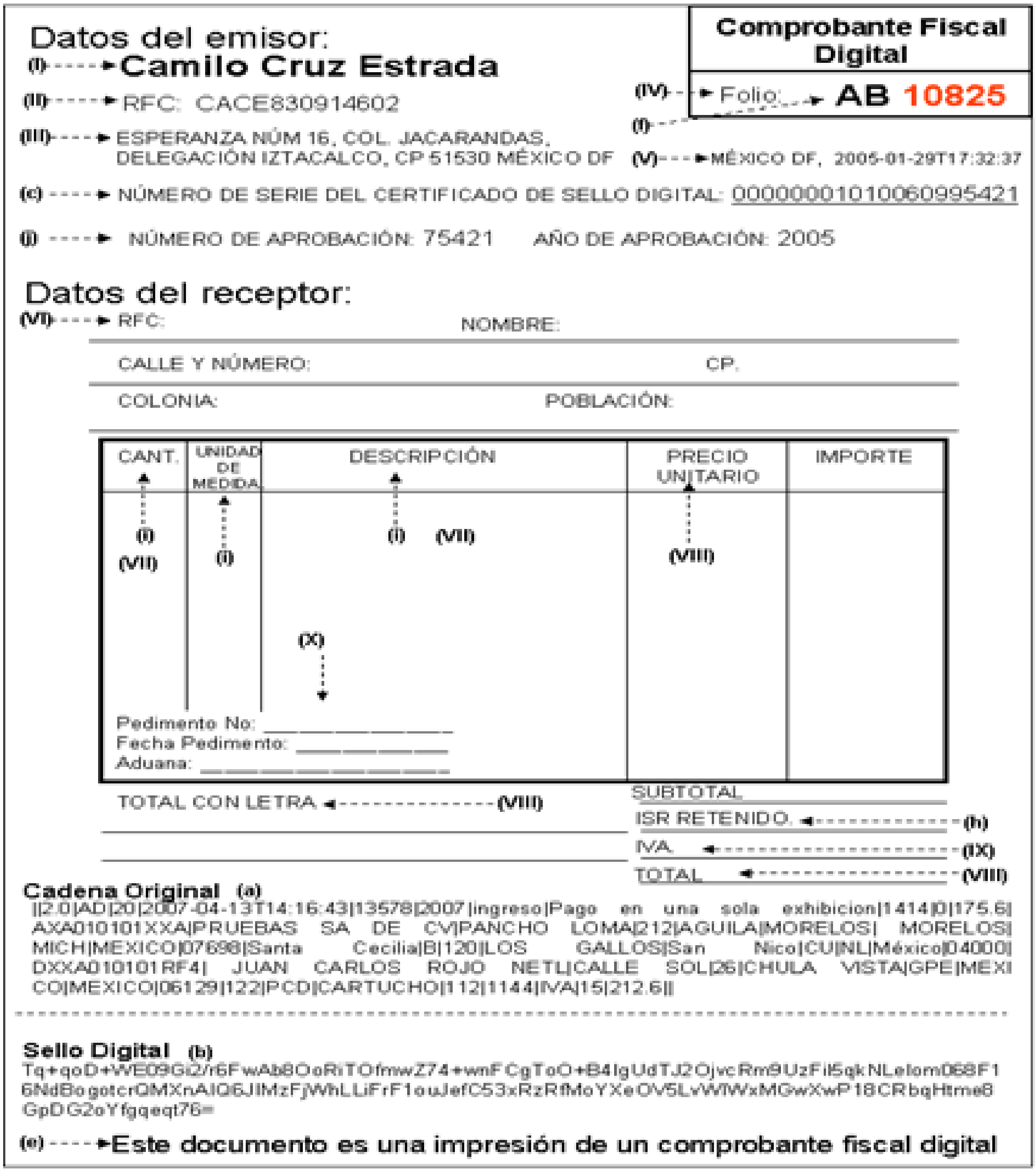
GqDiRrea6E2wQhqOCVzwME4866
yVEME/8PD1S1g6AV48D8VrLhKUD
q0Sjqnp9IwfMAbX0ggwUCLRKaHg
5q8aYhya63If2HVqH1sA08poer0
80P1J6ZBwTrQkhcb5Jw8jENXoE
rkFE8qdOcIdFFAuZPVT
9mkTb0Xn5Emu5U8=

4. THE ELECTRONIC INVOICING FROM SAT'S MICROE

The SAT's Microe is the official technological tool that allows taxpayer to fulfill different tax obligations. The technological platform is intended for use by corporates, individuals engaged in business, professional and leasing activities. Through Microe, taxpayers can carry the fiscal record of their operations in a simplified manner; can have the registry of employees by generating the payroll calculation; can prepare the information for payment of the Income Tax, the Value-Added Tax and the Single Rate Corporate Tax; can generate the information intended to report operations with third parties; can administer the value of assets by calculating the value of depreciations; can capture, generate and inquire digital tax receipts and issue different reports.

The objective of Microe is tax simplification. Taxpayer only needs to hold a FIEL and send a notice indicating their intention to become a user of the technological platform. Then SAT replies by forwarding a code that identifies taxpayer as user of Microe and allows taxpayer to use the software. From the platform, taxpayer can issue their digital tax receipts. The technological platform is an important tool for taxpayers with restrained technological capacity, since it provides the necessary elements that enable the performance of tax obligations.

When taxpayer begins to use the technological platform they must continue to use it through year end.



Datos del emisor:
(I) Camilo Cruz Estrada
(II) RFC: CACE830914602
(III) ESPERANZA NÚM 16, COL. JACARANDAS, DELEGACIÓN IZTACALCO, CP 51530 MÉXICO DF

Comprobante Fiscal Digital
(IV) Folio: AB 10825
(f)
(V) MÉXICO DF, 2005-01-29T17:32:37

(c) NÚMERO DE SERIE DEL CERTIFICADO DE SELLO DIGITAL: 00000001010060995421

(j) NÚMERO DE APROBACIÓN: 75421 AÑO DE APROBACIÓN: 2005

Datos del receptor:
(VI) RFC: NOMBRE:
CALLE Y NÚMERO: CP.
COLONIA: POBLACIÓN:

CANT.	UNIDAD DE MEDIDA	DESCRIPCIÓN	PRECIO UNITARIO	IMPORTE
(i) (VII)	(i)	(i) (VII) (X)	(VIII)	

Pedimento No: ______________
Fecha Pedimento: __________
Aduana: _______________

TOTAL CON LETRA (VIII)

SUBTOTAL
ISR RETENIDO (h)
IVA (IX)
TOTAL (VIII)

Cadena Original (a)
||2.0|AD|20|2007-04-13T14:16:43|13578|2007|ingreso|Pago en una sola exhibicion|1414|0|175.6|AXA010101XXA|PRUEBAS SA DE CV|PANCHO LOMA|212|AGUILA|MORELOS| MORELOS|MICH|MEXICO|07698|Santa Cecilia|B|120|LOS GALLOS|San Nico|CU|NL|México|04000|DXXA010101RF4| JUAN CARLOS ROJO NETL|CALLE SOL|26|CHULA VISTA|GPE|MEXICO|MEXICO|06129|122|PCD|CARTUCHO|112|1144|IVA|15|212.6||

Sello Digital (b)
Tq+qoD+WE09Gi2/r6FwAb8OoRiTOfmwZ74+wnFCgToO+B4IgUdTJ2OjvcRm9UzFi5qkNLelom068F16NdBogotcrQMXnAIQ6JIMzFjWhLLiFrF1ouJefC53xRzRfMoYXeOV5LvWIWxMGwXwP18CRbqHtme8GpDG2oYfgqeqt76=

(e) Este documento es una impresión de un comprobante fiscal digital

Source: print-out of a digital tax receipt. Document consulted on August 15 of 2010.
http://www.sat.gob.mx

5. PROTECTION OF INFORMATION AND NOM 151.

Under the Code of Commerce, Mexican merchants are obliged to retain for a term of ten years the original copies of any letters, telegrams, data messages or any other document containing contracts, agreements or commitments giving rise to rights and obligations. In the case of data messages, the information must be retained fully and unaltered from the time it was initially generated in its final form, and must be accessible for further consultation.

The Economy Secretariat issued the Mexican Official Regulation NOM-151-SCFI-2002, Business practices-Requirements to be observed when preserving data messages , the rules to be fulfilled to protect consumer's interests, the contracts, agreements or commitments giving rise to rights and obligations, and the persons with whom merchants deliver or enter into any such contracts, agreements or commitments.

The NOM 151 provides that where merchants intend to preserve through electronic, optical or any other technological means the information generated in an act of commerce, which is backed up by a similar or different physical means, they may opt to migrate such information to a digital format, in which case they should observe the rule's provisions. The migration of data must be supervised by a legally authorized third-party, who will see to it that such migration is made fully and inalterably just as it was firstly generated in its final form. The legally authorized third-party must be an individual or corporate having sufficient technological capacity and in good standing with the applicable legal requirements, notwithstanding the provisions in any other applicable body of legal rules.

The Economy Secretariat is empowered to certify the providers of migration services of data forming a special format proof to be provided only to the companies which decide to keep the information. Although the proof must be generated by a certificate service provider, the same company may be certified by the Economy Secretariat to preserve its own documents.

The NOM 151 is legally relevant because it supplements the processes of companies upon fulfilling both the fiscal validity elements and the commercial obligations. If the taxpayer opts out from the NOM 151, the company could remain at a state of defenselessness in the event of a legal conflict. In this sense, it could use them as evidentiary documents in the case of any controversy with any authority. The NOM 151 brings advantages to the commerce processes.

The legislation provides no penalties for not using it. However, it is important to highlight the evidentiary character that the information takes on when subjected to the NOM 151. This Mexican Official Regulation has no harmonization with any international rule because there existed none at the time it was created.

6. PARTY LIABLE FOR TAX PAYMENT

Taxpayers may issue their digital tax receipts through their own means or through service providers. Under the Fiscal Code, where taxpayer performs operations whose amount is not in excess of $2,000 (two thousand pesos with 00/100), they can issue their tax receipts in printed form through their own means or opt for a third-party provider that fulfills the fiscal requirements, except that they must contain the folio number assigned by SAT or the digital tax receipt certificate provider, the digital seal and the digital seal certificate of the issuing taxpayer.

Taxpayers performing operations with the general public must issue simplified receipts which shall contain the value of the operation without expressly segregating the value of the agreed consideration and the amount of taxes being transferred; and should meet the above explained requirements. Such taxpayers will be released from this obligation where the operations with the general public are carried out with an electronic prepaid card.

Corporates performing Business Activities subject to the General System, as well as the Intermediate Optional System of individuals, are generally obliged to issue e-invoices, as in the Simplified System. The fiscal system of the Small-sized Taxpayer is also covered by this provision because their activities are performed mainly with the general public, and should issue a digital seal with the federal generic taxpayers' registry number.

In Mexico large and multinational companies have a technological infrastructure, invest in equipment and information systems and are prepared for the IT innovation in digital tax receipts. Currently some companies are already applying the fiscal provisions to e-invoicing.

We may say that there are two groups of taxpayers: small and medium-sized companies and large taxpayers. If the first group hires digitalization and invoice issuance services for its accountability with a service provider authorized by SAT it will not have the urgency to train its staff and invest in systems and new computing equipment to issue the CFDs; however, it will have to look for a provider suitable to its needs. Alternatively, the group of large taxpayers has sufficient IT innovation to issue their own digital tax certificates.

The problems that arise presently in the electronic invoicing processes occur in the regeneration of already issued invoices. Some inconsistencies take place in the information when it is reported to SAT through the monthly report of folios; there are deviations in XML file structure and the tampering with databases leads to loss of tax receipts. The efforts to sustain a proper control of folios and the monthly delivery of all invoices that are to be sealed by SAT, prior to be delivered to the clients, are a great achievement for the tax authority. No doubt, it is also so for taxpayers who begin making their e-invoices through their own means.

7. BENEFITS

In the opinion of taxpayers who have used the digital technological innovation, the issuance of digital tax receipts reduces administrative times and processes, increases speed and security in the exchange of information, which translates into savings and increased productivity.

Cost savings during the invoicing process are reflected in decreased paperwork, storage and shipping expenses. Because processes are simplified, the audit procedures are smoothly applied, since they allow the rapid search and localization in one single place.

The administrative procedures are reduced because the shipment and reception of the invoice is done in a timely manner. The risk of corruption with regards to IT issues is low. The level of confidentiality in managing, preserving and shipping invoices is high. The possibility of forgery is unlikely thanks to the digital seal that brings strength to the document. The recipient is benefited upon having the opportunity to access an array of services to validate whether their invoice is effective and has not been altered.

The innovation of the technological platform by the Tax Administration System in Mexico has been a wise move. Mainly, it has enabled the use of digital tax receipts, which will probable result in a healthy legally-oriented economy. In the short term, the use of digital tax receipts will be tied to the other administrative IT-related obligations.

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Mexico. 2009 Code of Commerce of April 15, 2009. The Official Gazette of the Federation of August 27 of 2009; p.185 [on line]. Available on the web: http://www.diputados.gob.mx/LeyesBiblio/ref/ccom.htm

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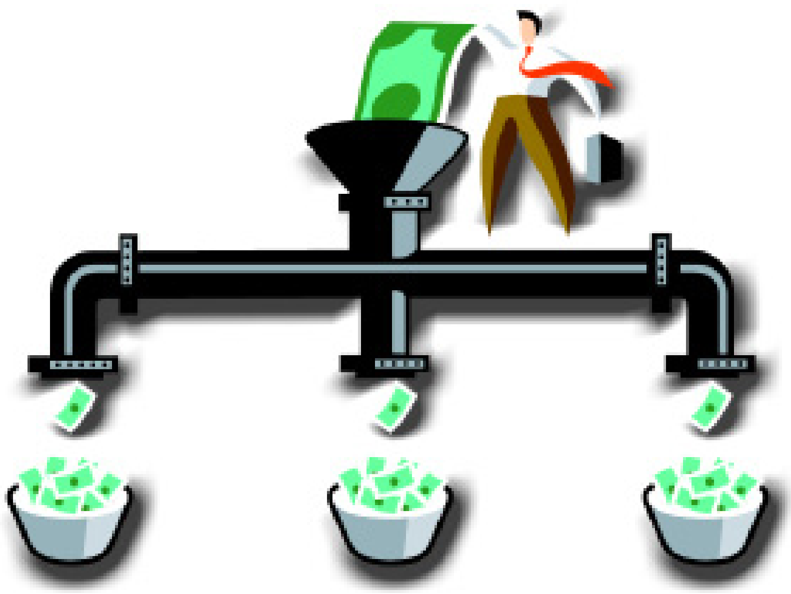
Thin Capitalization as a Tax Evasion Practice and its Control by the Tax Administrations

Marlon Vicente Manya Orellana



SUMMARY

Thin capitalization as a tax avoidance practice counteracts the transparency of the information that a tax administration pursues, and constitutes a latent problem that directly affects the erosion of the income tax taxable base. This article presents theoretical and legal aspects on this topic, and a benchmark related to the tax control applied by the OECD Ecuador, Argentina, Spain and Dominican Republic to address this problem.

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INTRODUCTION

Contents:

Thin capitalization involves the analysis of the forms of financing used by companies belonging to the same economic group that are linked and under common control. It is defined as any evident disproportion between the magnitude of the liability capital, established legally or statutorily, and the level of risk of the company that in each case is scheduled to implement the social purpose.

Speaking of capital, we have subscribed capital, i.e. the paid-up capital and the pending of disbursement capital, likewise, it is regarded as capital contributions from partners not formalized as equity premiums issues and contributions to compensate for losses, otherwise consider capital are positive results accumulated reserves.

The actual contribution of capital is overshadowed by the figure of the interest, which causes a change in the structure of the equity, indicating a minimum and at the same time attractive business risk for future partners, those who gain profit-earnings if the company presents positive results. These loans should have rates that are not higher than the rate authorized by the Central Bank, so they are appealing, and do not generate greater expenses to the related company acting as borrower and do not result being three times its equity.

On the other hand, it could happen that the group, in order to obtain this profit uses the legal location of the company generating the loan in a "tax haven" and this situation logically causes the increase in its profits. Conversely, if what is placed in the company is a contribution to the quality of the loan, it will charge yields regardless of the result of the company. Thin capitalization basically allow the relationships to take place between subsidiaries and the group they form part of, to act as a mask to conceal capital contributions, acquiring a tax advantage arising out of fiction financing with outside resources.

1. MEANING OF THIN CAPITALIZATION

Thin capitalization is the financing between undertakings of the same group which are located in different jurisdictions, to cover up funding with its resources with outside resources, where one of the parties is usually located in a tax haven or lower taxation country to minimize the taxable income of the company located in the country where more tax is paid. In other words, thin capitalization shows a company that is apparently funded through the access to credit, but is actually funded of share capital, in order to reduce the payment of the tax income through interest.

There are other definitions:

- **González Poveda**[1], "Thin capitalization is known as the elusive maneuver used by corporations, for tax reasons, to reduce or minimize the tax burden of the group, they turn to outside funding to conceal a genuine contribution of capital"

- **Silvia Catinot y Norberto Campagnale**[2], also commonly referred to as "little capitalization" (or "covert capitalization"), since it implies that a proportion of the corporate equity is financed through debt which is abnormally high in relation to the share financed with equity capital.

- **Lete**, defines thin capitalization as "the financial situation of a resident company in which the volume of the resources outside vis-à-vis its own resources exceeds the proportion which can be considered normal regarding operations carried out in free competition, seeking such situation through loans with non-resident related entities with the purpose of reducing for tax purposes of the taxable profits of the first company".

- From the perspective of the **Spanish Mercantile Law**, "thin capitalization refers to social responsibility and the responsibility of the partners for corporate debts." In that regard, this is the case of circumstances in which the partners or shareholders do not provide the resources necessary for the operation of the company, which results in a situation of insufficient capital.

- "In a broad sense, an entity is undercapitalized or in a situation of undercapitalization when its financial structure reveals a disproportion between the amount resulting from computing its own resources and the amount resulting from the various items comprising the outside resources.[3]"

- **García – Herrera Blanco**, "Thin capitalization consists of an elusive maneuver carried out by corporation for tax reasons, to reduce or minimize the tax burden of the group, turning to funding outside to conceal a genuine contribution of capital.

1 *Non-resident taxation 1st and 2nd Edition, Spain 1989.*
2 *Limitation to the deduction of interest, Silvia Catinot and Norberto Campagnale.*
3 *Undercapitalization doctrine: Conceptual approach to the undercapitalization of corporations.*

2. THE DILEMMA: OUTSIDE RESOURCES OR THE COMPANY'S OWN RESOURCES

Companies have different ways to obtain funding, either by provision of equity or debt. From the tax point of view any form of financing affects differently the tax burden, both for who receives this contribution and for who provides it. Outside funding is made by way of loans which are paid through the payment of interest, said funds come primarily from capital contributions made by members of the corporation; in the case of funds they are repaid through the payment of dividends.

The financed corporation considers the decision to use its own resources or outside resources and its decision directly impacts its tax base. Interests for the use of foreign capital are considered fiscally deductible expenses that reduce the taxable profit, o the other hand, the part of the benefit that the corporation distributes as a dividend to its partners part is not considered as a fiscally deductible expense, and therefore, comprises its tax base.

With regard to the taxation of each contribution generated by each class of funding, it can be considered that the interests are taxed exclusively where they were made, because they are deductible in the taxable amount the payer, therefore there is no double taxation. Dividends instead support a less favorable regime, since double taxation agreements authorize higher charges compared to the interests of the source country, since States rarely unilaterally waive tax for a dividends obligation, hence, double international taxation normally occurs.

Because interest and dividends receive different tax treatment, the deductibility of the interest acts as primary element when deciding which financing is the right, therefore it is more attractive at the time of choosing financing between related corporations, because the loan it is a measure to reduce the tax burden through the increase in liabilities and therefore increase expenses and much lower earnings before taxes, seeming more reasonable to think that on many occasions financing through loans would be preferable.

3. THIN CAPITALIZATION METHODS ACCORDING TO THE OECD

The report of the OECD distinguishes two methods, **the subjective and objective**. The method that best fits the independence principle formulated by article 9 of the OECD model is **the subjective method**, which consists of verifying if resources obtained by the related lender have also been obtained from a third party. It maintains as the primary objective to determine if the corporation has or not the possibility of accessing credit from a stand-alone where the tax administration is responsible for performing this test. This report states that in order to analyze this situation the following data must be compared:

a) debt ratio / capital before the operation
b) if the loan is intended to cover losses
c) it's possible convertibility into shares
d) the linking of interests to the corporate profits
e) subordination to other creditors.

With these criteria what they find is a possible involvement of the risks of the company by the lender, if this happens, it would not find to a loan in the free market, therefore, interests would be close to be considered dividends. Similarly, when you attempt to set a normal price to competition in related party transactions, it is complicated and difficult and the field test on thin capitalization is also complex to verify.

The target method is based on different parameters, the same that is used by a large number of countries. This means that the corporation may not exceed its indebtedness three times more than its share capital. If this limit is exceeded, it is undercapitalized. The legal consequences of the tax standard shall apply on the excess. Due to the rigidity of this method of the OECD report sets certain precautions, which mentions that if a corporation exceeds the debt ratio, this is only compatible with the principle of full jurisdiction (Article 9), if it proves that the indebtedness conforms to the principle of independence (e.g., demonstrating that it corresponds to routine indebtedness in companies in the same branch of activity in the country) and avoid the consequences of the thin capitalization standard.

Then, the test is to verify that resources obtained as a loan by a related company would have also been obtained by an independent. Then means its indebtedness with related companies is only circumstantial, since the company's credit capacity would have equally allowed it to obtain outside resources from third parties. The test is similar to the subjective method. The taxpayer must prove that its indebtedness with related subjects, while exceeding the legal limit, is in accordance with the principle of independence. Which indicates its credit capacity is not yet exhausted. It also clarifies that the existence of a single debt ratio for all kinds of corporations is not the most optimal situation, since each economic sector operates with different levels of indebtedness, therefore, a single coefficient may be detrimental to taxpayers. Considering this, the recommendation is to establish different rates depending on the sector where each corporation acts. Otherwise, you would force taxpayers to report when from the economic point of view, the tax debt ratio is lower than the economic sector where it operates.

4. THIN CAPITALIZATION CONTROL IN THE OECD

The following are the OECD's thin capitalization standards:

a) **Australia**. There is specific legislation on thin capitalization which takes into account the type of interest rate, the amount of the loan and equity ratio which is 3: 1.

b) **Belgium**. Loans between related companies are subject to a restrictive rule only when they are done by shareholders who are in turn company managers.

c) **Canada.** Loans concluded by a Canadian entity to its foreign subsidiary consider their yield as a dividend if its duration is over one year since the end of the year of its establishment. Interest rates are determined in a pre-established manner.

d) **France.** The equity ratio is 1.5 to 1 when funds are provided by a controlling non-French shareholder company.

e) **Germany.** In most cases the equity ratio is 3 to 1, 0.5 to 1 applies when the return of capital varies with the earning and is finally 9 to 1 for holding companies. Applies both to residents and nonresidents.

f) **Italy.** Does not have specific standards.

g) Japan. The equity ratio is 3 to 1. Now, this rule is not applied if there are higher ratios in comparable independent companies.

h) **The Netherlands.** It has no specific standard. Tax authorities analyze the interests depending on the obligations contracted by the loan.

i) **Spain.** The ratio is 3:1. As from 2004 its application is excluded to entities residing in countries of the European Union

j) **Sweden.** It has no specific standard, but the inspection may prove in the courts that there is thin capitalization.

k) United Kingdom. English statutes treat interests such as benefit-sharing unless the terms of the double taxation treaty proves that they are interests. In this case the equity ratio is 1:1.

l) **United States.** There are different levels of interest for different loans. The equity ratio is 3:1. There are introduced in the calculation of the loan equity ratio which is guaranteed by a related entity.

Where there is are thin capitalization clauses, the tax authorities adjusted interest rates when the loan amount is high, but they can also adjust this amount. The equity ratio exists under provisions of the limitation of interest payments.

5. THIN CAPITALIZATION CONTROL IN ECUADOR

Article 10 of the Organic Internal Tax Law[4], states in paragraph 2, the need to establish an optimum level of indebtedness: "to make deductible the interests paid by external credits granted directly or indirectly by related parties, the total amount of these may not be greater than 300% with respect to the equity, in the case of corporations. In the case of individuals, the total amount of external credits shall not be greater than 60% with respect to its total assets. The interest paid in excess of the relationships indicated, will not be deductible."

Accordingly, article 30 of the regulations for the implementation of the Organic Internal Tax Law in item II, states that interests generated by offshore credits will be deductible, when acquired for the course of business, until the rate authorized by the Central Bank of Ecuador, these interests and their payments are registered with the Central Bank of Ecuador; and they meet the following conditions:

- For corporations, interests generated by external credits will be deductible provided that the relationship between the total external indebtedness and the paid social capital does not exceed 300 per cent.
- For individuals with bookkeeping requirements, interest generated by external credits shall be deductible provided that the relationship between the total external debt and total assets does not exceed 60%.
- For foreign branches interest generated by foreign loans will be deductible provided that the relationship between total external indebtedness and allocated capital does not exceed 300%. External credits received from their headquarters shall not be considered.
- For oil company consortiums without legal capacity, interest generated by foreign loans shall be deductible provided that the relationship between total external indebtedness and the net difference between its total assets and liabilities does

4 *The Amended Organic and Interpretation Law to the Organic Internal Tax Law, to the Tax Equality Law of Ecuador and the Electric Power Section Regime Law, Official Registry. 392-2S, 30-VII-2008*

not exceed 300%. For this purpose, those amounts which are the result of accounting adjustments shall not be considered. External credits received by the members of the Consortium, their headquarters shall not be considered.

- De facto companies and other companies without legal capacity, interest generated by foreign loans shall be deductible provided that the relationship between total external indebtedness and the net difference between its assets and liabilities does not exceed 300%. For this purpose, those amounts which are the result of accounting adjustments shall not be considered.
- In the case of commercial trusts interest generated by credits from abroad will be deductible, provided that the relationship between the total external indebtedness and the summation of the contributions made by the constituents and adherents does not exceed 300%.

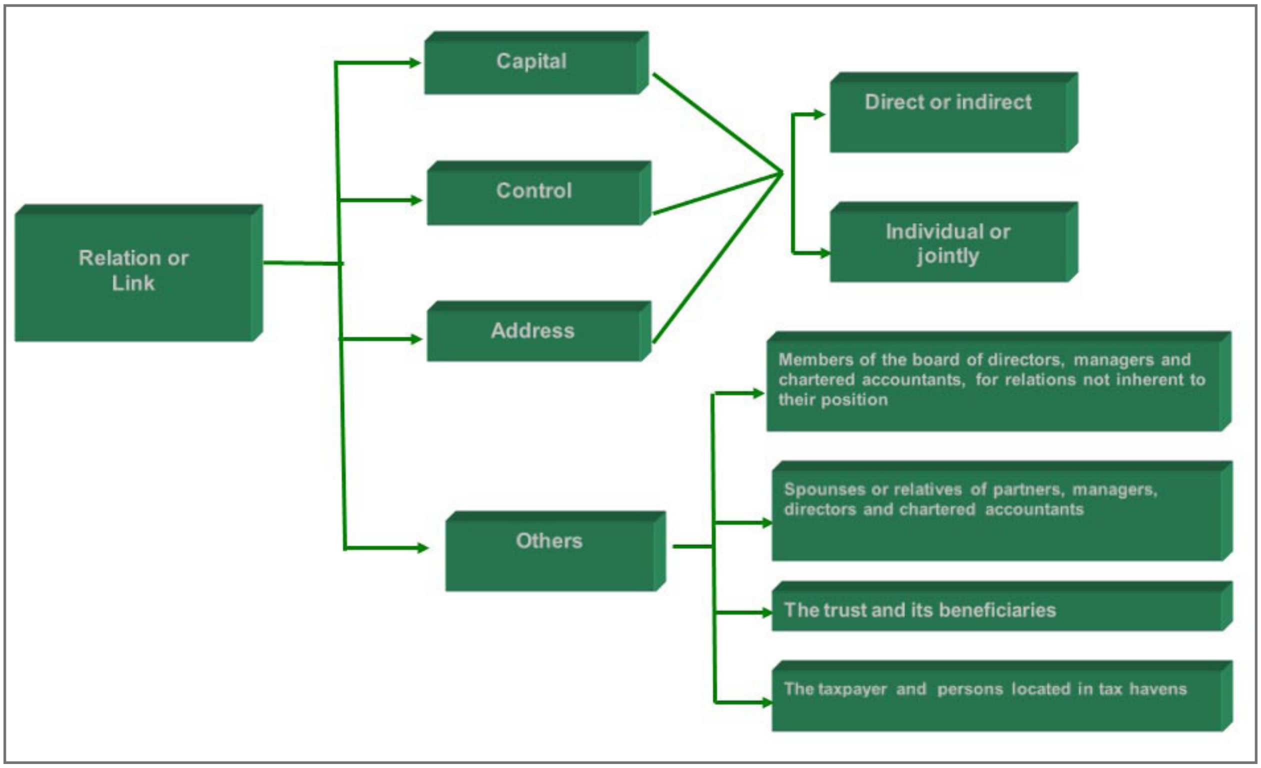
Where debt ratios mentioned above, exceed the limit set at the time of accruing the expense by concept of interest, the expense portion generated on the excess of the corresponding relationship, without detriment to the withholding at source of the income tax over the total interest will not be deductible. Taxpayers shall proceed with the corresponding reassessment of the tax, without detriment to the assessment capacity of the Tax Administration when the debt ratio is modified. External debt shall be understood as the total debt contracted with individuals and bodies corporate abroad. For the purposes of the implementation of the Internal Tax Law, the rate authorized by the Central Bank of the Ecuador to be applied to external credits will be that existing at the date of the registration of credit in the Central Ecuador Bank in accordance with the Law. If the external credit rate exceeds the rate authorized by the Central Bank of the Ecuador for credits from abroad, interest in the surplus portion of the authorized rates shall not be deductible.

The problem lies in the control of thin capitalization, as there are companies that opt to borrow capital from its partners, or with related companies belonging to the same. The amount of funding usually exceeds the possible amount that might be obtained in the financial markets from third parties. This leads to the existence of links between Contracting Parties. Regardless of this premise, and considering that each operator is aware of what is optimal for itself, the ideal tax policy to correct distortions in the ratio (debt/assets) generated by the real existing tax benefits via debt interest deductions, would be in creating and improving a equivalent stimulus on the side of the equity, in particular through the reinvestment of profits and regulating internal or external linked credits through the regulation of transfer pricing; so the tax rate savings per dollar of debt is equal to this same rate per dollar of equity.

That is, decisions to allocate money to debt and equity must be viewed as if they were two perfectly substitutable goods between themselves, showing at the end, the real debt-equity ratio that should exist for each firm.

With the Tax Equality Amendment Law[5], the concept of related parties is incorporated into the Organic Internal Tax Law, in its article 4: “For tax purposes related parties shall be deemed to be individuals or companies, domiciled or not the Ecuador, where one of them is directly or indirectly involved in the direction, management, control or capital of the other; or where a third party, whether an individual or a company, domiciled or not in the Ecuador participates directly or indirectly, in the direction, management, control or capital of these”.

5 *Published in the third Supplement of Official Registry No. 242, 29 December 2007*

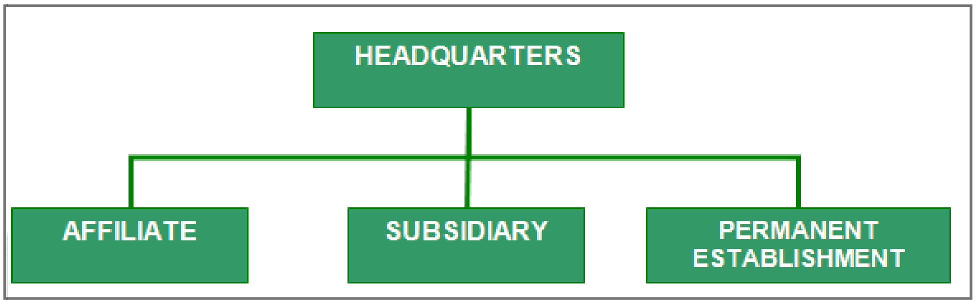


Official Registry No. 337, 15 May 2008, published the Regulations for the implementation of the Organic Internal Tax Law, indicating in its articles relating to transfer pricing the following: in Article 4 thereof, in order to establish related parties, in addition to those mentioned in the Law, the Tax Administration in order to establish some kind of link for percent of capital or transaction share, it shall take into account, inter alia, the following cases:

1. When a natural person or company is the holder directly or indirectly of 25% or more of the share capital or equity in another company;
2. Corporations in which the same partners, shareholders or their spouses or relatives to the fourth degree of consanguinity or second of affinity, participate directly or indirectly in at least 25% of the share capital or equity;
3. Where an individual or company is holding directly or indirectly 25% or more of the share capital or equity in two or more companies;
4. When an individual or company, domiciled or not in the Ecuador does 50% or more of its sales or purchases of goods, services or other operations, with an individual or company, domiciled or not in the country;

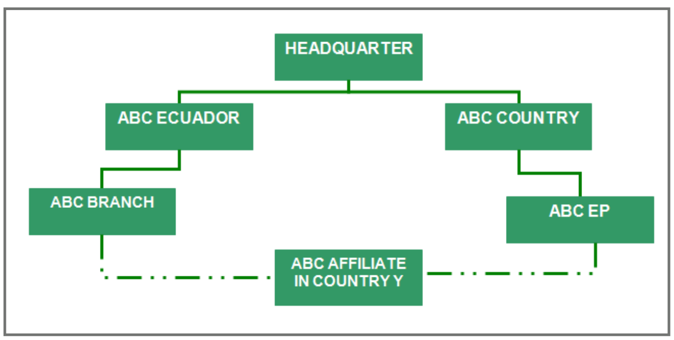
Graphically related parties are displayed as follows:

1. Affiliates, subsidiaries or permanent establishments with each other.



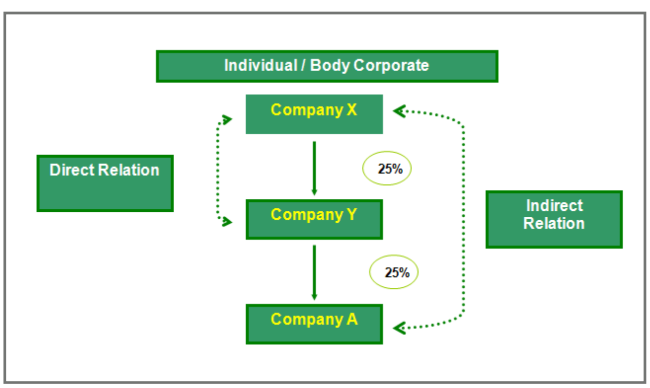
By the headquarters having a direct relation with its affiliate, subsidiary or permanent establishment, they are considered related.

2. Affiliates, subsidiaries or permanent establishments with each other.



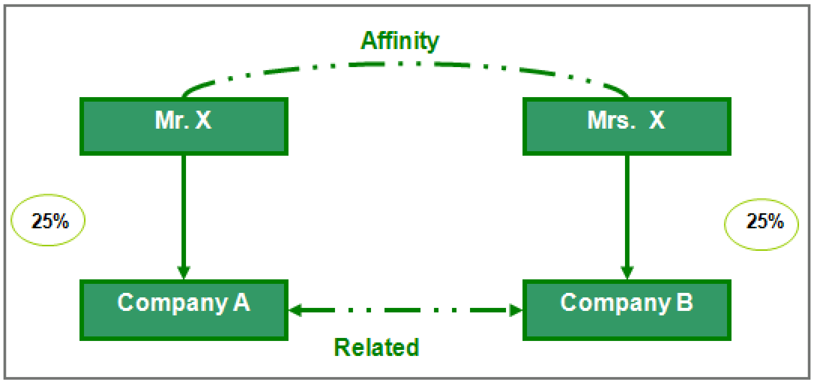
A percentage does not have to be established to determine relationship because headquarters directly exercises control and management.

3. When the individual or the body corporate owns directly or indirectly 25% or more of the capital stock or equity in another company, these will be related with each other.

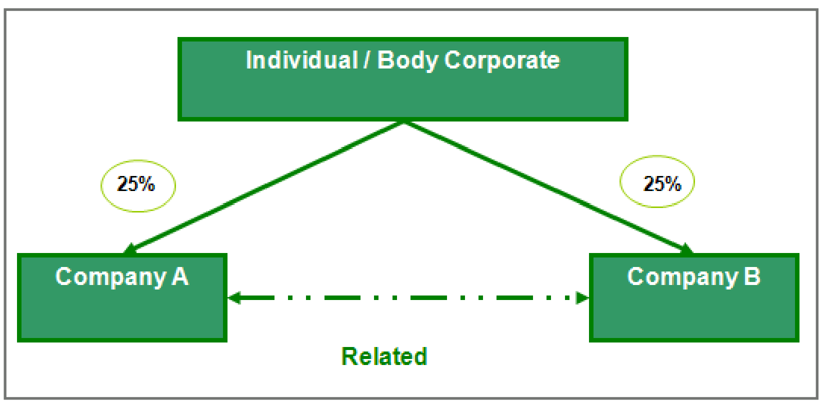


For owning 25% or more of the capital stock or equity, they are considered related

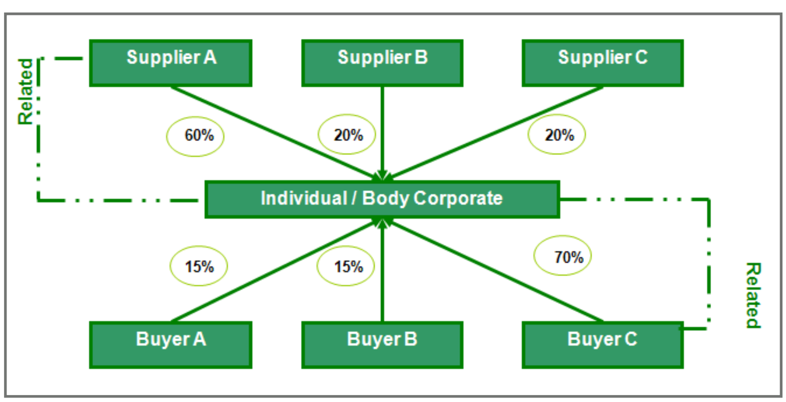
4. Two companies where the partners, shareholders or spouses or their relatives up to the fourth degree of consanguinity or second of affinity, participate directly or indirectly in at least 25% capital stock or equity.



5. When the individual or the body corporate owns directly or indirectly 25% or more of the capital stock or equity in two or more companies, these will be related with each other.



6. When the individual or the body corporate, with domicile or not Ecuador, performs over 50% or more of its sales or purchases of goods, services or another type of operations, with an individual or corporation domiciled or not in the country.



Suppliers or clients, which transactions exceed 50% or more in their purchases or sales, the link are established.

Furthermore, the following aspects were included:

- "Taxpayers are considered related parties when they perform transactions with corporations domiciled, incorporated or located in a low taxation jurisdiction or in tax havens.[6]"
- "Similarly, the Tax Administration may establish related parties by presumption, when the transactions that are done do not adjust to the arm's length principle."

6. THIN CAPITALIZATION CONTROL IN ARGENTINA

The reform was established by Law No. 25,063, it shows changes in the Profits Tax, the Value Added Tax and created a new tax on interest paid and the financial cost of the business indebtedness to regulate the problem of thin capitalization. These variations with their restrictions were made to obtain, maintain, and preserve encumbered and not encumbered profits generated by different production sources, stating also that the deduction will be of the gross earnings that each of them produces respectively, including results exempted from the encumbrance, i.e. that the subject company shall deduct interests in function of the proportion represented by the taxed earnings in regards to the total earnings (taxed, exempt and non-taxable). Law 25,063, adds a third paragraph to paragraph a) of Article 81 of the law establishing another constraint to the deduction of interest from debts by certain subjects, in the proportion corresponding to the largest surpluses arising from the limitations and provided that the same disburse jointly.

Regarding the payment of interests, the subject receiving the loan must pay 35% of the total interest expense with the purpose that the beneficiary of the interests does not pay said tax. Hereinafter, are details of Reform 25,063: "In the case of subjects under Article 49, excluding the entities ruled by Law 21,526, debt interests with the exception of those corresponding to loans granted by individuals or domiciled undivided interests or, as the case may be, domiciled in the country, including those in item 2 letter paragraph c) of Article 93 and forty percent (40%) of the remaining, of the corresponding taxable balance shall not be deducted, in the proportion corresponding to the greatest surplus resulting from the following limitations and provided that these take place jointly:

1. The total amount of liabilities that generate interests with the exception of amounts corresponding to the loans granted by individuals or undivided inheritance and foreign beneficiaries excluded from the limitation at the closing of the year, should not be greater than two and a half (2.5) to the amount of equity on the same date;

2. "The total amount of interests with the exception of the corresponding loans by individuals or undivided inheritance and offshore beneficiaries, excluded from the limitation must not exceed fifty percent (50%) of net income subject to tax for the period, determined prior to the refund thereof."

6 *Resolution NAC-DGER2008-0182. Published in Supplement two of Official Registry No. 285, 29 February 2008*

Interests shall be deducted in the taxable balance, provided that the loans are granted:

a) By domiciled individuals or independent bodies corporate or as the case may be, domiciled in the country

b) May fully deduct interest on debt in tax income, but must pay 35% on said interests as tax on interest paid and the financial cost of borrowing entrepreneur, excluding banking and financial entities.

c) By subjects from abroad (individuals, companies, banking or financial institutions) that are not a bank or financial institution established in countries in where their central banks have adopted international banking supervision standards established by the Basel Banking Committee. Excluding financial institutions, may fully deduct debt interests from the Profits Tax, but foreign beneficiaries receiving these incomes will suffer a withholding as a unique and definitive payment in respect of the 35% Profits Tax.

3. For the remaining subjects that are not covered in items 1) and 2) above (companies that are related). In these cases with the exception of banking, and financial entities they may only deduct 40 percent of debt interests, the remaining 60% will not be deductible.

When the restriction of the above analyzed interest deduction takes place, the surplus of non-deducted interest may be charged to the following fiscal years, 5 years since the origin thereof, taking into account for each, the limits mentioned above. Changes made to thin capitalization regulations prevent tax avoidance through the use of interest as a way of paying dividends. The previous standard establishes restrictions to resident companies, with this the transfer of the taxable matter to other States is encouraged, since interests remained in the country and the same beneficiary paid the tax. On the other hand, the fact of considering the interests in the liabilities that twice exceeds the net capital and that they are treated as dividends is one more point incorporated into this legislation.

7. THIN CAPITALIZATION CONTROL IN SPAIN

Article 20 of the current Consolidated Text of the Corporate Income Tax Law (TRLIS) rules thin capitalization in Spain. This norm has as a purpose to prevent the deduction of interests earned from a loan considered by the legislator as excessive, caused them to be considered dividends.

1. If net debt paid, directly or indirectly, of a corporation with another or other related companies, excluding financial institutions, exceeds three times the fiscal capital, accrued interest corresponding to the excess will be treated as dividend.

2. For the purposes set forth in the preceding paragraph, both paid net debt and fiscal capital will be reduced to their half status throughout the tax period.

3. Tax capital shall be understood as the amount of the entities equity, not including the result of the fiscal year.

7 *Edgar Morales Perez: "The Problem of Thin Capitalization and the Measures to Counteract the same in the Dominican Republic."*

4. According to article 16.7 of the Corporation Tax Law, the taxpayer may refer to the tax administration a proposal for the implementation of a coefficient other than that provided for in paragraph 1, the same is based on the fact that entity would have been able to obtain the loan in normal market conditions by a non-related corporation.

5. Is not applicable if the loan is made to resident individuals or entities in countries considered tax havens.

In the case that the taxpayer submits a proposal to the tax administration to apply another coefficient different from the one established law, this only possible for entities residing in territory of the European Union, with the exception of those which are tax havens. In this regard, excessive indebtedness is any loan exceeding this amount, determining that any excess must be taxed as a dividend. Furthermore, resident corporation can argue with the legislator a proposal for the implementation of a different coefficient ratio, which exceeds the one established by law. This proposal is consistent with transfer pricing standards mentioned in article 16.6 TRLIS, it must be based on the debt that the subject would have been able to obtain with unrelated third parties.

Another assumption is that thin capitalization is where the creditor resides in a country or territory considered as tax haven, whereas the resident company may not request any proposal to modify the ratio according to the anti-haven standard in Article 14(1) letter g of the TRLIS, except in the case that the related entity is a resident of a member state of the European Union, unless this State is designated as a tax haven. This rule is characterized by the following:

1. Net borrowing: If there are active and liability balances with the same related entity, the net balance of these items will be addressed.

2. Is not considered indebtedness with financial institutions, when these are considered as typical business thereof.

3. It talks about accrued interests, i.e. do not have to be actually paid.

4. To determine net debt and the tax capital figure, the mean balance of the taxable period will be addressed.

5. Tax capital shall be understood as the amount of equity of the entity, without including the results of the fiscal year.

Pursuant to the terms of articles 16 to 28 of the TRLIS taxpayers are expected to make proposals on a coefficient other than that provided for in Article 20.1 although this shall not apply to transactions carried out with or by persons or entities resident in tax havens. In the case of companies that pay taxes through a consolidated Group at the time of assessing the capital tax each individual company shall be addressed and there will be no possibility of accumulating all members of the group.

8. THIN CAPITALIZATION CONTROL IN DOMINICAN REPUBLIC

This country does not have provisions created specifically to counter the thin capitalization, however, the tax code collects a set of measures that help prevent Thin capitalization:

- Does not admit the deduction of the payment of interests, royalties, or technical assistance incurred by subsidiaries established in the country to its headquarters abroad if the 25% withholding have not been paid.

- When a company domiciled in the country pays interest on loans contracted with foreign credit institutions must retain 10% of those interests as tax payment. If the payment is not a credit institution it must retain 25% of the payment made.

- When the headquarters distributes corporate costs to the branch or establishment in the country, and the same do not correspond to the value of these costs for similar services charged between independent undertakings, the tax administration can challenge them.

- When the amounts paid or payable as interest, commissions, or any other payment, coming from credit or financial transactions between the headquarters and its subsidiary are considered excessive, the Tax Administration can challenge said excess as a non-necessary expense. That is, the assess expense shall not be deductible when assessing the taxable income.[7]

9. CONCLUSIONS

- The change of economic model derived from globalization, resulted in this case presented by the increase in flows of capital, has meant a change in the nature and the foundations of the economic relations between countries. Taxation is still inadequate to solve the specific problems posed in this new open economy model.

- Thin capitalization as a tax avoidance practice is one of the techniques most widely used, and consists in the funding between undertakings of the same group which are located in different jurisdictions, with the purpose of covering up funding with its own resources by outside resources, where one of the parties usually is located in a tax haven or lower taxation country to minimize the taxable profit of the company located in the country where higher taxes are paid.

- There are different methodologies to mitigate their impact, being the most used the ratio between the mean indebtedness and the equity or the company's net equity.

- The problem is in the control of the thin capitalization, as there are companies that opt to borrow capital from their partners, or the related companies belonging to the same. The amount of funding usually exceeds the possible amount that might be obtained in the financial markets with third parties. This leads to the existence of links between Contracting Parties

- Regardless of this premise, and considering that each operator is aware of what is optimal for itself, the ideal tax policy to correct distortions in the ratio (debt/assets) generated by the real existing tax benefits via debt interest deductions, would be in creating and improving a equivalent stimulus on the side of the equity, in particular through the reinvestment of profits and regulating internal or external linked credits through the regulation of transfer pricing; so the tax rate savings per dollar of debt is equal to this same rate per dollar of equity
- Accordingly, decisions to earmark the money to debt and equity must be viewed as if they were two perfectly substitutable goods among themselves, showing at the end, the real debt-equity ratio that should exist for each company

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